Republic of the **Marshall Islands**

2022 ECONOMIC BRIEF

Republic of the Marshall Islands

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Graduate School USA

EconMAP ECONOMIC MONITORING & ANALYSIS PROGRAM

Abbreviations

CURRENCY EQUIVALENTS

Currency unit: United States dollar (US$)

ABBREVIATIONS

ADB	—	Asian Development Bank
AMI	—	Air Marshall Islands
AML	—	Anti-Money Laundering
BCom	—	Banking Commission
BOMI	—	Bank of the Marshall Islands
CAP	—	Comprehensive Adjustment Program
CARES	—	Coronavirus aid, relief, and economic security act
CBDC	—	Central Bank Digital Currencies
CBR	—	Correspondent Bank Relationship
CDC	—	Centers for Disease Control and Prevention
CFT	—	Combatting the Financing of Terrorism
CMI	—	College of the Marshall Islands
COFA	—	Compact of Free Association
COVID	—	Coronavirus Disease
CPI	—	Consumer Price Index
CPRO	—	Coronavirus Pandemic Relief Option
CSO	—	Community Service Obligations
CTF	—	Compact Trust Fund
DBS	—	Doing Business Survey (World Bank)
DEZRA	—	Digit Economic Zone Rongelap Atoll
DRP	—	Disaster Resilience Program
DSA	—	Debt Sustainability Analysis
EPPSO	—	Economic Policy Planning and Statistics Office
EEZ	—	Exclusive Economic Zone
FAA	—	Federal Aviation Authority
FAS	—	Freely Associated States
FDI	—	Foreign Direct Investment
FDIC	—	Federal Deposit Insurance Corporation
FMIS	—	Financial Management Information System
FPUC	—	Federal Pandemic Unemployment Compensation
FRDMA	—	Fiscal Responsibility and Debt Management Act
FSM	—	Federated States of Micronesia
FTE	—	Full Time Equivalent
GDP	—	Gross Domestic Product
GFS	—	Government Finance Statistics
GNI	—	Gross National Income
GAO	—	Government Accountability Office
GSUSA	—	Graduate School USA
HIES	—	Household Income and Expenditure Survey
ICO	—	Initial Coin Offering
ICT	—	Information and Communications Technology

IMF — International Monetary Fund

JEMFAC — Joint Economic Management and Fiscal Accountability Committee

JICA — Japan International Cooperation Agency

KYC — Know Your Customer

LIBOR — London Interbank Offer Rate

LRA — Land Registration Authority

MAWC — Majuro Atoll Waste Company

MEC — Marshalls Energy Company

MICS — Multiple Indicator Cluster Survey

MISSA — Marshall Islands Social Security Administration

MOF — Ministry of Finance

NDC — National Disaster Committee

NOAA — National Oceanic and Atmospheric Administration

NTA — National Telecommunication Authority

OAE — Open Access Entity

OIA — Office of Insular Affairs

PCRAFI — Pacific Catastrophe Risk Assessment and Financing Initiative

PEFA — Public Expenditure and Financial Accountability

PFI — Public Financial Institution

PFM — Public Financial Management

PFMRR — Public Financial Management Reform Roadmap

PFTAC — Pacific Financial Technical Assistance Center

PNA — Parties to the Nauru Agreement

PPA — Performance and Policy Actions

PPP — Private Public Partnership

PSDI — Private Sector Development Initiative

PUA — Pandemic Unemployment Assistance

RFP — Request for Proposals

RMI — Republic of the Marshall Islands

RoP — Republic of Palau

RoC — Republic of China (Taiwan)

RUS — Rural Utilities Service

SAFER — Sustainability Accountability for Enhanced Resilience

SCI — Statement of Corporate Intent

SEG — Supplemental Education Grant

SOE — State-Owned Enterprise

SOEMU — State-Owned Enterprise Management Unit

SOV — Sovereign (Crypto Currency)

SPC — The Pacific Community

TCMI — Trust Company of the Marshall Islands

TRAM — Tax and Revenue Reform and Modernization Commission

VAT — Value Added Tax

VDS — Vessel Day Scheme

WASH — Water and Sanitary Hygiene

NOTE:

1. The RMI government fiscal year (FY) ends on September 30.

2. Figures in the report are subject to rounding

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Disclaimer

The views, thoughts, and opinions expressed in this economic brief are those of the authors and represent an independent assessment of the economic performance of the Marshall Islands. This document does not necessarily represent the views of the government of the Marshall Islands, the Graduate School USA, the US Department of the Interior, or any other organization, committee, group, or individual.

Foreword

This brief, the fifth of its kind, has been developed to assist the Republic of the Marshall Islands (RMI) in implementing the terms of economic assistance under the Amended Compact. This brief has also been designed to assist the RMI in overall policy and economic management. It has been developed under contract with the US Department of the Interior's Office of Insular Affairs (OIA) and administered through the Graduate School USA's Pacific Islands Training Initiative. The brief is intended to assess the RMI's economic performance and policy environment and to present a comprehensive set of economic statistics.

On behalf of Graduate School USA and EconMAP (Economic Monitoring and Analysis Program), the review was authored by Mark Sturton; Glenn McKinlay compiled the statistical data sheet. Additional inputs were received from Emil Friberg, Kevin O'Keefe and Jason Aubuchon. Special thanks are extended to: Hon. Brenson Wase, Minister of Finance; Fred DeBrum, Director of the Economic Policy, Planning and Statistics Office; Junior Peter and Disa Nani Bukida also of EPPSO; and the many civil servants and business operators from the RMI, who supported the preparation of this brief and its statistical tables.

A digital copy of this review is available online at **http://www.econmap.org**.

1. Key Features in the Brief

The Marshall Islands economy contracted by 1.6 percent during COVID less than originally had been feared. Following five years of pre-COVID economic growth, RMI real Gross Domestic Product (GDP) is projected to fall by 1.6 percent in FY2022 compared with FY2019 and employment to have contracted 1.4 percent. Reductions in the fisheries, retail and the small hotel sector represent most of the decline with public administration offsetting the reduction. The recent surge in inflation in other nations has yet to filter through to the Marshall Islands but is expected to rise rapidly in the coming months. The RMI benefitted from a $71-million donor response to COVID, primarily from the United States and the Asian Development Bank. The U.S. CARES Act unemployment benefits supported affected RMI workers. Household incomes in FY2021 are projected to be 8.7 percent higher than they would otherwise have been without the mitigation programs and unemployment benefits. However, the end of mitigation programs will lead to a projected 2.2 percent reduction of household incomes in FY2022.

Fiscal policy in the RMI has been driven by available revenue, with expenditures adjusting automatically to rises in revenues. With the boom in revenues from fishing fees, the government has doubled its expenses on subsidies and transfers. As fishing fees jumped from $3.0 million in FY2010 to $37.0 million in FY2021, subsidies to large State-Owned-Enterprises (SOE) and transfers to NGOs and households doubled from 12 percent to 26 percent of GDP, although some of the recent increase has been due to COVID. The RMI needs to modernize its tax regime, as current efforts to improve tax collections will not keep up with economic growth. Furthermore, progress with fiscal reforms has been weak despite numerous government commitments, and the RMI needs to establish counter-cyclical fiscal reserves. Establishing a climate resilience fund is also increasingly necessary to help mitigate adverse climate events and natural disasters.

The RMI should take steps to address an emerging structural fiscal deficit. Since its appearance in FY2019, the RMI's structural fiscal deficit has been disguised by the inflow of donor grants during the COVID-19 pandemic. With increased fishing fees, the RMI expanded its budgets in FY2015 through FY2019, but expenses grew faster than revenue. By FY2019, expenditures outstripped revenues and the RMI recorded a fiscal deficit that was 1.8 percent of GDP. In FY2020, COVID grants created a fiscal surplus of 2.4 percent of GDP, with a smaller surplus of 0.7 percent for FY2021. Without additional donor funds, deficits of 2.6 percent and 2.9 percent of GDP are projected for FY2022 and FY2023, respectively.

While the outcome of the coming Compact renewal process looks encouraging, the RMI could under less favorable circumstances need to adjust to lower levels of funding. While it is likely the current package of economic assistance will continue, a less favorable outcome or delays are possible. In the latter scenario the RMI would be required to rely on drawdowns from the Compact Trust Fund (CTF). As part of the GSUSA's CTF

> *The Marshall Islands took strong proactive measures to protect the health of the nation and benefitted from the US vaccination program, Operation Warp Speed.*

analysis the value of the projected CTF is estimated to attain a target value insufficient to sustain perpetual drawdowns equivalent to the projected FY2023 inflation-adjusted level of grants. This would imply a reduction in drawdowns of $8.7 million or 31 percent. Thus, in addition to the existing need to correct the emerging structural deficit, the RMI would need to adjust to a lower level of sustainable funding on entering a new Compact era without additional Compact funding.

The RMI financial sector faces a series of challenges: instituting sufficient anti-money laundering and anti-terrorism financing procedures so that the Bank of the Marshall Islands can maintain its correspondent banking relationship with First Hawaiian Bank, addressing the high debt stress of RMI households, and careful monitoring of the fragile financial position of the RMI Social Security Administration. The RMI law establishing a digital cryptocurrency, the SOV, which would act as legal currency raises money laundering and terrorism finance concerns that may jeopardize relations with U.S. banks. In addition, the high price to value volatility of cryptos could destabilize the economy. The proposal to create a tax-free Digital Economic Zone in Rongelap Atoll carries similar risk. Both of these enterprises pose huge financial risks that a small nation like the Marshall Islands has limited capacity to address. For now, both enterprises have been put on hold.

2. Recent Economic Performance

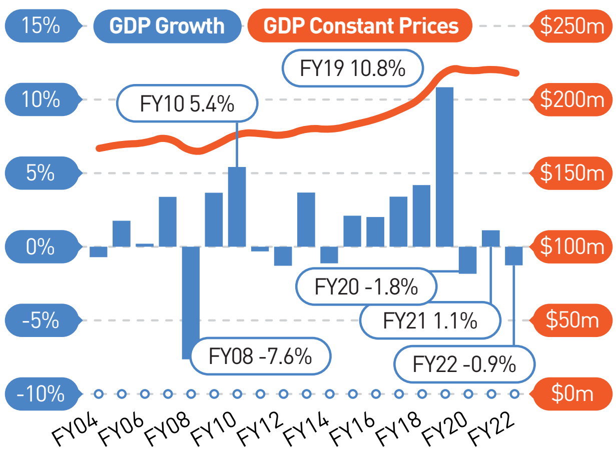
Performance

Economic growth in the RMI has been modest during the amended Compact, averaging 1.4 percent annually with high volatility. The RMI's economic performance from FY2004 to FY2019 and just prior to the onset of COVID-19 has been modest, with real economic growth averaging 1.4[1] percent during the period, see Figure 1. This rate compares favorably with the RMI's sister FAS; both the FSM and Palau averaged 0.3 percent growth. The RMI's low average growth during the period reflects high fluctuation between periods of strong growth in fisheries, construction, and services versus periods of substantial contraction. The

[1] Log linear growth estimate

Figure 1: Real GDP level and annual growth, FY15 prices, percent

Economic growth has been volatile but was displaying signs of sustained growth before COVID-19



main drivers of growth during the amended Compact period have been fisheries, private services including finance, and public sector services, see Figure 2. Public administration, education, and health have all been forces of growth supported by disbursement of the Compact sector grants in education and health and more recently by booming sovereign rents.

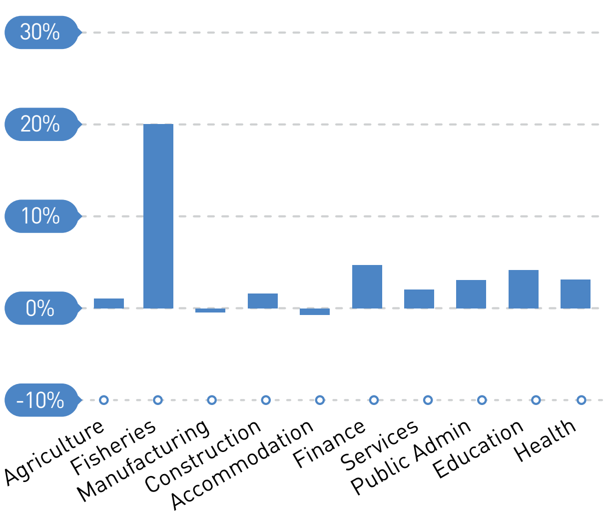
During FY2015-FY2019 economic growth picked up to an average of 4.7 percent before COVID-19 struck. During the first half of the amended Compact, through FY2014, economic growth was weak, averaging 0.7 percent per annum. However, during FY2015-FY2019 the economy grew more rapidly with an average rate of growth of 4.7 percent. This change reflected growth in fisheries, construction, shore-based services to fishing fleets, and financial services. It was further boosted by the general boom in sovereign rents (fishing royalties and fees from the shipping registry), which increased the fiscal envelope and allowed growth in public expenditures.

The overall economic impact of COVID-19 is now estimated to have been far less than originally projected. The economy is estimated to have declined by 1.8 percent in FY2020, grown by 1.1 percent in FY2021, and to have fallen by a further 0.9 percent in FY2022, bringing the total impact of COVID-19 to a 1.6 percent decline over the three years[2]. The overall impact of COVID-19 on the economy after a significant projected decline[3] of -5.5 percent has been far less than anticipated. Firstly, the fishing sector[4] went through a positive period and contributed 1.7 percent to economic activity despite the cutbacks in the loining plant which was responsible for -0.6 percent of the decline. In the wholesale and retail sector, fuel distribution led to -1.0 percent impact on the economy reflecting reduced travel, but domestic retailing largely - for local consumption purposes - contributed a positive 0.2 percent, reflecting the donor driven mitigation effort. The small hotel and restaurant sector, reflecting travel restrictions, is estimated to have been responsible for -0.6 percent of the impact.

The economy is projected to have fallen by 1.6 percent during COVID FY2019-FY2022 less than original feared.

Figure 2: Contribution to economic growth by industry, FY04-FY21

Fisheries has been the main contributor to economic growth



The impact of COVID-19 on the transport and construction sectors turned out to be far less than feared. It was originally anticipated that due to travel restrictions shore-based activities supporting fishing-fleet provisioning in Majuro port would contract significantly. However, the impact was far less than anticipated and while port activities contributed -0.5 percent to the overall results, increased domestic operations of AMI led to an increase of 0.6 percent. Overall transport made a positive contribution to the economy during COVID-19 of 0.2 percent. It

[2] The data presented in this report through FY2021 is based on provisional economic statistics, while the data for FY2022 is based on projections derived from a hybrid of actual data and through the GSUSA economic model for the RMI.

[3] Graduate School USA, September 2021, Economic Brief, Honolulu.

[4] Includes household fishing, domestic near-shore fishing and Pan Pacific purse seiners.

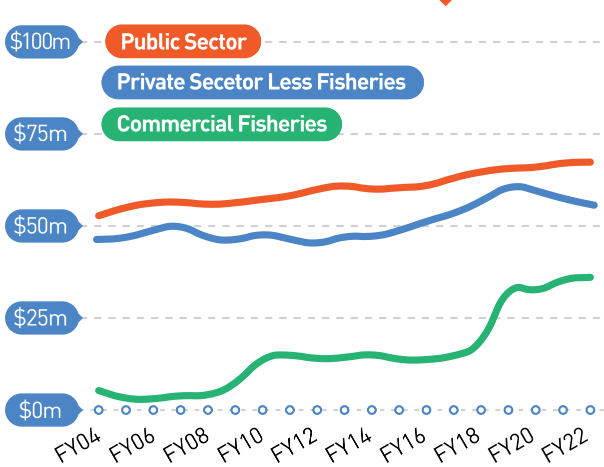
had also been feared that the construction sector would suffer a major decline. However, the impact was minor and only responsible for -0.3 percent. Despite the negative impact of travel restrictions on key skilled personnel, the construction industry avoided any large cutbacks. Finally, while there were other offsetting impacts, the education sector is projected to have supported the economy by contributing a positive 0.6 percent to GDP growth.

During the pandemic the public sector and private commercial fisheries grew while the non-fisheries private sector experienced a large contraction. Figure 3 indicates the growth in commercial fisheries[5], non-fisheries private and public sectors during the FY2004-FY2022 amended Compact period. The figure clearly reveals the rapid growth in commercial fishing during the period. There was as surge in commercial fishing in FY2010 when Pan Pacific commenced operations and again in FY2019 when it added 3 new purse seiners to its fleet[6]. During the FY2019-FY2022 period commercial fishing contributed 6.5 percent to overall economic performance. However, the remaining private sector contracted significantly leading to a sizeable loss in economic activity of 8.4 percent. The public sector played a significant role throughout the amended Compact period growing consistently. During COVID-19, it contributed 2.4 percent to the overall outturn mitigating the impact of the non-fisheries private sector.

[5] Includes domestic near-shore fishing, Pan Pacific fishing and loining (manufacturing), MIFV (manufacturing) and Koos (transhipment).
[6] In FY2019 Pan Pacific withdrew 2 leased vessels from operations and replaced them with new vessels.

Figure 3: RMI constant price GDP: commercial fisheries, private (less fisheries) and public sectors, FY15 prices

Public sector value added grows consistently with significant volatility in the private and commercial fisheries sectors



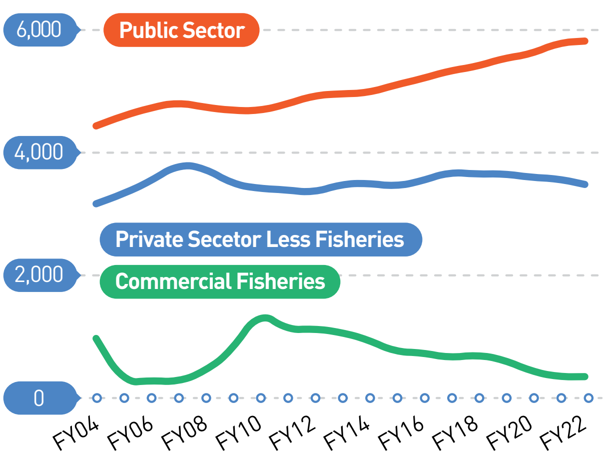
While the impact of COVID-19 on the overall economy may appear "conservative", it was highly uneven with a large reduction in the private sector balanced by growth in fisheries and the public sector. The impact of COVID-19 on the main sectors of the economy has thus been quite different. While the public sector, supported by the donor community, grew during FY2019-FY2022, the brunt of the impact was felt in the private sector. While the overall impact of the pandemic on the economy of a loss of 1.6 percent of GDP may appear "conservative," when the structure of the economy is taken into full account it is clear that the economic impact was highly uneven. During the crisis, the public sector supported economic activity, and commercial fishing made a strong contribution, but the impact on the private sector was painful.

Employment

Before COVID-19, public sector jobs grew steadily, but in the non-fisheries private sector employment growth has been anemic. Figure 4 indicates the growth in employment in the commercial fisheries, non-fisheries private and public sectors since the start of the amended Compact. The pattern in the public sector during FY2004-FY2019 mirrors that sector's contribution to GDP, which rose steadily with little volatility and averaged 1.2 percent growth per annum. With the increase in sovereign rents since FY2014, the RMI's fiscal envelope grew significantly, which enabled expansion of the civil service. In the commercial fisheries sectors, the pattern

Figure 4: RMI employment in the commercial fisheries, private (less fisheries) and public sector

After FY10 public sector employment has grown steadily as private sector (less fisheries) employment stagnated



largely reflects the operation of the fish loining plant. In FY2004, the former owners of the plant ceased operations and employment in the sector declined. In FY2009 the plant reopened under new management, Pan Pacific, and employment peaked in FY2010. However, beset by labor shortages, employment levels fell through FY2019. In the remaining non-fisheries private sector employment growth was anemic growing by an annual average of just 0.4 percent during the amended pre-COVID, FY2004-FY2019 period.

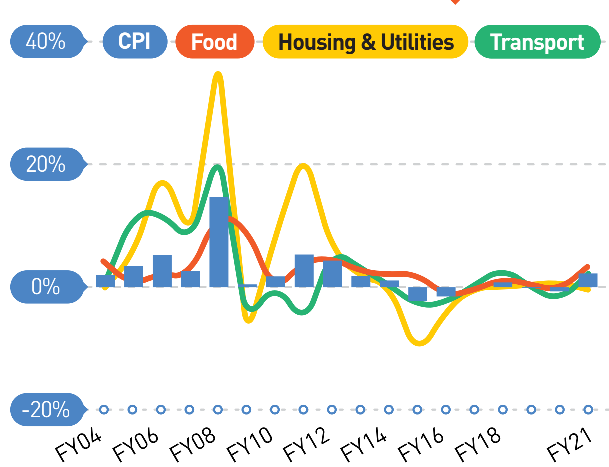
A loss of 155 jobs or decline of 1.4 percent of the work force has been estimated for the FY2019-FY2022 period. This loss in jobs should be understood as a reduction in full-time-equivalent (FTE) positions rather than a specific loss in employed persons. Firms are likely to institute reduced hours for employees before terminating their jobs. The loss in total jobs has been small and similar to the reduction in GDP. However, the distribution of the reduction has been uneven. In the commercial fisheries sector 281 jobs were lost primarily at the loining plant. Support from the US CARES unemployment benefits provided a perverse incentive. The company was able cut back on its loining operations and thus reduce costs of a loss-making activity. At the same time the beneficiaries, the plant workers were able to increase their income through higher unemployment compensation available under the CARES Act. In the non-fisheries private sector, a loss of 201 jobs was recorded, with the major sectors impacted being construction, a loss of 26 jobs, wholesaling and retailing 85 jobs, and the hotel sector 68 jobs. Offsetting this decline, the recent trend of a growing public sector helped compensate for the private sector loss with the creation of 370 jobs in public administration.

Inflation

Inflation has been moderate since the global financial crisis but started to rise rapidly in FY2022. After the initial part of the amended Compact and the rapid price increases of the global financial crisis, inflation moderated and the overall price level at the end of FY2020 was below that of FY2012, see Figure 5. Inflation continued to be modest during the pandemic and fell from the FY2019 rate of -0.1 percent to -0.7 percent in FY2020. In FY2021 prices started to rise and CPI recorded an increase of 2.2 percent mainly reflecting increases in food prices. In FY2022 by the end

Figure 5: Change in CPI by selected major commodity groups, annual percent change

Inflation remains modest rising by 2.2% in FY21 as world fuel prices surge



Inflation has been modest but is expected to rise rapidly in the coming months.

of the June quarter, the CPI had reached 4.0 percent (year-on-year) but remained lower than other regional economies such as Palau, which had recorded 12.3 percent over the same period. In the RMI the rise in inflation was driven by an increase in food prices of 4.7 percent, transport by 12.5 percent, but with the housing and utility section (including electricity) only recording 1.1 percent.

Impact of surge in oil prices has resulted in rapid increase in MEC costs and if passed onto consumers will have a strong impart on inflation. The MEC was in September recording a doubling of fuel costs and running a large deficit with projected exhaustion of reserves by year end without increasing tariffs or subsidies. Depending on government policy and whether to subsidize or pass on the cost to the consumer, MEC would require a subsidy of $8 million or electricity tariffs would need to rise by 40 percent[7]. This would suggest that inflation may be set to rise significantly in the coming months.

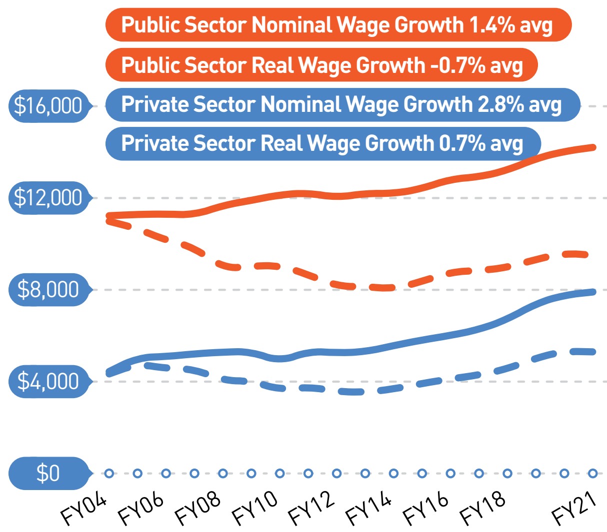
Wages

Between FY2013 and FY2021 real wages have grown as financial conditions improved and inflation remained low. Nominal wages have grown modestly in the RMI by 2.8 percent and 1.4 percent per annum in the private and public sectors, respectively, during the amended Compact period, see Figure 6. However, once inflation has been taken into account, real wages grew modestly by 0.7 percent in the private sector and fell by 0.7 percent in the public sector per annum. These long-term trends mask two distinct phases: first, there was an early phase (FY2004-FY2013) when financial conditions were adverse and nominal wages

[7] Estimates based on MEC FY2021 audit

Figure 6: Nominal and real wage rates by major institutional sector

Real wages have risen since FY13; but wages differential between the sectors remains large



struggled to remain positive and real wages declined; second, (after FY2013) as financial conditions in the economy eased and inflation moderated, both nominal and real wages rose in both the private and public sectors. Between FY2013 and FY2021 real private sector wages have risen by 6.0 percent and real public sector wages by 2.4 percent. However, from the start of FY2022 and with rising inflation, these trends are likely to be reversed and real incomes to fall. Finally, the wage differential between the private and public sectors remains large although the different skill mix between the two sectors would explain much of the difference.

3. COVID-19 Mitigation Programs and Donor Assistance

Analysis of the response of both the public sector and donors to the pandemic can be usefully divided into several components:

- The RMI Coronavirus (COVID-19) Preparedness and Response Plan
- Donor health assistance programs
- ADB COVID-19 Pandemic Relief Option.
- US CARES Act and unemployment assistance.

The RMI Coronavirus (COVID-19) Preparedness and Response Plan

RMI Preparedness and Response Plan sets framework for COVID-19 mitigation. In early 2020 in response to the COVID-19 pandemic the National Disaster Committee (NDC), chaired by Chief Secretary, was tasked with the primary responsibility for the development of the COVID-19 Preparedness and Response Plan. The National Disaster Management Office along with various Cluster groups (i.e. WASH, Health, Logistics, Infrastructure and other relevant agencies) were tasked to provide the technical support to the NDC for the implementation of the Plan. In June 2020 the government of the RMI released the original version of the Plan with an estimated financing need of $42.3 million. This was subsequently extended several times and the IMF reported had reached $63.3 million by May 2021[8]. Information provided by the government at the time of this Economic Brief indicates a total available funding level of $70.6 million. Allocating this funding by known broad categories provides the following allocations:

- Health mitigation, $30.2 million,
- Household mitigation programs, $14.1 million (CARES support and ADB funded hot lunch program),
- Education support through CMI, $1.9 million (Federal Program),
- Private sector business support, $6 million (Preparedness Plan), and
- General budgetary support, $18.4 million.

Donor assistance programs

RMI has been the beneficiary of a large donor response to support the Preparedness and Response Plan: The major benefactor to support the Plan has been the US government with $34.8 million. US resources include support under the CARES Act unemployment benefits of $10.8 million, and $24.0 million of health-related funding disbursed through CDC, OIA and various other Federal Programs. The ADB was the second largest donor and contributed $23.7 million largely through budgetary support. Additional health-related funding was available from the World Bank $2.5 million, the European Union $2.7 million, and other donors for $2.6 million. The ROC-Taiwan contributed $1.5 million in budgetary support and the RMI allocated $2.8 million of its own internal funds.

ADB COVID-19 Pandemic Relief Option

ADB played a major role in funding the mitigation effort. A lead donor for the mitigation program has been the ADB with a program totaling $23.7 million, of which $6 million has been funded through the Disaster Resilience Program (DRP), $16 million through the COVID-19 Pandemic Response Option (CPRO), a further $1 million in grants

[8] IMF, Article IV consultation Staff Report, May 2021, Washington D.C.

The RMI benefits from a $71 million donor assisted COVID mitigation program.

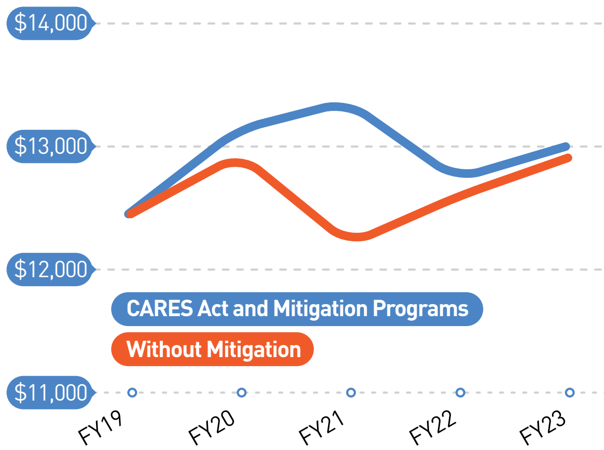
under the Asia Pacific Disaster Response Fund, and $0.7 million in health-related TA. The DRP and CPRO funds provided budgetary support to cover funding shortfalls in the financing of COVID-19 impact mitigation projects and programs specified under the Preparedness Plan. Of this amount $3.3 million was earmarked for the government's hot-lunch program.

US CARES Act and unemployment assistance.

CARES Act unemployment benefits generated significant benefits to affected RMI workers: As in the other Freely Associated States, RMI citizens were made eligible for unemployment support from the US government under the US CARES Act. The program has provided two forms of benefit: the Federal Pandemic Unemployment Compensation (FPUC) and Pandemic Unemployment Assistance (PUA). The FPUC was initially awarded at $600 a week for four months (April-July 2020). A second phase of the FPUC was awarded from January 2021 through early September 2021 at $300 a week. The PUA has been available continuously since July 2020 and expired in September 2021. A benefit of $262 a week has been awarded during the period. Total funding of $10.8 million has been awarded and $7.6 million has currently been disbursed with $3.6 under the PUA and $3.9 million under FPUC.

Mitigation programs had large beneficial impacts on household incomes. Without the various mitigation programs and CARES unemployment benefits, household incomes were projected[9] to have fallen by 4.9 percent in FY2021, which would have resulted in rising levels of distress in the workforce, see Figure

Figure 7: Household real incomes with and without mitigation, FY15 prices
Household incomes are 8.7% higher with mitigation



7. With mitigation, however, average household incomes are projected to attain a level 8.7 percent higher than the projected level had no action had been taken. In fact, the impact of the various mitigation programs has pushed household incomes above their trend level. Overall, the magnitude of the coordinated government and donor response has been both timely and significant. The government and donor community should both take credit for rapid and apparently effective mitigation efforts. However, the end of mitigation programs will lead to a projected 2.2 percent reduction of household incomes in FY2022.

[9] Graduate School USA, Economic Brief, October 2021, Honolulu.

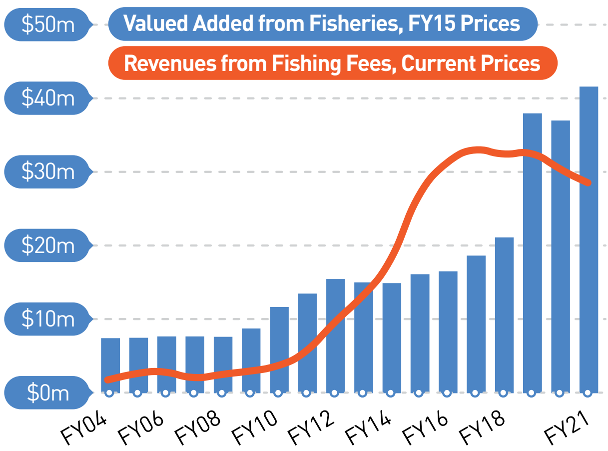
4. Fisheries Developments and Policy

RMI recorded massive growth in fishing rents from FY2010 through FY2019, which has had a large impact on the fiscal envelope. The fisheries industry in the RMI comprises provision of shore facilities to skipjack 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 $41.6 million in FY2021, with a large increase in the FY2019 period due to the addition of three new boats to the Pan Pacific fleet[10], see Figure 8. Total fish licensing and fees collected by the Marshall Island Marine Resources Authority (MIMRA) rose rapidly from $1.8 million in FY2010 (current prices) and recorded a level of $28.6 million in FY2021[11]. Most of the increase has been 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, have had remarkable increases in revenues. Freely traded bilateral daily fishing rates currently average close to $11,000 per vessel day and the RMI received over $26.0 million in revenue from this one source in FY2021.

Job losses at the loining plant remain well into FY2022. In FY2020 the largest negative impact of COVID-19 was on the loining plant.

Figure 8: Commercial fisheries value added and fishing fee revenues

Strong growth in fisheries valued added and revenues from the VDS



As supplies of raw materials dried up the loining plant terminated operations and 206 employees were lay-off, with a skeleton staff remaining to maintain readiness for resumption of operations. Fortuitously, the US CARES Act provided eligible staff with unemployment benefits in both FY2020 and FY2021. In September 2021, these benefits terminated but the plant remained closed through the FY2022.

FSM Arrangement provides discounts to domestically flagged vessels at substantially reduced rates. 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 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, which is considerably less than the current bilateral market rate of $11,000 per day. The issue of concern is

The FSM arrangement leads to distortions in the management of the Vessel Day Scheme and potential loss of revenues.

[10] In FY2019 Pan Pacific withdrew 2 leased vessels from operations that were classified as non-resident and replaced them with new vessels owned by Pan Pacific and treated as resident.
[11] See MIMRA audits

whether the reduced fishing fee and concurrent loss in revenue will be offset by increases in benefits to the PNA economies. In the RMI case, Koos fishing company operates 4 purse seiners and another boat under a joint equity venture with the government. Pan Pacific operates 6 boats and the loining plant, but at a significant recorded loss in order to take advantage of the reduced domestic fee rate.

FSMa is an economically inefficient regime that misallocates sovereign rents. A recent unpublished study of the fisheries sector conducted by the GSUSA suggests that the additional economic benefit to RMI from each domestic vessel compared with bilateral vessels is about $500 per day. Therefore, discounts to domestic vessels should not exceed $500 per day. Under the FSMa, fish caught by RMI flagged vessels pay a transfer fee of $4,000 a day when fish are caught in other FSMa jurisdictions. Discounts to locally flagged vessels must therefore at least match the $4,000 to enable payment of the transfer fee. However, the FSMa entails a loss of sovereign rents when fish are caught in RMI waters, and the rents accrue to the locally flagged operators. Based on the economic benefit of domestic fishing fleets of $500 per day, plus the transfer fee of $4,000, its estimated that the annual loss to the RMI economy ranges from $0 to $7.6 million depending on where the fish are caught. This range is large but the actual loss to the RMI lies somewhere in between. The FSMa is inherently inefficient and incurs a loss in sovereign rents to participating nations. It needs replacement with a more efficient approach, such as that of Papua New Guinea in which fishing fleets are rewarded for the value added and the contributions made to the local economy.

MIMRA had generated a significant pool of underutilized reserves: In September 2016 the Nitijela passed a law, the Marshall Islands Marine Resources Authority Surplus Funds Amendment Act, designed to enable "surplus" funds, defined as resources in addition to those approved by the Board as part of the annual budget, to be transferable to the government. The provision arose due to the large accumulation of unused revenues in the MIMRA account that had reached over $30 million by the end of FY2016. In FY2017 approximately $14 million of the surplus reserves were drawn on and used to fund additional expenditures. However, the remaining reserves are substantial and by the end of FY2021 had once again exceeded $30 million. The reserves are held either as cash or TCDs.

Revisions to the Fiscal Responsibility and Debt Management Act would provide a sound basis to guide the use of any available reserves: The use of any additional funds such as occurred in FY2016 to inflate general fund expenditures would not be desirable. The current legislative framework for the identification and use of surplus funds is not well formulated in that they follow article VIII of the Constitution which defines surplus funds to be "unanticipated revenues." Unanticipated revenues can be apportioned by the cabinet the same day without the need for appropriation by the Nitijela. Revision of the Fiscal Responsibility and Debt Management Act, discussed in the next section, would provide an appropriate institutional structure to guide responsible use and investment of the reserves including possible deposit in the proposed cyclical and/or climate reserve funds. The adoption of well-defined principles in the FRDMA to guide the use of any surplus funds could then establish a sound basis for resource management without the risks of fiscal indiscipline inherent in current practices and law.

5. Fiscal Performance and Policy

Fiscal Trends pre-COVID

Revenues fell as a share of the economy in the first ten years of the amended Compact but then rose rapidly with the growth in sovereign rents. Figure 9 indicates recent trends in fiscal performance, that is, current revenues and expenses, together with capital grants and fixed assets, as a share of the economy. During the first ten years of the amended Compact through FY2014 revenues declined as a percent of GDP. This decline reflects the inelastic and outmoded tax regime and the static nature of Compact grants in nominal terms, see Figure 10. The FY2014-FY2019 period reflected growth in a new form of revenue, sovereign rents: comprising both fishing royalties arising out of the VDS from the PNA and increases in earnings from the TCMI, resulting in a 9 percentage point increase in the ratio of revenues to GDP. During the COVID period, FY2020-FY2022, the upward momentum in revenues was sustained through the large receipt of grants to protect the health of the nation and for budgetary support to mitigate the impact of the pandemic.

Payroll has declined as a share of GDP, but expenses on subsidies and transfers have doubled. Current expenses have followed the trend of current revenues. The decline in the revenues-to-GDP ratio prior to FY2014 led to a tight fiscal period of constrained expenditures. However, as the revenue base expanded with the increase in sovereign rents, expenses also expanded, see Figure 11. The recent large expansion in COVID related grants led to a matching increase in health expenses and additional programs to mitigate the impact on businesses and households. Within current expenses, payroll declined in relation to GDP through FY2014 by 3 percent and then stabilized at 22 percent of GDP until the current time, FY2021. The use of goods and services has remained stable but rose in FY19 due to unusually large repairs and

Figure 9: RMI consolidated revenues and expenditures, percent GDP
RMI executes expansionary budgets during FY15-FY21 with overall fiscal surplus averaging 2.1% of GDP

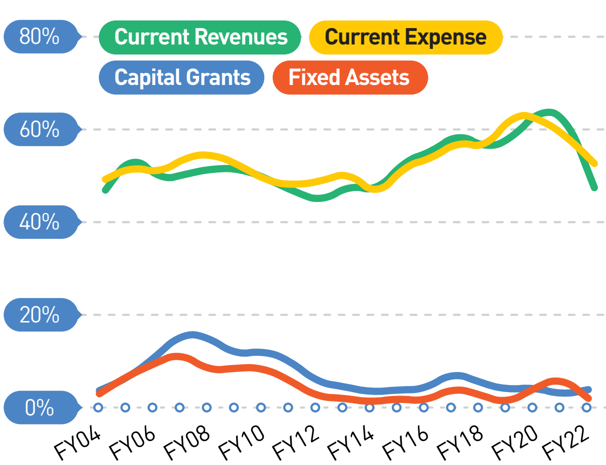


Figure 10: RMI revenues by source, percent GDP
Tax revenues are an inelastic source of revenues while soverign rents have boomed

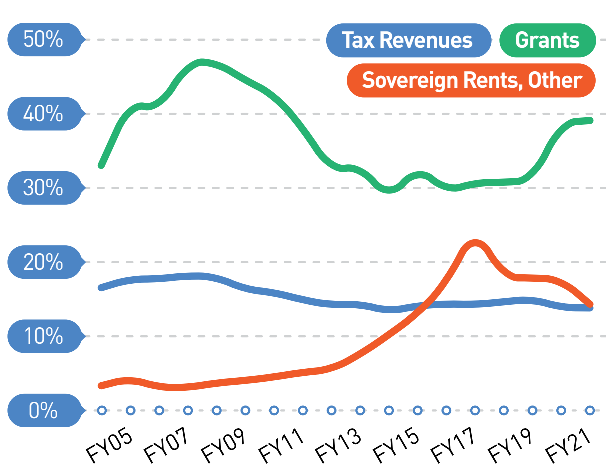
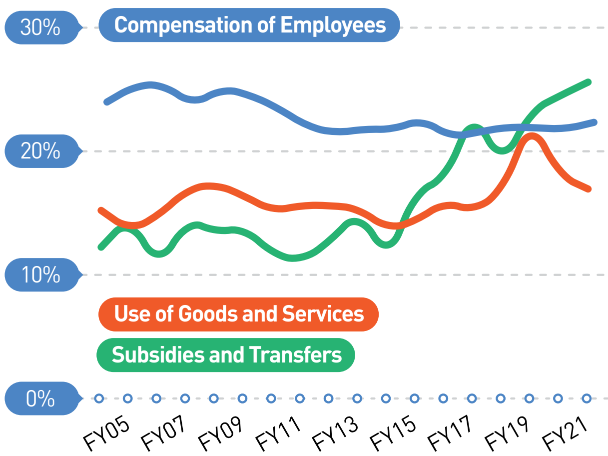


Figure 11: Expense by economic category, percent GDP
Subsidies and transfers have grown rapidly since FY2014



maintenance charges and rose in FY2020 and FY2021 with the recent increase in COVID-19 related expense and anticipated to fall back as the economy emerges from the pandemic. The main area of expansion has been in subsidies to the large SOE sector, grants to other levels of government and transfers to NGOs and households, which has nearly doubled from 13 percent to 26 percent of GDP. On the capital side, expenditures have been primarily covered by grants, which, as with current expenses, have risen and fallen in tandem.

Fiscal policy in the RMI has been driven by revenue availability. While not directly indicated in Figure 9, the fiscal deficit (in essence the difference between current revenues and current expenses) was largely in balance throughout the period. Fiscal policy in the RMI has been driven by revenue availability and the stage of the economic cycle. During the initial period through

> *Fiscal Responsibility and Debt Management Act fails to place a break on runaway expenditures and will require redrafting.*

FY2014, budget expenses were forcibly constrained. Thereafter, with the boom in revenues, expenses were less constrained. The failure to create a fiscal reserve during the period when the fiscal envelope was expanding dramatically carries a lesson for RMI policy makers going forward.

Fiscal performance during the COVID period

Revenues grew strongly in FY20 with the onset of COVID-19, stabilized in FY2021 and are projected to return to normal levels in FY2022. At the start of COVID the tax base contracted by 3.9 percent with the loss in economic activity. While wage tax collections and import duties held their ground, there was a 10.7 percent fall in the gross receipts tax reflecting the decline business activity. In FY2021 there was a rebound in all categories of taxation with total collections growing by 7.1 percent, and in FY2022 a similar improvement of 5.4 percent is projected. While tax revenues performed well given the circumstances, the onset of COVID-19 was associated with a massive increase in grants. In FY2020 grants increased by 30 percent or $21.7 million reflecting support from the US for health and basic incomes with additional resources made available from the ADB for disaster mitigation. In FY2021 a reduction in health funding was compensated by continued resource transfers through the US CARES Act and the large CPRO grant from the ADB of $16 million for general budget support. Overall grants continued to grow in FY2021 by $7.6 million or 8 percent. In FY2022 funding for COVID-19 had largely been exhausted and grants are projected to fall by 15 percent and return to normal levels. The main area of disappointment in revenues was the reduction in MIMRA transfers. While VDS revenues fell by $2 million in FY2021 transfers to the government were cut by $5.3 million despite MIMRA reserves attaining the second highest level recorded of $30.2 million by year end. While funding for budget support compensated and remained strong, the failure to establish a mechanism to draw on abundant reserves at a time of crisis suggests an area of policy weakness in need of reform.

During COVID-19 government expenditures grew strongly in FY2020 and FY2021 but are projected to fall in FY2022. During the COVID-19 period payroll costs grew by an average annual rate of 5.3 percent above the long-run average of 2.9 percent. Most of this increase occurred in FY2021 with the large infusions of budgetary support arising from the ADB CPRO. Expenses on goods and services rose during the early stages of COVID with additional health needs but were offset to a degree by reduced outlays on items that were in short supply due to the travel restrictions. After a period of rapid increases in subsides to SOEs, subsidies fell during the period due to more favorable world prices of coconut oil. Grants to other government entities remained largely unaffected by COVID-19, but transfers to schools, households and private business rose rapidly with additional expenditures on the hot lunch program, unemployment benefits through the US CARES Act, and support to stressed private sector enterprises. Lastly there was a very large increase in capital outlays predominantly due to increased health related infrastructure.

RMI runs a fiscal surplus in FY2020 and FY2021, but a deficit is projected for FY2022 and FY2023 as a pre-COVID structural deficit reasserts itself. After a period of strong fiscal performance in FY2019, where the RMI recorded a fiscal deficit that was 1.9 percent of GDP, reflecting the emergence of a structural deficit as rising expenditures outstripped revenues, balance was restored in FY2020, and 2.4 percent surplus was recorded. During FY2020 the rapid increase in grants led to a build up in deposits with the accumulation of unused funds. In FY2021 the fiscal surplus fell to 0.7 percent of GDP as capacity limitations were overcome and cash balances were drawn down. In FY2022 a 2.6 percent deficit is projected and a 2.9 percent deficit is projected in FY2023 as the large increases in COVID related grants and additional expenditures worked their way through the system, and the underlying structural fiscal deficit existing pre-COVID is expected to reassert itself.

Fiscal responsibility

Passage of a Fiscal Responsibility and Debt Management Bill is a key trigger for both World Bank and ADB support. The above discussion of recent fiscal trends indicates rapidly rising expenditures, which are growing to absorb the increasing level of revenues. Fiscal discipline to restrict the growth in expenditures, and thereby to build a reserve to accommodate downturns in the business cycle, has been absent. Rather, expenditures have raced to catch up with the expanding funding envelope. In 2019 a committee was formed, chaired by the RMI Chief Secretary, to design a fiscal strategy and to consider a fiscal responsibility framework. As a result, in late 2019 a Fiscal Responsibility and Debt Management Act (FRDMA) was drafted, and in early 2020 adopted by the cabinet and submitted to the Nitijela. In May 2021, the bill became a law and accompanying regulations were issued. The adoption of the FRDMA-related regulations was a trigger for a World Bank Development Policy Operation (budgetary support), and also was committed to by the RMI government as a key element of the ADB's Performance and Policy Actions (PPA), which are required for continued grant support at planned program levels.

Proposed modifications to FRDMA would better enable it to address the needs of the RMI. The sudden appearance of COVID-19 in early 2020 left the development of the FRDMA with an incomplete level of technical review; however, the new law would benefit from the addition of several key, RMI-specific elements that would make the law a better fit for the RMI's unique circumstances and fiscal risks. Perhaps most importantly, the FRDMA neither restrains growth in expenditures within the medium-term revenue envelope nor in relation to the size of the economy. At present, efforts are being offered to modify the FRDMA to reflect the key principles identified in the RMI-vetted fiscal strategy and to better reflect the budgetary cycle within the Marshall Islands. It is hoped the FRDMA will be revised to reflect these principles and create an environment for the conduct of responsible fiscal operations as was intended in the World Bank's and ADB's respective PPAs.

Tax Reform

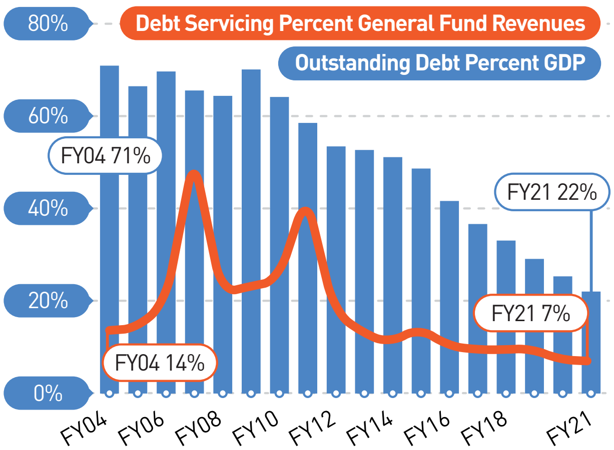
The RMI tax regime is inherently inelastic relative to economic growth and in need of modernizing reforms. The RMI, along with its two sister Freely Associated States (FAS) of Palau and the FSM, inherited a tax regime from the Trust Territory days. The regime is outdated, distortionary, and in need of reform. Figure 10 indicates the decline in the tax/GDP ratio and inherently inelastic nature of the current batch of taxes: wage withholding tax, the gross receipts tax, and import tax. A tax reform advisor was recruited in 2012 with support from AusAid for a two-year period, a legislative package was drafted, and an implementation program was prepared. Unfortunately, the package failed to garner support and was neither taken up by the Nitijela nor passed into law. The major focus of opposition was from the business community, which resisted the introduction of a Value-Added Tax (VAT), despite the fact that the incidence of tax would fall on consumers.

As the boom in sovereign rents plateaus and the RMI enters a new post-amended Compact era, it needs to reignite the tax reform agenda once again. Since the tax reform efforts of the early 2010s following shortly after the financial crisis and tight fiscal envelope of the time, reform of the tax regime has not been seriously reconsidered. The donor perspective has been that without commitment to reform of the tax regime, donor support should focus on administrative strengthening. The Pacific Technical Assistance Center (PFTAC) has continued to provide support and in 2020 the ADB launched a TA under the Public Financial Management (PFM) project to provide administrative support in compliance, improved tax collections, internal processes, and risk management. The ADB TA resulted in one major recommendation to improve IT systems to enhance efficiency. However, while such efforts are highly desirable and will result in increased revenue collections in the short-term, they will not overcome the inherent weaknesses, inefficiencies, and lack of buoyancy of the existing regime. In other words, tax collections will fail to keep up with the growth in the economy, which will constrain the delivery of public services. The on-going tax reform initiative in Palau and introduction of a VAT (Palau Goods and Services Tax) will provide a good example of reform and should be closely monitored in the RMI).

External debt management

External debt and debt service fall to low levels. As a result of the IMF/World Bank's Debt Sustainability Analysis (DSA) indicating the nation as being at high risk of debt distress, the RMI has been designated as a "grant only" recipient, making the RMI no longer eligible for loan financing from multilateral donors. The high-risk assessment has been based on two major factors: (i) the historically high ratio of debt to GDP and the (ii) potential shortfalls in resources in an adverse scenario after the end of the amended Compact period. External debt stress had posed significant risk to the RMI fiscal position during the early years under the amended Compact, including periods of delinquency in the late 2000s. However, the current position has improved significantly, and external debt has fallen from 71 to 22 percent of GDP (see Figure 12). Debt service as a ratio of payments to general fund revenues has also fallen significantly from over 20 percent at the height of the global

Figure 12: RMI external debt (percent GDP) and debt service (percent general fund revenues)
External debt has been falling rapidly with adoption of grant only status



financial crisis, when the RMI was in a state of default, to just 7 percent in FY2021.

The designation of "grant only" status has served the RMI well. External debt has fallen sharply to sustainable levels as a result of being accorded "grant only" status. This status is accorded on the proviso that the RMI does not incur debt from third parties at non-concessional rates. This requirement has inhibited the surge of debt that occurred during the original Compact period through FY2003 and during the amended Compact period through FY2010, with much of the debt from ADB loans. However, while grant-only status has inhibited borrowing, this is not to say that a pressure to incur new debt has disappeared. So far, the DSA provision and analysis has imposed a useful brake on any reemergence of the past debt-financing trends. However, as the Compact-renewal terms become known and with a possible favorable outcome, it may be that a reassessment of the major assumptions of the DSA will result in a changed designation for the RMI regarding loans. The current proposal to implement a well-specified FRDMA reflecting the needs of the RMI is thus viewed as essential for providing guidelines on the proper management of debt at sustainable levels and for well-vetted purposes.

Counter-cyclical policy, fiscal buffers, and climate events management

The RMI has a need for counter-cyclical fiscal buffers and reserves that could be established and maintained through the use of MIMRA surplus funds. The fiscal policies during the amended Compact have resulted in periods of substantial cash-flow shortfalls, which have led to fiscal and economic instability. This was seen in both the failure to service accounts payable and the temporary default on external debt repayments during the late 2000s and more recently during the COVID crisis. The RMI, unlike more financially developed nations, has no access to capital markets. Further, the adoption of the US dollar and the lack of a central bank removes the availability of a domestic source of funds for cash-flow management. Under these circumstances the RMI needs to build a pool of savings for funding government operations during cyclical downturns and periods of illiquidity. In the previous section and the discussion of the management of the MIMRA surplus funds, it was suggested that transfer of the surplus to a cyclical reserve, would provide a more efficient means of investment and principled approach to their use.

Target levels of cyclical reserve funds may be set in relation to domestic revenues. Many Pacific Island Countries (PICs) with their own currencies, fixed exchange rates, and central banks operate on the principle of maintaining foreign reserves at a defined level of imports. In the RMI's case, this objective would translate into maintaining a minimum level of resources equivalent to a target number

> *Establishment of fiscal buffers through deployment of surplus MIMRA funds would support fiscal responsibility and stability.*

of months of domestic revenues. This could be determined with reference to historical periods of cyclical volatility. A source of funds to establish the cyclical fund reserve does not presently exist and would need identification. It might be achieved on a matching basis with donor funding and internally generated RMI domestic funds. Once established, the fund would need periodic augmentation to ensure the reserve target was met and a mechanism to replenish the fund after it had been drawn upon was identified. Clear rules would need to be adopted to specify the conditions under which the reserve funds could be accessed.

A Climate Resilience Fund is likely to become increasingly necessary. In the case of periodic climate events and natural disasters, the RMI could establish a climate resilience fund to help mitigate adverse impacts. While the RMI does have access to climate event insurance funds from the World Bank and ADB, there may be events and circumstances for which these funds may either be unavailable or just not available on a timely basis. Contributions from domestic revenues and from donor partners could be set aside into a resilience fund until a target amount is reached. The exact target amount might be based on the World Bank's Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI). In the RMI's case the risk and cost of an annual climate event has been estimated at about 2.0 percent of GDP. The target for the fund might be set in relation to this risk and the availability of other donor contributions. Withdrawal of funds would be permissible once the president declares a state of national emergency. Commitment costs of the World Bank's and ADB's disaster funds, or premium costs for any other such insurance facility, could be drawn from the climate resilience fund.

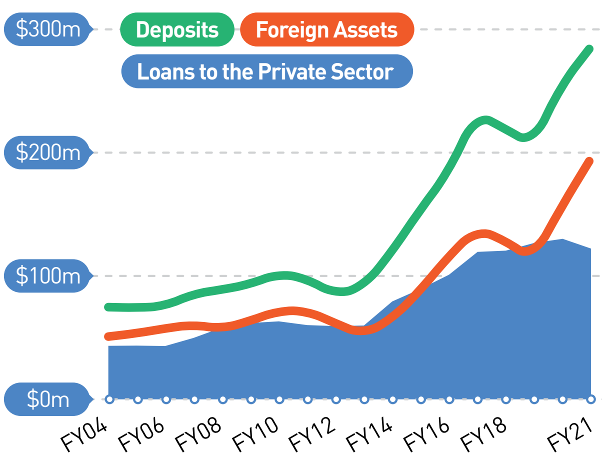
6. The Financial Sector

Banking

The RMI banking sector operates a more proactive lending policy than its sister Freely-Associated States (FAS). Commercial bank lending in the RMI is more active than in the sister FAS states of the FSM and Palau and achieved a loans-to-deposits ratio of 51 percent, as compared to ratios of 18 percent in FSM and 6 percent in Palau (see Figure 13). 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, greater financial intermediation has been limited by: the inability of businesses to prepare meaningful

Figure 13: Commercial bank deposits, lending and foreign assets

Commercial bank lending remains weak, funds invested offshore



Households are at risk of high debt stress due to large indebtedness at the commercial banks.

business plans and financial statements; lack of collateral; and the limited ability to use land as security. However, the introduction of secure-transactions legislation and property registry has enabled lending against moveable chattels (personal property). With limited opportunities in RMI, commercial banks have preferred to invest their assets offshore in less risky and more secure markets.

The RMI banking sector remains at risk due to possible loss of BOMI's correspondent banking relationship. A particular issue for the RMI has been the worldwide phenomena of "de-risking" by international financial institutions. In order to reduce exposure to money laundering, the financing of terrorism, or the stiff penalties imposed by regulatory authorities, international banks have reduced 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 Anti-Money Laundering (AML) and Countering the Financing of Terrorism (CFT) procedures, but a permanent CBR solution is needed. Until such time, BOMI and the RMI financial sector as a whole, remain at significant risk.

Households are at risk of high-debt stress due to large indebtedness to commercial banks. A further issue relating to banking is the high ratio of consumer debt to household income. Consumer debt represents 28 percent of GDP and 49 percent of compensation of employees. Consumer debt attracts high rates of interest (13.6 percent in FY2021) and is largely secured against the payroll of public sector employees through direct allotment, which guarantees repayment. Analysis of government payroll indicates allotments for debt repayment average 47 percent of total wages, which leaves the net take-home after-tax pay of employees at an average of 15 percent of gross wages. More than 25 percent of employees take home less than 3 percent of their gross wages. As a result, government employees are reported to be at high risk of debt stress. Many national government employees have such low levels of net take-home pay that they are unable to meet their basic family needs.

To reduce risks to both households and the financial system, policy makers need to focus attention on a range of policy responses. As noted in a 2019 policy paper prepared by the Chief Secretary's Office, the government has been presented with a series of potential actions to consider. It was recommended that the government: (i) address the growing consumer debt problem through review of banking practices, laws and regulations, and the role of the Banking Commission and its oversight; (ii) strengthen consumer education and financial literacy programs; and (iii) establish a new Consumer Protection law to strengthen governance over this and related consumer issues. Such a program of action undertaken with private sector and civil society collaboration can be expected to improve fairness in the consumer lending sector and reduce the risk of potentially disruptive levels of stress on the financial sector. The Banking Commission has reported that it will be issuing regulations to address this issue and to reduce household debt stress through placing a limit on debt service obligations.

Social Security sustainability management

An actuarial study in 2011 projected collapse of the Social Security System in 2023, motivating a series of important reforms. The financial position of the Marshall Islands Social Security Administration (MISSA) has been a long-standing issue. MISSA had been identified as being at significant risk and in

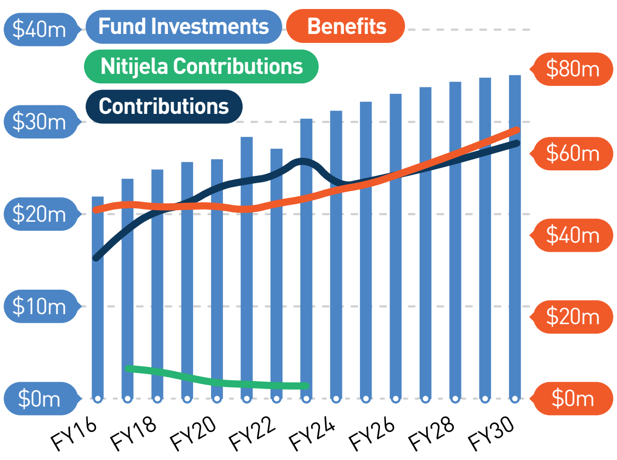
Earlier reforms to the Social Security system have improved financial sustainability.

need of reform. In 2011 an actuarial study projected the threats to the system and the exhaustion of its reserve investments by 2023. As a result of these dire predictions, a series of reforms were proposed in 2013 but failed to be acted upon by the Nitijela. However, given the imminent collapse of the system, a revised version of the reforms was enacted in 2017. Compared with the original reform list, it was recognized that these reforms would likely be insufficient to restore long-term sustainability. The Nitijela acted to provide annual transfers of $3.6 million in FY2017, but these transfers have been gradually reduced to $1.4 million in the FY2022 and FY2023 budgets.

Recent financial data indicates MISSA contributions now exceed benefits. The impact of reforms and cash transfers appears to have been significantly greater than originally projected. In the FY2020 audit and FY2021 preliminary financials, MISSA indicates that contributions now exceed benefits by an average of $3 million. This will allow the fund to accumulate from both the excess contributions and annual earnings on investments. Based on the current financial position of the fund, projected contributions (based on recent economic work conducted by GSUSA), and projections of benefit streams from prior actuarial assessments, the outlook for MISSA appears brighter.

Projections indicate MISSA's financial position remains fragile and careful monitoring is needed. Figure 14 suggests that contributions will exceed benefits for some years but with a narrowing of the balance as benefit growth exceeds that of contributions. The projections, which are based on a 4.5 percent return on invested assets, the rate assumed in the 2017 actuarial assessment, and termination of government transfers

Figure 14: MISSA benefits, contributions, fund investments and Nitijela contributions
Social Security Funds now projected to rise after recent reforms



at the end of FY2023, indicate that reserves will continue to rise and attain a value of over $100 million by FY2030, an increase of $50 million on current fund balances. These results suggest that the financial position of MISSA is out of the danger zone. However, the benefit projections presented here are based on earlier actuarial studies. There remains a need for a reevaluation and careful monitoring of the system.

Cryptocurrency, the Sovereign (SOV), and Digital Economic Zone for Rongelap Atoll (DEZRA)

RMI announces intention to issue a digital currency, the SOV, in the RMI as legal currency. In late February of 2018 the RMI passed legislation to issue a digital currency based on block-chain technology to be known as the SOV, which would act as legal currency in the RMI in addition to the use of the US dollar. An "appointed organizer," named by the cabinet, would be responsible for the Initial Currency Offering (ICO) as well as the development of the block-chain technology and software for transacting in the currency in the RMI. An initial 24 million SOVs were to be issued, half of which would be held by the RMI government, and the remainder owned by the organizer. The minister of Finance would be responsible for regulation of the SOV, and the banking commissioner would be responsible for compliance with anti-money laundering and combating financing of terrorism AML/CTF requirements and standard Know Your Customer (KYC) procedures.

The passage of the law to issue the SOV as legal tender resulted in a widespread concern from international institutions. While there are many cryptocurrencies in existence worldwide, few have been issued as legal tender by a sovereign state. Many central banks are examining the potential to issue digital currencies to the public that are backed by the currency in circulation but have so far been hesitant to issue their own Central Bank Digital Currency (CBDC). Thus, the RMI proposal is unique. 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 this would be done in jurisdictions outside the RMI or after the ICO. Since anonymity is one of the major attractions of cryptos, its absence could limit the uptake of SOV.

Creation of SOV threatens the RMI's correspondent banking relationship (CBR). 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 or other international banks. It is also not clear what the position of the FDIC might be regarding the acceptance and holding of SOVs by the other bank in the RMI, the Bank of Guam.

> *The proposed cryptocurrency, the SOV, in addition to the Digital Economic Zone at Rongelap Atoll (DEZRA), would create huge fiscal risks for the RMI.*

Potential high volatility in the value of the SOV poses significant risk to the RMI government and private sector agents. The intention to issue the SOV as legal currency and high price/value volatility poses further financial risks. Should the SOV be taken up actively, such volatility could prove highly destabilizing, undermining balance sheet integrity, with disruption of orderly payments.

Introduction of SOV is delayed as the RMI commissions a due-diligence study. In March of 2020 under a new government, a bill was introduced to repeal the SOV legislation. The Marshall Islands Journal reports[12] it was not the intent to repeal the legislation but to put the process on hold while the new administration had time to commission a comprehensive study on whether to procced with implementation of the law. At this time the legislation to repeal the law is on hold and the process has effectively stalled.

Creation of a Digital Economic Zone in Rongelap Atoll poses additional risks to financial stability, and the draft legislation failed to gain sufficient support to become law. Subsequent to the slow process in implementation of the SOV, a bill was introduced into the Nitijela for the creation of the Digital Economic Zone in Rongelap Atoll (DEZRA). Rongelap Atoll was contaminated by radioactive fallout from US nuclear testing. DEZRA is intended to generate foreign investment through the creation of a virtual means of exchange, including assets based on block chain technology, coupled with the creation of a tax-free zone. However, it is likely that most if not all of the transactions would occur offshore. Many of the same

[12] Marshall Islands Journal, 2022-09-22, Majuro.

criticisms of the SOV also apply to DEZRA. The IMF points out[13] that the benefits to the RMI are likely to be limited while the new zone is likely to generate a host of new risks. In an unsophisticated jurisdiction with limited regulatory capacity, DEZRA would be subject to the same AML and CFT risks and concerns as the SOV. This would further compound the issues of maintaining the RMI's CBR with First Hawaiian, which underpins the financial stability of the nation. Both First Hawaiian and the US Treasury have expressed grave concerns and as a result the bill lost support and was not taken up for the third and final reading[14].

[13] Republic of the Marshall Islands: 2021 Article IV Consultation, IMF, Washington DC, May 2021

[14] Ibid, Marshall Islands Journal

7. Public Financial Management (PFM)

Public Expenditure and Financial Accountability (PEFA)

The RMI has developed a PFM Reform Roadmap, but progress has been slow. In December 2011, the RMI underwent an external PEFA assessment, and the cabinet adopted the report and directed the government to request PFTAC to compile a PFM Reform Roadmap (PFMRR). In collaboration with the government, PFTAC prepared the PFMRR in 2014. An observed weakness at the time of the first PFMRR review in 2015 was the lack of prioritization of the adopted components and activities and the allocation of insufficient resources for implementation of the reform efforts. Progress was slow and many of the components had yielded no actions. However, since then, prioritization has been implicitly expressed through donor assisted resourcing of the reform effort.

ADB technical assistance (TA) to support the PFMRR has been underway since 2018 and has played an important role in enhancing PFM in the Ministry of Finance. As part of the ADB's 2018-2020 project cycle a $2 million PFM project was initiated to support the Ministry of Finance with the PFMRR

> *Reforms to the poorly performing SOEs are showing signs of improvement, despite setbacks during COVID but there remains a long road ahead.*

by providing the focus of the reforms. The major initiative has been in strengthening the Ministry of Finance with improved staffing levels and providing a focus upon financial management, accounting, and controls. An additional focus has been the establishment of the SOE monitoring unit that is part of the ADB PFM project. The initial project was largely successfully completed, and a 2-year extension period is underway.

Financial Management Information Systems (FMIS)

With World Bank support a new FMIS has been identified and the vendor contracted for the delivery of the new system. The original FMIS, that had been in existence throughout the amended Compact, has reached the end of its effective life. The responsible software company is no longer operational, and support is not available. With $9 million in donor grant support from the World Bank for budget execution and financial reporting systems, an RFP for a new financial management information system was issued. While initial proposals were deemed unacceptable, a revised RFP was issued, and a vendor identified. Implementation started early 2022 and user acceptance testing was underway in September for a "go-live" date set for end of fiscal year FY2022.

Public Sector Payroll

Government payroll has declined as a share of GDP since the start of the amended Compact. At the start of the amended Compact period there were 1,911 public servants as compared to 2,599 today. However, there was an increase in 380 public servants or 20 percent in the first two years in response to the depressed levels of public employment after the reforms of the late 1990s and with the incorporation of the Head Start Federal Program into government. Between FY2006 and FY2014 during the fiscal repressed years there was practically no increase in employment reflecting imposition of a wage and hiring freeze. However, since that time the public service has expanded modestly adding an extra 277 jobs or an annual 1.6 percent average growth. Wage rates reflected similar forces growing by 1.2 percent per annum in the initial period and rising to 2.8 percent since FY2014 through FY2021. Payroll costs as a percent of GDP has fallen from 25 percent in FY2006 to 22 percent in FY2021. Two important conclusions may be drawn from this analysis. Firstly, payroll cost has not been the driving force behind the recent growth in the share of public expense in GDP. Secondly, average wages have grown throughout the period despite the imposition during much of the period of a wage freeze. Wage drift due to annual increments, imbedded in civil service hiring conditions, imparts a gradual increase in cost despite attempts to control expenditures.

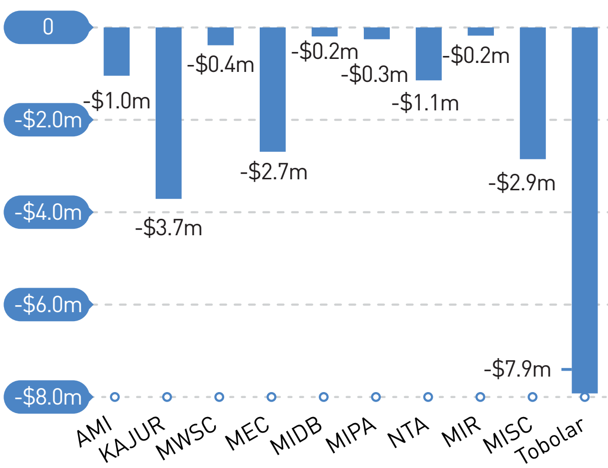
State-Owned Enterprise (SOE) Reform

The SOE sector, comprising a dozen public enterprises, has underperformed and poses significant costs and fiscal risks. Given the challenges posed by remoteness, small size, and dispersion, SOEs remain active in numerous crucial sectors of the RMI economy. While in some circumstances there are legitimate reasons for the state to subsidize the provision of key public services, for many years the RMI's SOE sector has underperformed, operating at an average annual loss of up to 7.6 percent of GDP and incurring average subsidies of 6.8 percent of GDP over the last three years, FY2019-FY2021. Figure 15 indicates virtually all of the RMI SOEs required a significant support over the same period. Furthermore, rates of return on assets and on equity over the period FY2018–FY2020 were –10 percent and –16 percent, indicating both poor performance and a negative return on government investments.

The government of the RMI enacted the SOE Act, which was almost immediately amended to reverse the restriction on the participation of government Ministers and

Figure 15: State-owned enterprises subsidies and capital transfers, average FY19–FY21

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



officials on boards. In response to these concerns, in 2015 authorities introduced an SOE Act that was designed to focus public enterprises on achieving commercial viability as well as strengthening governance structures and accountability. The Act included the requirements of annual Statement of Corporate Intent (SCI), Business Plans (BP), and the introduction of Community Service Obligation (CSO) contracts. Unfortunately, the law was almost immediately amended to reverse those reforms that had restricted the participation of government ministers and officials on SOE boards. The law was further amended in 2020 with further provisions concerning the appointment of public officials requiring at least one but no more than three such appointments. In 2022 the law was further amended removing both the Ports Authority and NTA from the list of entities covered by the SOE Act. These entities with majority public sector ownership are functionally SOEs and treated as such in the RMI statistics.

SOE monitoring unit was created to drive reform process. In 2018 an SOE Monitoring Unit (SOEMU) was created as part of the ADB PFMRR. The unit started with training of Ministry of Finance (MOF) officials and SOE key officials in the contents and implications of the SOE law. Once internal systems and templates were established to fulfill the unit's monitoring mandate, the SOEMU's consultant and 3 staff members began work on capacity-building within each SOE. In FY2019 and FY2020 virtually all SOEs had completed SCIs for review by the Nitijela and prepared BPs as required by the SOE law. For FY2022 a total of 8 BPs and SCIs were prepared and were ready for submission to the Nitijela.

Four SOEs were identified to develop Community Service Obligations, but only one is close to completing agreement. The design of the project was that once an SOE had achieved a degree of competence in financial and commercial management, existing subsidies would be replaced with contractual CSOs for the delivery of quantifiable services. A selected sample of SOEs: Air Marshall Islands (AMI), Majuro Atoll Waste Company (MAWC), Marshall Islands Shipping Corporation (MISC), and Tobolar were identified to develop CSOs for the delivery of specified services. However, with a lack of management capacity, suitably trained staff, reluctance to change management practices and onset of COVID-19 progress has been slow. Only one SOE, the Majuro Atoll Waste Company, is close to formalizing a CSO agreement.

COVID-19 has resulted in lost momentum in SOE reform but efforts to regain the lost ground are underway. The SOE project, given its small size, was initially successful in raising the level of awareness and management in the sector compared to prior years. However, the onset of COVID-19 and the impact on TA support, resulted in a slowdown in the earlier momentum and a reduced level of engagement of the SOEMU. This was unfortunate given the fiscal risk and cost of the sector but is understood to be under rectification now travel and TA support has recommenced. The project, clearly, warrants continued donor support and resourcing to consolidate the earlier gains and achieve full compliance with the SOE Act across the entire sector.

8. Private Sector Developments

The World Bank's "Doing Business" Survey

Although the World Bank's "Doing Business" survey has been discontinued it painted a discouraging view of the environment for private sector growth in the RMI. The World Bank's ease-of-doing-business survey has now been discontinued because an independent investigation found that senior World Bank officials had improperly influenced the results[15]. However, the survey provided a useful broad indicator and yardstick on the attractiveness of the business environment. From the 2020 DBS survey out of 190 countries the RMI ranked 153, 81 percent down the list, indicating that there was much room for improvement. The RMI fared worse than Palau but better than the FSM, which were ranked 145 and 158 respectively. This is substantially below most South Pacific nations. Samoa was ranked 98, Tonga 103, Vanuatu 107, Fiji 102, and Papua New Guinea 120. Overall, the RMI's scores were weak.

[15] "The World Bank's Doing Business Report", Congressional Research Service, October 29, 2021, Washington D.C.

> *World Bank's "Doing Business" survey places the RMI in the lowest 20 percent and indicates that the environment for private sector development is weak and needs reform.*

For example, their scores in the areas of registering property and protecting investors fell in the bottom decile of countries, while scores for providing electricity and resolving insolvency were also very weak.

Private Sector Registration and Licensing

Online upgraded business registration is needed for transparent identification of business ownership. An assessment of the private sector[16] for the RMI provides a useful analysis of the regulatory environment for the private sector. Many areas need reform. 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 system in the public domain would allow businesses to be legally identified for commercial transactions. The RMI lacks a national business licensing law although local governments do have the power to issue licenses and collect fees under the Local Government Act. This has led to a lack of transparency as well as discretionary decision making at the local level. Reforms could combine registration and licensing into a single process, but local governments would need to be compensated for their lost revenue due to this change.

Foreign Direct Investment (FDI)

The environment in the RMI for FDI is antiquated, overly bureaucratic, and in need of replacement with a modern system. FDI is implemented under the Foreign Investment Licensing Act 2005 but appears to have failed to simplify the process as the act was intended to do. FDI permitting is done manually and licenses take weeks or

[16] Pacific Private Sector Development Initiative, Republic of the Marshall Islands, Private Sector Assessment, Draft: July 15, 2016

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, and others have been fulfilled. To reduce uncertainty, an automated process is needed to allow other legal requirements to be fulfilled on a parallel timeline, as is required for any domestic enterprise. There is a substantial list of restricted activities, which appears not to be enforced. This lack of enforcement encourages "front" businesses, which hide illicit economic activity. In a modern FDI regime, businesses are only required to submit information required for statistical and monitoring procedures, and licenses are issued in just a few days.

Land Tenure

The Land Registration Authority (LRA) was introduced to support voluntary registration but start-up has been slow and needs reinvigoration. In the RMI, as in many Pacific Island 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 (i.e., protection against eviction) 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 means for custom owners to voluntarily register land via an accessible registry of land transactions. The Land Registration Authority (LRA) was introduced to implement the new legislation, but use of the LRA has been minimal. Despite the slow start, 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 a restart so that secure registration and leasing of land can support its critical role toward business and financial development.

Corporate and Shipping Registry

The IMF indicates the non-resident corporate and maritime shipping sector has been inadequately supervised. In the recent IMF Article IV consultations, the Fund indicates that financial integrity risks are concentrated in the non-resident corporate registration and shipping services sector. Under a long-standing and confidential agreement, the operation of these registries has been delegated to the Trust Company of the Marshall Islands (TCMI), which is a subsidiary of a US company, International Registries Inc. Oversight conducted by TCMI to ensure compliance with legal requirements was reported to appear ineffective, although a monitoring system has been introduced. Further no government body at present conducts any meaningful supervision.

A transparent evaluation of the costs and benefits of the Corporate and Shipping Registry remains needed to assure that the RMI is receiving its fair share of royalties. In addition to the financial integrity risks associated with TCMI, there is concern regarding the distribution of sovereign rents accruing from the activity. At the start of the amended Compact the RMI government received $1 million annually from the registry and $8.2 was received in FY2021. For FY2023 $10 million has been budgeted. However, there is a general lack of transparency and publicly available financial information on TCMI operations. As a result, the question arises whether or not the RMI receives its fair share of the royalties. However, it is known that in similar jurisdictions the host nations receive a far higher return. There is thus a need for a transparent evaluation of TCMI in light of perceived unfairness and possible underpayment of royalties that are due to the RMI. It is understood that the government commissioned a study some time back to evaluate this issue and to recommend a range of actions, but these are also not publicly available.

9. Compact Issues

The RMI Compact Trust Fund

FY2021 was the best year of investment performance during the amended Compact period to-date, resulting in the CTF growing from $514,429,278 at the end of FY2020 to $668,934,668 at the end of FY2021. The RMI CTF experienced an asset-weighted return of 23.78 percent during FY2021; these gains, combined with a scheduled contribution from the US of $19,528,450 million at the outset of the fiscal year, plus $5,000,000 as an RMI contribution of tax and trade compensation in April 2021, plus $2.4 million from Taiwan in May of 2021 and $250,000 from the RMI in September of 2021, enabled the fund to achieve its final balance of $668,934,668 on September 30, 2021, see Figure 16. During the period of investment since FY2006 (October 1, 2005) and based on the reported dates of deposits from public reports of the RMI CTF, the annualized asset-weighted rate of return through FY2021 had been 8.44 percent. The asset-weighted annual rate of return during the period since initial deposits in June 2004 had been 8.14 percent.

Further demonstrating the importance of the endpoints of reported data, as of this writing using the CTF value at the end of September 2022, the rate of return while invested from October 1, 2006, was down to 5.60 percent. As of September 30, 2022, the CTF value had declined to an unaudited value of $567,603,786 despite FY2022 contributions of $19,895,467 from the US, $5,000,000 from

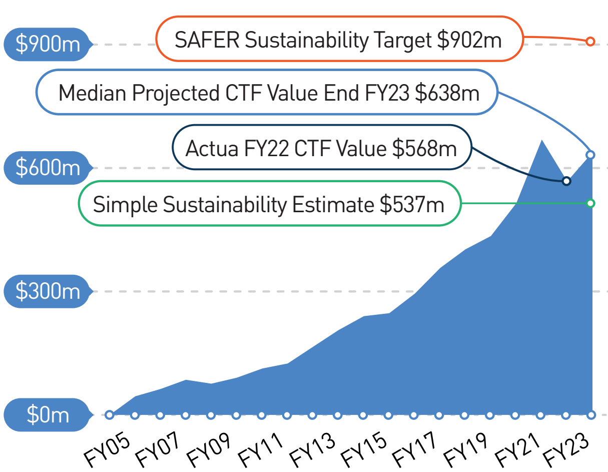
> *The median expected value of the RMI CTF at the end of FY2023, estimated at $638 million, would still be significantly below the $902 million estimated to be necessary to achieve sustainable distributions under modified (closer to optimal) CTF rules*

the RMI's tax and trade compensation, and $2,400,000 from Taiwan. The asset-weighted return for FY22 was an estimated 18.63 percent though confirmation of the dates of the three deposits will impact that result. The negative investment return in FY22 was only the fourth year with a negative return since FY04.

Prior GSUSA reports have placed substantial focus on the sustainability of the RMICTF in achieving a notional goal of replacing the fully-inflation adjusted value of FY2023 expiring grants from FY2024 onward. That analysis is herein reduced to a basic level given two key factors: first, inflation has spiked in the most recent two years and its path is not being sensibly projected by the Congressional Budget Office, our usual source for such projections; and second, the direction of the ongoing negotiations between the US and the RMI have the parties discussing a possible re-purposing of the RMICTF to achieve different objectives, apparently unrelated to the notional replacement of the FY23 expiring grants. Those negotiations continue in a non-public manner, so there is no clarity on the potential re-purposing and no assurance at all as to negotiated outcomes.

Figure 16: Compact Trust Fund balances through FY22 and for end of FY23

CTF losses in FY22 reduce the chances of achieving SAFER Sustainability target



So, notwithstanding the potential for a new paradigm in the purpose and/or use of the CTF, we briefly note that in order to replace the $27.6 million of expiring FY23 sector grants (only, not including SEG, audit support or disaster assistance) achieving sustainable and perpetual replacement in real terms would imply an RMI CTF size at the end of FY23 of $902 million. Assumptions include a geometric mean (average) real rate of return of 5.3 percent annually and a 95 percent confidence level for sustainability. The implied necessary level of the CTF is virtually unachievable with just 12 months and less than $30 million of remaining contributions above the September 30, 2022, balance of $567,603,786. An exceedingly unlikely annualized rate of return of 52.3 percent would be required to achieve the sustainability estimated value. Either relaxing the confidence level for sustainability or introducing some form of calibrated support to the CTF would reduce the cost of achieving sustainability. The former would place risks of facing fiscal cliffs on the RMI, while the latter would presumably require some form of conditional funding from the US.

Multiple providers of independent analysis point to a need for both administrative and technical or rules-based amendments to the CTF Trust Fund Agreement. No distribution rules would simultaneously allow for (i) protecting the real value of the

The scale of total US assistance to the RMI in relation to the size and fragility of the RMI economy begs for a successful outcome of ongoing negotiations for renewed Compact economic assistance.

CTF corpus, (ii) ensuring distributions at or near the real value of the FY2023 grants, and (iii) avoiding year-to-year volatility of distributions. Certain administrative issues have been raised pointing to the language of the CTF Agreement not being amenable to efficient administration when the distributions phase begins. In addition, recent independent studies have shown that technical improvements to the existing rules could provide objectively better results at no extra cost. Of course, making substantial improvements to the administrative and distribution terms of the CTF Agreement would require mutual agreement by the original parties, which for the US entails both executive and congressional approval.

Post-FY2023 Uncertainties

Annual Compact sector operating grants, Compact infrastructure grants, supplemental education grants, support for audits, and disaster assistance are scheduled to expire in FY2024. The loss of approximately $27.6 million annually of operating and infrastructure grants is targeted to be replaced through funding provided from distributions from the Compact Trust Fund; the other three items exceed $7 million annually, but the Compact Trust Fund was never intended to replace those additional flows. As the parties continue talks with the clear intent of achieving timely agreement—and authorization and appropriation by the US Congress—there is still a clear and present risk of delay. Delay could result in a substantial fiscal risk to the RMI. Without amendments to the CTF Trust Fund Agreement, the amount that could be legally distributed from the CTF for FY2024 could not be known until at least several weeks into the new fiscal year. No provisions would be in place for the three above-mentioned additional funding flows, and special attention would be required to ensure federal programs could continue even if funding for such programs were authorized and appropriated. It would clearly be in the RMI's best interests if CTF distributions could be forestalled and if "bridge funding" could be appropriated to maintain fiscal stability in FY2024 and as needed.

The scale of total US assistance to the RMI in relation to the size and fragility of the RMI economy, especially post-COVID-19, begs for a successful outcome of ongoing negotiations for renewed economic assistance under the Compact. The RMI leadership is in a challenging position where they are required to seek positive negotiating results that would allow the RMI to respond favorably to renewal terms; however, the leadership must also prudently prepare for an unlikely, but far less beneficial, outcome that would bring on a period of unwelcome fiscal compression as early as October 2023.

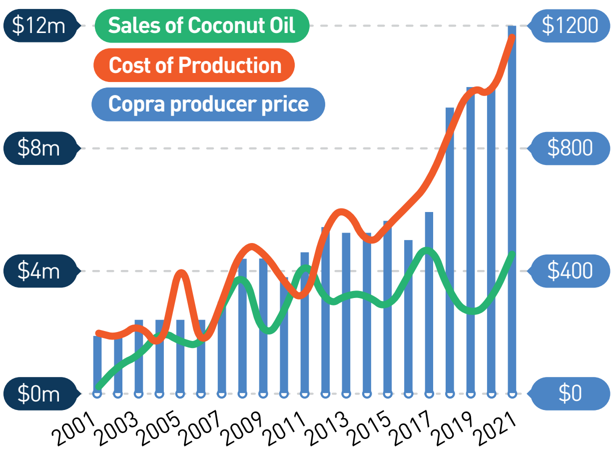
10. Other Issues

Outer atoll income-support mechanisms

Increase in copra producer prices to levels well above world market prices to support outer atoll incomes represents a significant fiscal issue. Related to the recent rapid increase in subsidies to the SOE sector, subsidies to Tobolar, the copra processing plant, has been a major contributing factor. Tobolar collects copra from households/ producers in the outer atolls at subsidized prices, processed into coconut oil in Majuro and exported to world markets at prices generally below the cost of operations (see Figure 17). Since FY2014 Tobolor has operated at an increasing level of loss which maxed out at $7.1 million in FY2021. This loss has been matched by an increasing level of subsidy to maintain financially viable operations.

Support to outer island households has become a high-priority social objective of the government. The rapid increase of the subsidy since 2014, which was originally intended as a temporary, pre-Christmas bonus in 2015, has now become a permanent feature of the budget and represents a significant additional element of fiscal cost. This review and the recent IMF Article IV[17] report have argued for development of a more direct and targeted social protection system for outer island income support. The IMF argues that the current system of redistributing income is inefficient and distortionary. Farmers are subsidized independently of their income level

Figure 17: Sales and cost of coconut oil operations & copra producer prices
Producer prices rise rapidly and Tobolar runs large operating deficits since 2011



and a high copra price reduces incentives for farmers to change to other, commercially more viable crops. While these arguments have validity, the cultural and communal nature of island communities have developed effective redistribution mechanisms and in reality, there are few alternative viable cash crops in resource scarce atolls that could provide an alternative source of income. The development of more economically efficient income redistribution mechanisms therefore needs to be examined critically before implementation.

Statistical Issues

The RMI has significantly improved the nation's economic statistical systems. In prior Graduate School USA reviews of the RMI, statistical availability has been found to be satisfactory. Since the start of the amended Compact the RMI has developed a wide range of statistics that enable the monitoring of economic performance. The set of annual economic statistics is generally produced 11 months after the end of the fiscal year, and a new set of quarterly indicators is now being prepared in time

[17] Ibid

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 Joint Economic and Fiscal Accountability Committee (JEMFAC) annual meeting. In some years a preliminary set of statistics has been prepared to support budget preparation and periodic International Monetary Fud (IMF) missions. Due to COVID-19 this cycle has been interrupted due to the inability of the auditors to visit the RMI. However, this is anticipated to return to normal now that the RMI has lifted its COVID travel restrictions, although the introduction of a new FMIS poses risk that may delay audit availability.

The absence of modern tax administrative software for both customs and domestic taxation has been a particular area of weakness. The 2021 IMF Article IV staff review found "*Data provision is broadly adequate for surveillance…though some shortcomings tend to constrain policy analysis, including limited coverage and timeliness of data releases.*" Weak data systems in Tax and Customs for both trade and the gross revenue taxes inhibit comprehensiveness and timeliness. It is understood the RMI will be introducing Asycuda for customs administration and this will dramatically improve the provision of trade statistics and overlaps with the compilation of many parts of the economic statistical system: the balance of payments and GDP by expenditure. Introduction of modern tax administration software for domestic taxes would not only improve compliance but also enable the provision of up-to date data on which the national accounts are based.

Population and Migration Issues

Population projections for the RMI made at the time of the 2011 census estimated a level in the 54,000—55,000 range for 2021. In previous economic reviews and briefs the Graduate School had estimated the

> *Large reductions in the population indicated in the recent census raises issues of validity and reliability for planning.*

2020 RMI population to be 54,962. This was derived from the 2011 census of population estimate of 53,138. SPC had also projected a similar population level of 54,456 for 2021, while the UN projected a higher figure of 59,600 for 2021[18].

The new population census for 2021 released a preliminary figure significantly lower than the prior projections. The new 10 year Census was conducted in September 2021. By November 2021 a preliminary population count of only 39,262 persons was released to both domestic and international surprise and concern. Substantial additional work has since been undertaken on both enumeration follow-ups and validation comparisons against other data sources. Final Census results have not yet been published, but this report assumes a 2021 population level of 42,500 which it is anticipated will be close to the final census result when it becomes available.

The census results were totally unanticipated and led to questions concerning validity. A reduction in population of 10,600 or 20 percent compared with 2011 was a remarkable reduction given the earlier projections. It raised serious questions about the validity of the results that a reduction of this magnitude could have occurred in a short time period. There was an absence of other potential flags. For example, employee numbers from Social Security data have been remarkably stable and increased slightly during 2011-2021.

However, there are clear indications that net out migration has increased since 2011. The US Department of Transportation "Net air

[18] United Nations Department of Economic and Social Affairs/Population Division, World Population Prospects, 2019.

passenger" data, was not credible for 2012-2016, but averaged -1,950 during 2017-2019 (when data improved), up compared with the 1,055 average over the 1991-2011 period. The Graduate School has liaised with domestic airline sources and RMI Immigration to derive estimates of -651 for 2020 and -2,515 for 2021. In much of 2020 there were no RMI passenger flights, but after resumption there was a long period when passengers could depart freely. However, arrivals were highly restricted through much of 2021. The 2020-21 average of -1,583 per annum was a net drop on the pre COVID 2017-2019 period.

Increase in migration noted in GAO study. A GAO study[19] that analyzed US Border control data over 2017-2019 for RMI passport holders estimated -1,450 persons per annum. This is less than the GS estimates but also a substantial pickup from the previous intercensal period.

Implied migration rates seem unlikely in comparison to available data. SPC reran their model to assess the level of out-migration that would be needed to reduce the population to the anticipated 2021 Census level. This was indicative only as the method assumed a set of age distributions and fertility rates. The exercise implied that net migration would have had to have averaged close to 2,250 in each year of the 2012-2021 period. The available migration data while only partial is suggestive that this level may be too high.

There is a need for a further exercise to validate the recent census estimates. There has clearly been a substantial shift in the RMI migration dynamic, supported anecdotally by empty houses especially in the outer islands, but also elsewhere. SPC and EPPSO have not been able to identify any obvious unusual Census undercount and have made strong efforts to validate the census. Ideally the Census would have included a post-enumeration survey, an increasingly standard approach to measuring the percentage undercount. In lieu of this an urgent household listing exercise has been recommended. This is needed to prepare for the HIES and MICS sample surveys, but if done promptly could also provide backup for the surprisingly low Census result.

[19] US GAO, Compacts of Free Association: Populations in US Areas Have Grown, with Varying Reported Effects, GAO-20-491, June 15, 2020.

11. The Reform Agenda

Progress with Reform

Progress with the reform agenda has been weak despite numerous commitments. 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) in 2009 were not implemented. At the same time a Tax and Revenue Reform and Modernization Commission (TRAM) was established but failed to garner momentum to initiate the tax reform proposal, although there has been some renewed interest of late. While the SOE Act has become law and progress has been made through the creation of the SOEMU, adoption of the "best practices" enshrined in the Act have yet to be well established. In May 2021, a draft of the Fiscal Responsibility and Debt Management Act was passed by the Nitijela into law. Unfortunately, due to the onset of COVID-19 the bill had been inadequately vetted and failed to include restraint on government behavior to budget all available revenues as well as other prudent policies. The Act now needs major revisions before it is ready to act as a guide for the conduct of responsible and transparent fiscal policy.

Long-Term Fiscal Issues

> *The RMI will need to improve its commitment if it wishes to attain lasting reforms and improved long-term economic and fiscal management.*

Since FY2019 the RMI has been running a significant structural fiscal deficit, which has been disguised by the inflow of large grants during COVID-19. With a boom in sovereign rents, the RMI embarked on a series of expansionary budgets in FY2015 through FY2019. During this period expenses grew by an average of 11.2 percent while revenues only grew by 8.8 percent, which resulted in a growing fiscal problem. During FY2015-FY2018 a fiscal surplus averaging 3.4 percent of GDP was achieved, but by FY2019 rising expenditures outstripped revenues and a 1.8 percent deficit was recorded, which indicated an emerging structural deficit and a need for adjustment. Then in FY2020 COVID-19 hit, which resulted in a large influx of aid and budgetary support and created a fiscal surplus of 2.4 percent in FY2020. A smaller surplus of 0.7 percent has been estimated for FY2021. However, in FY2022 the earlier emergence of a structural deficit in FY2019 is likely to recur. Without a major infusion of donor funds, significant deficits of 2.6 percent and 2.9 percent are projected for FY2022 and FY2023, respectively. After all accumulated unspent donor resources have been spent and a new Compact period begins, budgetary adjustments will be necessary.

While the outcome of the coming Compact renewal process looks encouraging, the RMI could under less favorable circumstance need to adjust to a lower level of sustainable funding. In addition to the need to correct the current structural deficit, the details of a new period of Compact assistance post-FY2023 remain to be finalized. While it is likely the current package of economic assistance will continue, a less favorable outcome or delays are possible. In the latter scenario the RMI would be required to rely on drawdowns from the Compact Trust Fund (CTF). As part of the

GSUSA's CTF analysis[20] the median value of the projected CTF is estimated to attain a target value sufficient to sustain a perpetual drawdown equivalent to 79 percent of the projected FY2023 inflation-adjusted level of grants, projected to be $28.2 million. This implies that in the median case a reduction in drawdowns of 31 percent or $8.7 million would be required. Thus, in addition to the existing need to correct the emerging structural deficit, the RMI would need to adjust to a lower level of sustainable funding in a new Compact era.

Commitment to Reform

The RMI will need to change past practices if it wishes to attain lasting reforms and improved long-term economic and fiscal management. The above discussion indicates that there remains uncertainty about the details of Compact renewal and that the RMI is about to enter a period of structural deficit. However, while donor support to assist the RMI during a cyclical event is appropriate, the RMI also needs to design reforms for internal adjustments in order to rectify a structural deficit. Such reforms might entail a two-pronged approach. First, to revise the Fiscal Responsibility and Debt Management Act in order to reverse a portion of the recent expansion of budgeted expenditures. Such revisions would set the nation on a path of long-term fiscal sustainability. Second, the reform agenda outlined in the CAP, TRAM, and SOE Act all remain highly relevant and in need of implementation. 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 continuing donor support to provide the right incentives and conditions to foster a better result.

[20] Economic Review RMI FY2018, Honolulu, 2019; ***https://pitiviti.org/marshall-islands***.

RMI summary economic indicators, FY15-FY21

	FY15	FY16	FY17	FY18	FY19	FY20	FY21
Per Capita Income measures							
GDP current prices, $ million	183.0	200.7	212.7	219.3	232.1	241.7	259.5
Population	50,155	49,028	47,376	45,810	44,665	44,519	42,500
GDP per capita $	3,649	4,094	4,490	4,788	5,196	5,430	6,107
GNI per capita $	**4,886**	**5,261**	**5,621**	**5,968**	**6,425**	**6,604**	**6,911**
GNDI per capita $	5,968	6,337	6,677	7,151	7,807	8,521	9,073
National accounts							
GDP, at constant prices $ million, FY2015 prices	**183.0**	**186.7**	**193.1**	**201.2**	**223.0**	**218.8**	**221.3**
GDP, % growth	**2.1**	**2.0**	**3.4**	**4.2**	**10.8**	**-1.8**	**1.1**
GDP, % growth (excluding purse seine fishing boats)	1.5	2.0	2.5	3.1	2.6	-1.7	-1.1
Prices (annual percent change)							
Consumer price index	-2.2	-1.5	0.1	0.8	-0.1	-0.7	2.2
Employment and Wages							
Number of employees	**10,744**	**11,061**	**11,283**	**11,404**	**11,404**	**11,182**	**11,294**
% change	-0.9	3.0	2.0	1.1	0.0	-1.9	1.0
Private sedctor	4,147	4,228	4,278	4,288	4,218	3,957	3,837
% change	-6.1	2.0	1.2	0.2	-1.6	-6.2	-3.0
Public sector	5,103	5,207	5,337	5,401	5,540	5,603	5,792
% change	2.6	2.0	2.5	1.2	2.6	1.1	3.4
Average annual wage	**10,180**	**10,539**	**10,802**	**11,151**	**11,913**	**12,489**	**12,735**
% change	3.9	3.5	2.5	3.2	6.8	4.8	2.0
Private sector	5,814	6,006	6,264	6,704	7,402	7,772	7,904
% change	4.4	3.3	4.3	7.0	10.4	5.0	1.7
Public sector	9,381	9,772	9,867	10,274	10,687	10,988	11,319
% change	1.6	4.2	1.0	4.1	4.0	2.8	3.0
Average annual real wage (less inflation)	**9,147**	**9,365**	**9,420**	**9,457**	**9,162**	**8,577**	**9,524**
% change	2.2	2.4	0.6	0.4	-3.1	-6.4	11.0
Government Finance Statistics, $ millions							
Revenue	**108.6**	**122.4**	**145.5**	**138.6**	**148.4**	**169.8**	**174.3**
Tax revenue	25.9	28.9	30.4	32.1	34.9	33.5	35.9
Grants	58.7	59.1	65.3	67.3	71.9	93.6	101.2
Other revenue	23.9	34.4	49.9	39.2	41.5	42.6	37.2
Expense	**-96.4**	**-108.4**	**-123.2**	**-122.9**	**-146.5**	**-149.7**	**-152.4**
Compensation of Employees	-41.4	-42.4	-45.9	-48.2	-50.8	-52.7	-58.0
Use of goods and services	-26.3	-32.0	-32.2	-36.8	-50.0	-43.5	-44.0
Other expense	-28.8	-34.0	-45.2	-38.0	-45.7	-53.5	-50.5
Net Worth and its Changes	**-12.1**	**-14.0**	**-22.3**	**-15.7**	**-1.9**	**-20.1**	**-22.4**
Nonfinancial assets	-7.0	-6.2	-12.9	-10.1	-6.1	-14.3	-20.0
Financial assets	-2.3	-5.8	-10.0	0.0	-2.1	-8.1	-3.1
Financial liabilities	-2.9	-2.0	0.7	-5.6	6.3	2.3	0.7
Overall fiscal balance	**5.2**	**7.8**	**9.4**	**5.6**	**-4.2**	**5.8**	**1.9**
(In percent of GDP)							
Revenue	**59.3**	**61.0**	**68.4**	**63.2**	**63.9**	**70.2**	**67.2**
Taxes	14.1	14.4	14.3	14.7	15.0	13.9	13.8
Grants	32.1	29.4	30.7	30.7	31.0	38.7	39.0
Other revenues	13.1	17.1	23.4	17.9	17.9	17.6	14.3
Domestic revenues	27.2	31.5	37.7	32.5	32.9	31.5	28.2
Expense	**-52.7**	**-54.0**	**-57.9**	**-56.0**	**-63.1**	**-61.9**	**-58.7**
Compensation of Employees	-22.6	-21.1	-21.6	-22.0	-21.9	-21.8	-22.3
Use of goods and services	-14.4	-15.9	-15.1	-16.8	-21.5	-18.0	-17.0
Non Financial Assets	-3.8	-3.1	-6.1	-4.6	-2.6	-5.9	-7.7
Overall fiscal balance	**2.8**	**3.9**	**4.4**	**2.6**	**-1.8**	**2.4**	**0.7**

RMI summary economic indicators, FY15-FY21 cont'd

	FY15	FY16	FY17	FY18	FY19	FY20	FY21
Money and Banking ($ million)							
Assets	189.4	220.4	261.8	257.0	245.9	293.8	324.8
Foreign assets	87.6	115.4	135.7	129.2	113.6	155.3	193.2
Loans	89.6	101.1	119.7	120.6	126.8	130.2	122.3
Commercial loans	27.0	35.1	44.7	43.7	51.5	54.5	49.8
Consumer loans	62.6	66.0	75.0	76.9	75.4	75.7	72.6
Other	12.2	3.9	6.4	7.2	5.5	8.3	9.3
Liabilities	189.4	220.4	261.8	257.0	245.9	293.8	324.8
Deposits	152.9	183.3	227.2	219.7	208.9	254.4	284.1
Other	6.0	6.6	5.4	7.0	5.6	7.0	7.3
Capital	30.4	30.5	29.1	30.3	31.5	32.3	33.4
Loans to deposit ratio, %	58.6	55.2	52.7	54.9	60.7	51.2	43.1
Balance of Payments $ million							
Trade balance	-53.9	-49.6	-53.3	-63.0	-135.4	-57.2	-32.7
Service balance	-37.2	-37.0	-46.3	-43.8	-45.7	-33.6	-28.2
Primary Income balance	62.0	57.2	53.6	54.1	54.9	52.3	34.2
Secondary Income balance	54.3	52.8	50.0	54.2	61.7	85.4	91.9
Current Account, balance	25.2	23.4	4.0	1.5	-64.4	46.9	65.2
Capital Account, balance	16.1	18.3	20.1	16.5	13.0	15.0	13.2
Financial account balance	-3.5	-8.8	-10.7	20.9	90.9	-31.0	-31.3
International Investment position (IIP), $ million							
Total stocks, net	253.9	277.2	308.7	309.7	302.0	348.3	
Direct investment, net	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	
Portfolio investment, net	256.0	245.9	251.5	253.6	255.5	254.8	
Other investment, net	-2.1	31.2	57.2	56.1	46.5	93.5	
memo: COFA Trust Fund	259.1	307.8	372.1	418.4	450.4	527.3	666.4
External Debt, $ million							
Gross External Debt Total	89.0	83.5	77.9	72.5	67.5	61.2	55.6
Gross External debt as % of GDP	48.6	41.6	36.6	33.1	29.1	25.3	22.0
Debt Service	7.6	6.9	7.9	7.1	7.6	6.7	6.7
Debt service as % of national gov. revenues	14.4	10.4	9.5	9.5	9.8	7.3	7.0

2022 ECONOMIC BRIEF

Republic of the Marshall Islands

November 2022

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 RMI and the U.S. Department of the Interior's Office of Insular Affairs to fulfill their respective reporting requirements under RMI's Compact of Free Association with the United States.

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