## Republic of the Marshall Islands

# Fiscal Year 2011 Economic Review

### PRELIMINARY REPORT

*August 2012*

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

EconMAP
Economic Monitoring & Analysis Program
www.econmap.org

Graduate School USA
Pacific Islands Training Initiative
www.pitiviti.org

## Currency Equivalents

| | | |
|---|---|---|
| Currency Unit | — | United States Dollar (US$) |

## Abbreviations

| | | |
|---|---|---|
| ADB | — | Asian Development Bank |
| Amended Compact | — | The second phase of the Compact, FY04-FY23 |
| CIP | — | Capital Improvement Project |
| Compact | — | RMI Compact of Free Association with the US |
| Compact I | — | First 17 years of the Compact, FY1987-2003 |
| CTF | — | Compact Trust Fund |
| EPPSO | — | Economic Policy, Planning, and Statistics Office |
| FDI | — | Foreign Direct Investment |
| GDP | — | Gross Domestic Product |
| IMF | — | International Monetary Fund |
| MEC | — | Marshalls Energy Company |
| MIDB | — | Marshall Island Development Bank |
| MIITF | — | Marshall Island Intergenerational Trust Fund |
| MISSA | — | Marshall Islands Social Security Administration |
| MTBIF | — | Medium Term Budget Investment Framework |
| NTA | — | National Telecommunications Authority |
| NGO | — | Non-Governmental Organization |
| PM&O | — | Philippines Micronesia and Orient Line |
| PSE | — | Public Sector Enterprise |
| PSRP | — | Public Sector Reform Program |
| RIF | — | Reduction in Force |
| ROC | — | Republic of China |
| RMI | — | Republic of the Marshall Islands |
| TA | — | Technical Assistance |
| US | — | United States of America |
| VAT | — | Value Added Tax |

## Note

The Government's fiscal year (FY) ends on September 30.

# Table of Contents

# Figures

## FOREWORD

This report presents the preliminary findings and conclusions of the FY2011 RMI Economic Review. The purpose of the Review is to assist the governments of the Republic of the Marshall Islands (RMI) and the United States of America (U.S.) in fulfilling their respective reporting obligations under the Compact of Free Association. The RMI is required under Title One, Section 215, to report to the President of the United States on the use of sector grant assistance and progress in meeting mutually agreed-upon program and economic goals. In the case of the U.S., under Title One, Section 104.h, the President is required to submit a similar report to the Congress concerning developments in the RMI.

This report was prepared with funding assistance from the U.S. Department of the Interior, Office of Insular Affairs, and administered by the Graduate School USA. It is not intended to directly fulfill the reporting requirements of the two governments, but rather to assess RMI's economic performance and policy environment, and to provide an updated set of economic statistics. Much of the material will be directly relevant to the two reports. However, the reporting requirements of the two governments are different; thus, not all the material will be relevant to both reports.

This report is also available online at http://www.econmap.org.

Mark Sturton

## Executive Summary

After a weak start in the first year of the amended Compact when economic growth was stagnant, the next three years FY2005-FY2007 saw positive growth averaging 2.6% as the nation adjusted to improved provisions of the Compact. In FY2008-FY2009, growth turned negative—as it did in many countries during this period—with the onset of the international recession. However, FY2010 turned out to be a particularly favorable year for the RMI, with strong economic growth of 5.6% resulting from low inflation and expansion in the fisheries sector. In FY2011 the economy weakened, but growth remained positive at 0.8%. Employment data indicates that the economy has managed to generate a number of additional jobs amounting to 0.6% per annum during the amended Compact. Both the private and public sectors have grown, despite declines at the Kwajalein military base. However, the generation of additional jobs has been insufficient to provide gainful employment opportunities for those seeking work, and outward migration remains substantial, averaging 1.7% annually during the amended Compact period.

The failure to prepare the RMI single audit in time for this Preliminary Economic Report has curtailed analysis, and discussion has therefore been limited to the information on hand. After a period of fiscal stagnation at the end of Compact I, the RMI went through a period of rapid public sector expansion at the start of the amended Compact through FY2007. Public expenditures grew by an annual average rate of 10% between FY2004 and FY2007, and employment in the public sector expanded by an annual average rate of 2.8% over the same period. The various forces that had permitted the rapid expansion came to a halt in FY2007, and the government was left in a stressed fiscal position suffering a tight cash flow. Total public expenditures have been held in check since that time, but the government went through periods of default on debt service, delays in vendor payments, payroll and negative unreserved general fund balance. The fiscal position is now less stressed but huge challenges remain. Debt service now represents 8% of the general fund, and annual subsidies and capital transfers to the troubled State-Owned Enterprise sector represent 19% of the general fund, respectively. Meanwhile, the annual decrement in Compact funding is declining in real terms, requiring an increasing proportion of general fund revenues to support essential services in education and health.

Cognizant of the economic and financial circumstances facing the nation, the RMI leadership initiated a series of reforms. The Comprehensive Adjustment Program (CAP) Advisory Group, and the Tax and Revenue Reform and Modernization Commission (TRAM) were created, and the reports of both of these groups were endorsed by the Cabinet. A report on the SOE sector was initiated, and the MEC adopted a comprehensive recovery program. The ADB is supporting these reform efforts through a Public Sector Program which includes a loan to refinance the external debt of the MEC. However, as the review of the current status of the PSP indicates, while some reforms, such as energy and tax reform, are on track, others, such as expenditure compression and the generation of sustained fiscal surplus, are not.

The RMI committed itself in FY2008 to wide range of economic reforms. At the end of FY2011 a new government was formed and the reform agenda passed on to a new team. At the end of Compact I the RMI embarked upon a similar reform agenda. Although some progress was achieved initially, little was sustained. The RMI currently faces declining real transfers under the Compact and an anticipated shortfall in the Compact Trust Fund, suggesting the need to reform is now more important than ever. It remains to be seen whether the nation can engender the necessary resolve to implement outstanding reform commitments.

The Trust Fund for the People of the RMI was created "to contribute to the long-term budgetary self-reliance of the RMI… [and] to provide the Government of the RMI with an ongoing source of revenue after FY2023." The US Government has made it clear that the amended Compact and its subsidiary agreements contain no commitments that the Trust Fund will sustainably achieve distributions to maintain the real value of sector grants after 2023. It is thus important that the RMI Government assess Trust Fund performance against a sensible goal. That sensible goal is the projected ability of the Trust Fund to support a smooth and sustainable transition from US-appropriated annual grants to annual Trust Fund distributions.

Such a "sustainability estimate" is presented herein to inform key decision makers well in advance of the Trust Fund distribution period. The sustainability estimate for the end of FY2023 is $748 million. In order to be precisely "on-track" to achieving that level, the value would have grown to $183 million as of June 30, 2012; however, the actual value of the RMI Trust Fund was $158 million. This difference of $25 million leaves the Trust Fund 12.9 percent "below track" after 8.75 years of the projected accumulation period. The growth rate required to "catch-up" is 9.0 percent. This rate of return is achievable over the remaining 12.75 years, though by no means assured. It is recommended that policy makers mobilize additional contributions—from domestic and external sources—to the Trust Fund. It is further recommended that the parties to the Trust Fund consider changes to the Trust Fund Agreement. The current Trust Fund rules are likely to result in immense and repeated fiscal shocks that could be reduced in severity and frequency through better design.

# I. ECONOMIC PERFORMANCE

## *The Economy*

FY2004 marked the start of the amended Compact, and the RMI negotiated a favorable assistance package that resulted in an increase in funding of $10 million above the prior five year period of Compact I (FY1997-FY2001). However, the economy stagnated overall, primarily resulting from the closure of the fish loining plant and capacity constraints in utilizing additional fiscal resources.

By FY2005, the substantial increase in Compact resources over those prevailing during Compact I had reached a peak. Greater capacity utilization of the available resources enabled the economy to expand. The private sector maintained economic activity, with additional investment demand arising from the Compact infrastructure grant, renovation of the Majuro airport, the ROC-funded convention center, and reconstruction of the Majuro fish loining plant under new ownership.

After a weak start the RMI shows favourable growth in the initial years of the amended Compact.

By FY2008 the economy had peaked, and GDP fell by -1.9%. The initial wave of Compact infrastructure construction projects had come to fruition, and further expansion in government was no

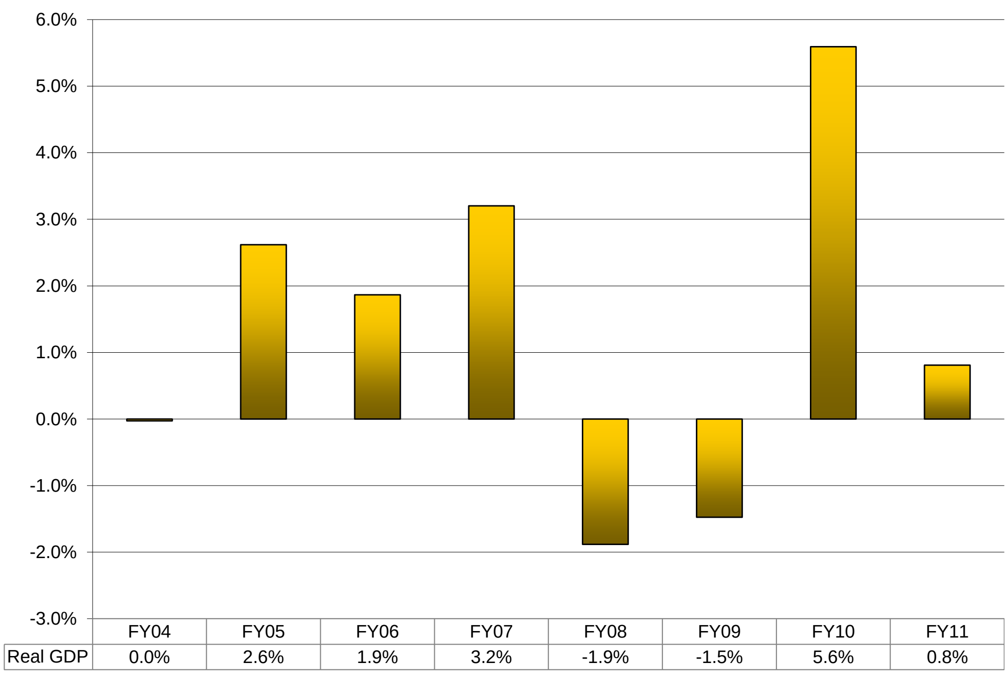



Figure 1 RMI Real GDP Growth

Recession hits the RMI in 2008 as further fiscal expansion is no longer possible and rapid inflation erodes the value of incomes.

longer possible as expenditures hit their ceilings. FY2008 also saw the end of rapid expansion in the world economy as fuel and food prices reached record levels. Inflation in the RMI reached 15%, eroding domestic real incomes and reducing demand for local business. Compounding these problems, the Marshalls Energy Company (MEC) underwent a severe cash flow crisis as fuel prices reached record levels, requiring substantial cash infusions from government. These forces prompted the RMI leadership to declare a first-ever “state of economic emergency” in late FY2008. In FY2009, while inflation eased back to 0.7% and reduced the erosion in household incomes, the same general economic forces exerted themselves, and GDP fell again by a further -1.5%.

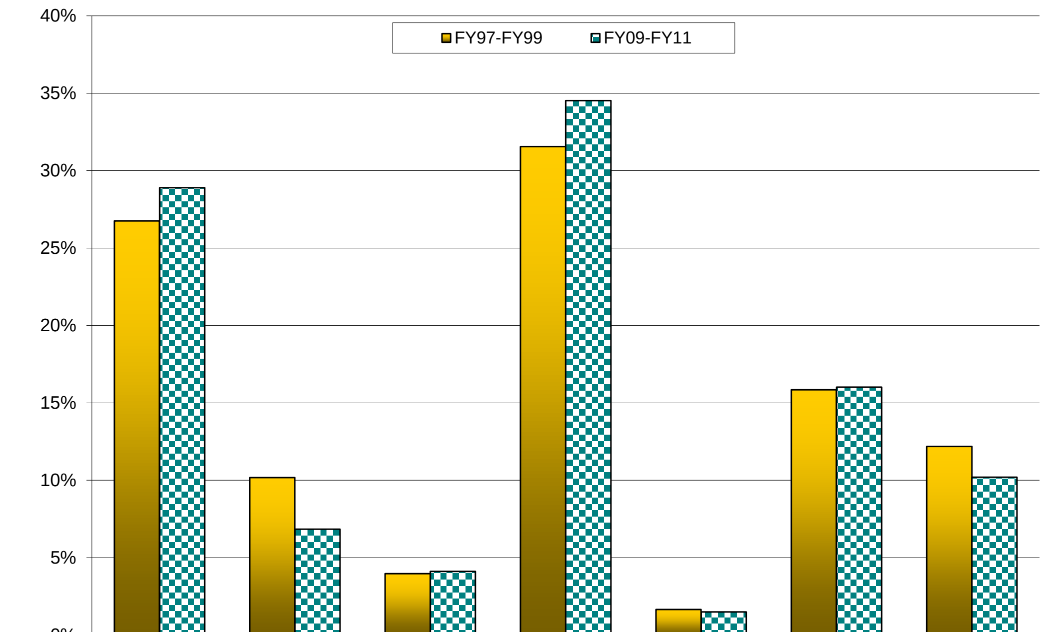
Economy experiences strong growth in FY2010 driven by expansion in fisheries, but was sluggish in FY2011

In FY2010, the RMI economy grew by 5.6%—a surprise, given world economic conditions. The main driving force was expansion in the fisheries sector, which contributed half of the overall growth with increased output from the reopened loining plant and the addition of new purse seiners to the fishing fleet. Education and health services also continued to expand throughout FY2010, producing a positive result with spillover to other sectors. Improved tax collections also contributed to growth, although these gains were largely offset by increased subsidies to the SOE sector.

Economic performance in FY2011 was lackluster with disappointing performance in the productive sectors of the economy. The contribution of fishing remained positive with a full year of operation of the new purse seiners commissioned in FY2010, but production at the loining plant was held back by labor shortages. Manufacturing output fell, reflecting lower international prices for coconut oil. Construction activity was also weak as the FAA road airport realignment project was held up due to environmental concerns. Output in education and heath expanded with recruitment of new teachers at the College of the Marshall Islands having a significant impact. Overall GDP grew by 0.8%.

Share of government increases significantly over 10 year period

Given the rapid rate of growth in public expenditures, the contribution of government to GDP grew significantly, increasing from 32% between FY1997 and FY1999, to 35% over the past two years (Fig. 2). Public enterprises as a share of GDP fell by 3%, reflecting a large increase in subsidies. The deteriorated position of the SOEs led to a decline in the public sector’s share of GDP (including both government and SOEs) from 42% to 41%. The private sector has increased its contribution, but the small increase indicates an inability to assume a more dynamic role as an engine of economic growth. The share of indirect taxes has fallen by 2%, which reflects discretionary reductions in tax rates, and weak collections.




| | Private Enterprise | Public Enterprise | Finance (Banks) | Government | NGOs | Households | Indirect taxes |
|---|---|---|---|---|---|---|---|
| FY97-FY99 | 26.8% | 10.2% | 4.0% | 31.5% | 1.7% | 15.8% | 12.2% |
| FY09-FY11 | 28.9% | 6.8% | 4.1% | 34.5% | 1.5% | 16.0% | 10.2% |

Figure 2 Structure of the RMI Economy by Institutional Sector.

The finance sector shows some increase, while the share of households and NGOs remain largely unchanged.

Real incomes grow strongly between 1981 and 1995, but collapse as Compact money dries up in the late 1990s.

Fig. 3 shows the changes in constant price per capita GDP since 1981. The advent of the Compact in the late 1980s saw a large improvement in income levels in the run-up to the Compact. After a period of stagnation in the earlier years, growth was boosted in the early to mid-1990s through a series of bond issues that enabled the nation to embark on a number of risky ventures. However, the gamble on public sector involvement in productive activities did not pay off, and the nation was forced into a difficult period of decline as the economy adjusted to low levels of net aid transfers depleted by the need to repay failed investments.

Real incomes improve during the initial part of the 2000s.

Ground lost in FY2008 and FY2009 due to the world recession is regained in FY2010 and FY2011.

In FY2000 matters improved, as fiscal stability was restored with new donor assistance, repayment of debt, and a favorable financial outcome of the amended Compact negotiations. Between FY2000 and FY2007, GDP per capita expanded by $368, or at an average annual rate of 2.1%. However, it failed to regain the level achieved in the mid-1990s. In FY2008 and FY2009 GDP per capita faltered and took a downward turn as the economy went into recession, but regained the lost ground with strong economic growth in FY2010 and a small improvement in FY2011.

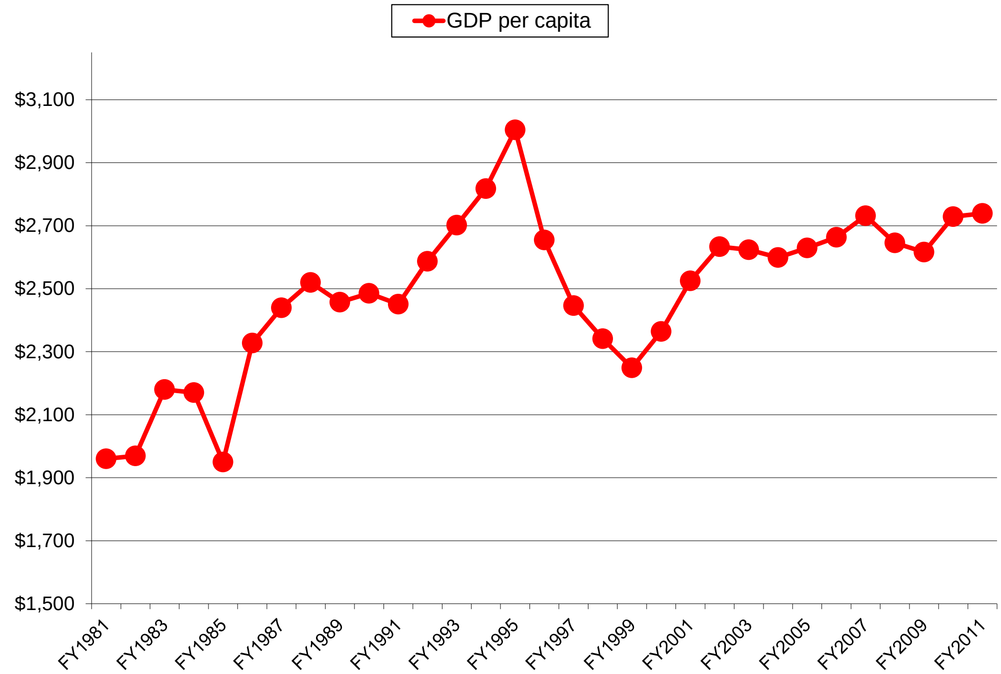



Figure 3 Constant GDP per capita, 2000 prices

## *Population, Migration and Employment*

Failure to generate sustained economic growth results in substantial out-migration.

Population in the RMI has historically grown at very high rates. During the period 1980-1988, in the lead-up to Compact I, the annual average rate of growth was 4.3%. This pattern changed radically between the next two census points in 1988 and 1999. Population growth slowed down significantly to 1.5%, reflecting the emergence of large out-migration to the U.S. under the provisions of the Compact. Results from the recent population census indicate that these trends continued between 1999 and 2010 and population growth has been further reduced to 0.4%. Indicators based on net movements of air passengers departing the RMI indicate that out-migration as a percent of the population reached 2.4% between 1997 and 2003 and 1.7% during the amended Compact. Clearly, the limited job opportunities and depressed economy of the late 1990s encouraged large-scale out-migration in search of employment opportunities and higher wages in the U.S. While economic performance has improved during the amended Compact, earnings differentials with the U.S. continue to provide a strong motivation to emigrate.

From a stagnant level of employment in the late 1990s, public sector employment expanded strongly between FY1999 and FY2007, growing by 29% or at an annual average rate of 3% (Fig. 4). This reflects growth not only in the national government, buts also in the SOEs. From FY2007 through FY2011, however, the public sector has failed to provide further job opportunities and employment levels remain largely unchanged. Developments in private sector employment in the first part of the 2000s were dominated by public-sector-led expansion in the economy and the opening of the PMO fish loining plant in FY2000. In FY2005 employment in the private sector fell with the closure of PMO, but expanded in FY2006 and FY2007 as construction activities created a strong demand for additional labor. In FY2008 the fish loining plant reopened and the fisheries sector created an additional 822 jobs by FY2011, although many were part-time. These developments helped offset the decline in construction activity, as well as the loss of jobs at the Kwajalein military base. As a result, employment expanded strongly between FY1999 and FY2004, at an annual rate of 4.9%. However, between FY2004 and FY2011, an additional 329 jobs have been created and employment creation has averaged significantly less, at 0.6% per annum.

Strong job growth in the early 2000s in both public and private sectors.

Employment growth has been erratic since FY04, but has remained positive despite peaking in the public sector and reductions in the Kwajalein base.

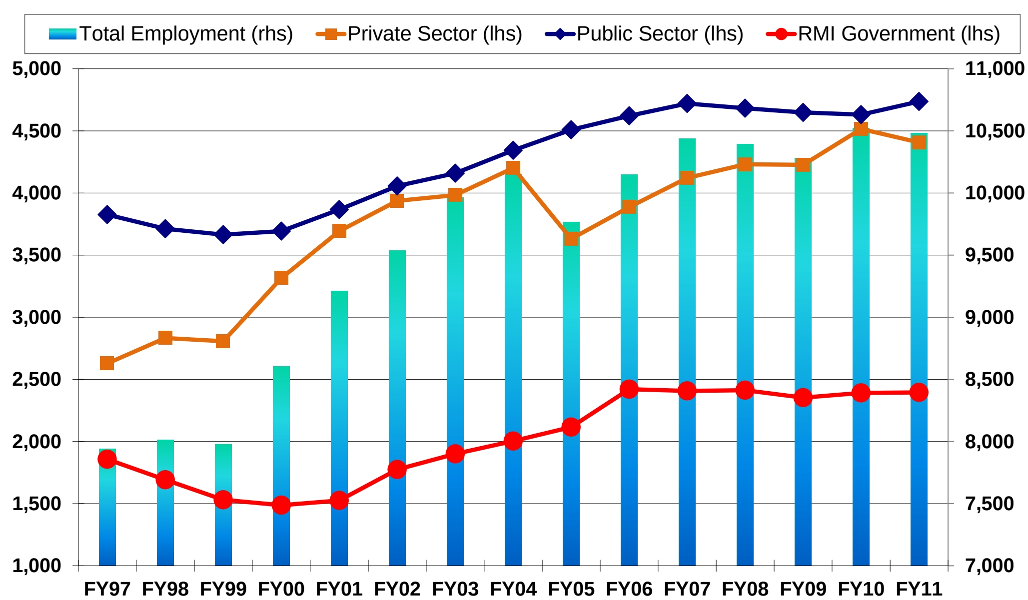



Figure 4 Employment by Sector FY1997-FY2011

## Inflation

Inflation rises at alarming rates in 2008 reflecting increases in food, electricity and world energy prices, but has subsequently moderated.

Fig. 5 indicates changes in the CPI for selected commodity groups since the first quarter of 2004. After relatively modest rates of inflation through the end of 2007, consumer prices increased at alarming rates in 2008. Clearly, the most dominant price change has been in the housing and utility section of the CPI, reflecting the impact of higher utility prices, which peaked at 62% in the third quarter of 2008. The changing environment confronting the MEC required large changes in electricity prices because of both a hike in world fuel prices and a need to charge prices more closely related to the basic costs of operations. The direct impact of higher fuel prices can be seen more clearly in transportation prices, which rose by 42% in the same quarter. Meanwhile, the food section of the CPI, reflecting the increases in world food prices, rose by 31%. The combination of these forces caused overall CPI to rise by 15% in FY2008—rates not experienced since the mid-90s.

In FY2009 food and fuel prices moderated significantly to levels below the FY2008 levels. In the third quarter of 2009 fuel prices had fallen by 31% and food prices by 7%. During FY2010 average price changes were generally less erratic with food prices continuing to decline and transport prices rising modestly at 1%. However,

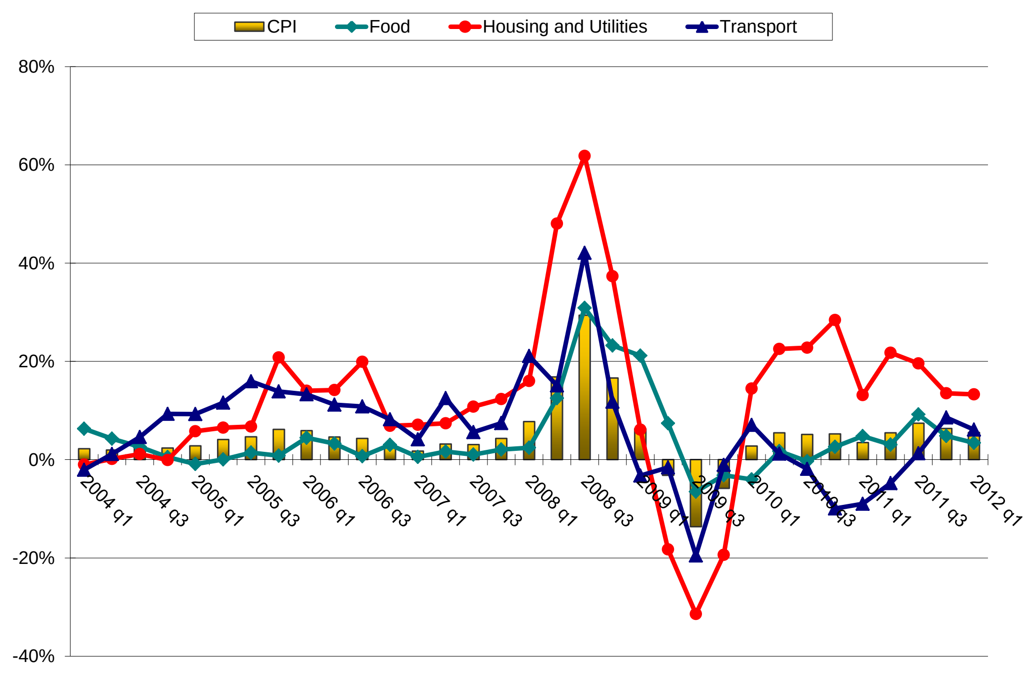



Figure 5 Change in CPI and selected commodity groups, FY2004-FY2012

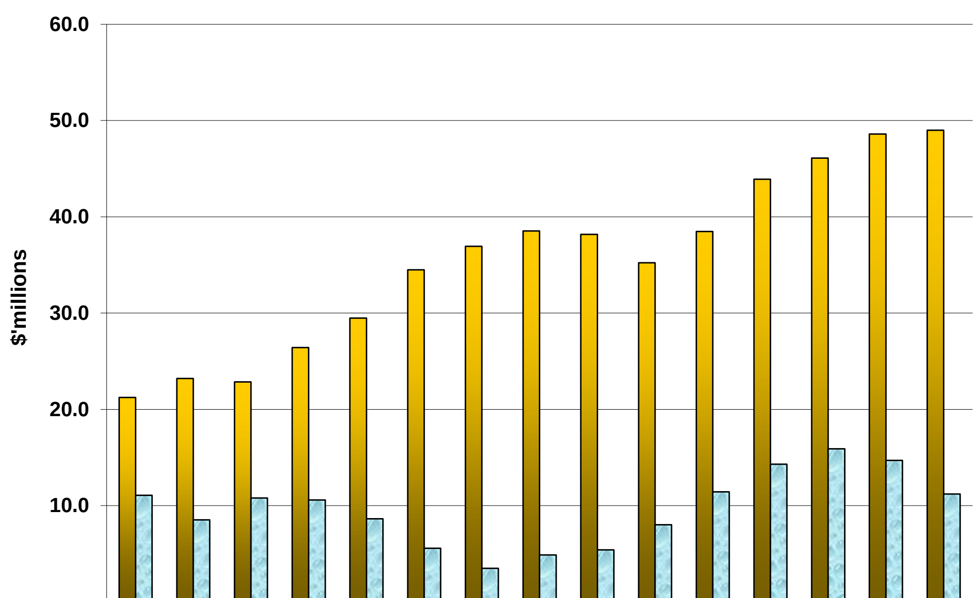
the housing and utility sections again returned to high rates of inflation and prices rose by 8% and the overall CPI rose by 1.8%. In FY2011, the same trends continued as utility prices rose by a further 21%, reflecting current fuel prices and the basic costs of production.  Food prices also rose significantly in FY2011, by 4.9%, and the overall CPI rose by 5.4%.

## *The Banking Sector*

Fig. 6 indicates the extension of credit to the private sector in the consumer and commercial markets since 1997. After a weak period in the late 1990s, consumer credit expanded rapidly in the initial 2000s, as confidence in the economy returned, and the government embarked on a rapid increase in the size of the public service sector. Between FY1999 and FY2011, consumer credit grew by an annual average of 5.8% and consumer lending stood at 48.3% of total employee compensation. This indicates a high level of household indebtedness, which not only places stress on household finances, but also poses a threat to the banking system as a whole. For the commercial sector, lending collapsed after FY2000, with the departure of the Bank of Hawaii. Commercial lending began

Consumer credit expands rapidly, incurring high levels of household indebtedness.

Commercial lending to the private sector has been lackluster reflecting the many impediments to lending.  In the last two years commercial lending has fallen by nearly 30%.




| | CY1997 | CY1998 | CY1999 | CY2000 | FY2001 | FY2002 | FY2003 | FY2004 | FY2005 | FY2006 | FY2007 | FY2008 | FY2009 | FY2010 | FY2011 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Consumer | 21.2 | 23.2 | 22.8 | 26.4 | 29.5 | 34.5 | 36.9 | 38.5 | 38.2 | 35.2 | 38.5 | 43.9 | 46.1 | 48.6 | 49.0 |
| Commercial | 11.1 | 8.5 | 10.8 | 10.6 | 8.6 | 5.6 | 3.5 | 4.9 | 5.4 | 8.0 | 11.4 | 14.3 | 15.9 | 14.7 | 11.2 |

Figure 6 Commercial Bank Credit by Sector

improving after FY2003, but in FY2010 took a downward dip which continued into FY2011, collapsing by nearly 30% over the two year period. In all, commercial lending has been lackluster and reflects lack of collateral, poor business management, and the many impediments to lending. With the enactment of the "secure transactions" law in 2007, it had been hoped that this segment of the market, which is of critical importance to private sector development, would show signs of expansion. So far this has not been evident.

## External Debt

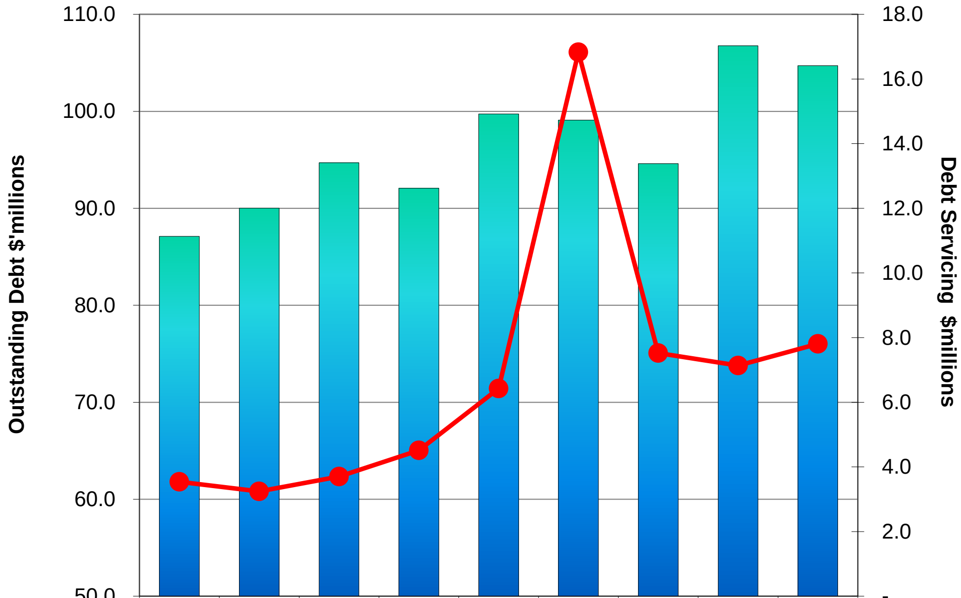
The FY2011 RMI single audit had not been completed prior to the drafting of this Preliminary Report. The following discussion thus relates to trends through FY2010. While the information base is not up to date the following analysis to FY2010 remains substantially relevant.

External debt increases significantly since 2002 as result of government and SOE borrowing.

During Compact I the government developed a substantial portfolio of loans from the Asian Development Bank (ADB). The portfolio included loans for water supply, the social sector, fisheries, transport projects, and a reform program. In total, the ADB has approved $85.7 million in loans, with an outstanding debt, at the end of FY2010, of $56.7 million. All but $4 million of this outstanding amount is provided on concessional terms. In addition to direct borrowing, the government guarantees a substantial portfolio of loans for the SOEs. Government-guaranteed loans include $30.1 million for the National Telecommunications Authority (NTA), $14.8 million for the MEC, and $1.8 million for the Marshall Islands Development Bank (MIDB); in total an amount of $48.0 million.

Debt service grows as ADB loan grace periods expire and place pressure on fiscal policy.

Fig. 7 shows the substantial size of the RMI's external debt and the burden of debt servicing since FY2002. In FY2002, the level of outstanding debt was $87 million, or 70% of GDP. Since this time external debt has risen to $105 million in FY2010, but in relation to GDP fell slightly to 64%. While most of the debt is on concessional terms, the level of debt remains substantial. There has been a substantial increase in debt service in recent years as prior loans have now passed expiration of their grace periods. Debt servicing was $7.8 million in FY2010, of which $2.9 million was due for government debt to the ADB. This represents 22% and 8% of the government's discretionary resources, or general fund, respectively. Since external debt servicing is funded from these sources there are significant implications for fiscal policy.




| | FY2002 | FY2003 | FY2004 | FY2005 | FY2006 | FY2007 | FY2008 | FY2009 | FY2010 |
|---|---|---|---|---|---|---|---|---|---|
| Outstanding | 87.1 | 90.0 | 94.7 | 92.1 | 99.7 | 99.1 | 94.6 | 106.8 | 104.7 |
| Servicing | 3.5 | 3.2 | 3.7 | 4.5 | 6.4 | 16.8 | 7.5 | 7.1 | 7.8 |

Table 7: External Debt and Debt Servicing, FY2002-FY2010

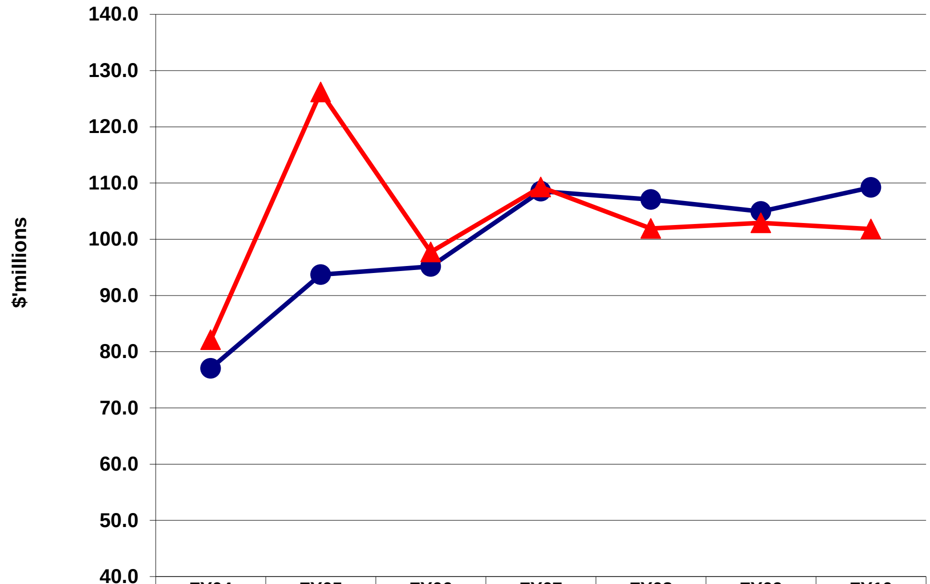
## *The Fiscal Situation*

The failure to complete the FY2011 RMI single audit by the June 30th requirement has limited the ability of this Preliminary Report to analyze recent fiscal trends. The following discussion is therefore limited to the FY2004-FY2010 period.

Late completion of FY2011 audits limits analysis of recent fiscal trends.

Figure 8 indicates recent trends in the fiscal position and close proximity of revenues and expenditures (including non-financial assets). Expenditures grew strongly in the first three years of the amended Compact as a result of higher levels of funding and increased capacity utilization of the sector grants—the infrastructure grant, in particular. In FY2004, expenditures significantly exceeded revenues and the fiscal account recorded a sizeable deficit of $5.1 million, or 3.9% of GDP. In FY2005, expenditures grew strongly reflecting both the increasing use of available resources, and need to contribute to the Compact Trust Fund (CTF). Revenues also grew strongly and even after accounting for the CTF contribution, a small surplus of 1.0% of GDP was recorded. In FY2006 and FY2007, the fiscal situation continued to tighten, and an overall deficit of -1.8% and -0.5% of GDP was recorded, respectively.

Strong growth in expenditures during initial years of amended Compact as capacity utilization constraints are alleviated.




| | FY04 | FY05 | FY06 | FY07 | FY08 | FY09 | FY10 |
|---|---|---|---|---|---|---|---|
| Total Revenues | 77.0 | 93.7 | 95.1 | 108.6 | 107.1 | 104.9 | 109.2 |
| Total Expenditures | 82.1 | 126.2 | 97.7 | 109.3 | 101.9 | 102.9 | 101.8 |

Figure 8 Consolidated Revenues and Expenditures, FY2000-FY2010

By FY2008, the period of fiscal expansion had run its course, and a fiscal correction was required. Total expenditures contracted by $7.4 million, reflecting a significant drop-off in non-financial assets of $10.7 million. Revenues were also weak, dropping by 1.4% reflecting the contracting economy, and a failure to sustain the growth of earlier years. However, adjustment was achieved and an overall surplus of 3.4% of GDP was attained. In FY2009, revenues continued to weaken, but expense was held in check although subsidies to SOEs grew strongly. While there was some expansion in non-financial assets, overall the government ran a small surplus of 1.3% of GDP. In FY2010 the economy grew strongly and all categories of revenues expanded: taxes, non tax revenue and grants. Meanwhile, despite growth in payroll and a significant expansion in non-financial assets, other categories of expense contracted and a large fiscal surplus of 4.7% of GDP was attained.

Relatively favourable fiscal outturn during the last five years of the amended Compact masks underlying fiscal pressure and instability.

The apparently close proximity of revenues and expenditures and ability to maintain a fiscal surplus averaging 0.6% of GDP during the amended Compact period provides a misleading impression of the fiscal situation in the RMI. The emerging crisis in FY2008 with the onset of the world recession and higher fuel prices precipitated a financial crisis at the MEC, which in turn threatened the fiscal stability of the nation. The existence of a priority list of creditors, difficulties in maintaining debt service obligations to the ADB, increasing use of the ROC project grant to fund operational expenditures, and daily cash flow problems all indicate a stressed fiscal position. The limited ability of the government to borrow to finance a deficit, the fine balance between revenues and expenditures, and the high risk of insolvency in the SOE sector, all indicate that the RMI remains in a precarious fiscal position.

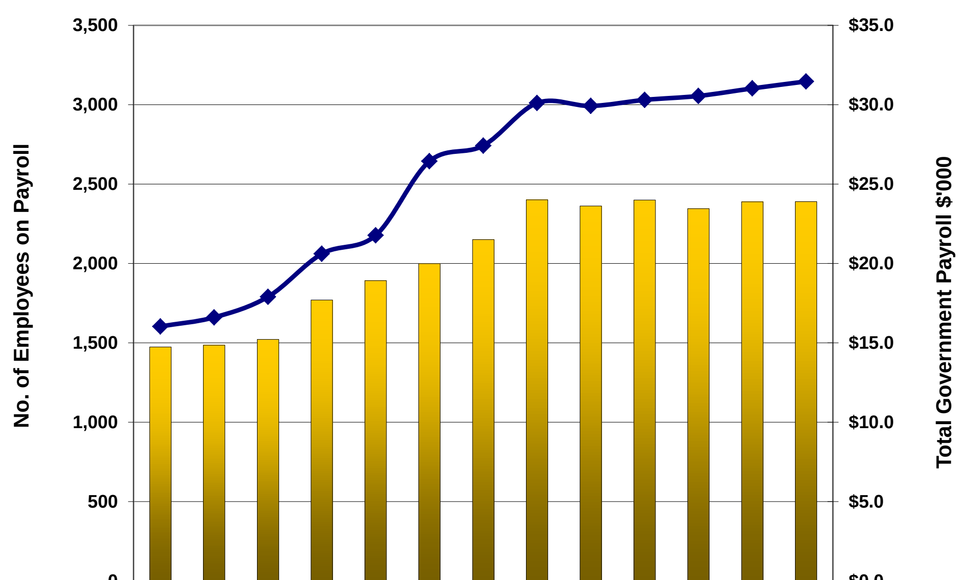
## II. Policy Issues

### *Government Payroll*

Rapid increase in government payroll puts pressure on fiscal situation.

Government employment increases by 565 employees or 38 percent since end of RIF.

Towards the end of Compact I the RMI government implemented a Reduction-In-Force (RIF) of public servants as part of a necessary fiscal adjustment. By FY1999 the number of public servants had been reduced to 1,475. The trend since FY1999, however, has seen a rapid increase in public servants (Fig. 9), reaching 2,389 by the end of FY2011, a 62% increase. Over the same period payroll costs have nearly doubled. As part of the Compact re-negotiations, the RMI became ineligible for the US Federal Program Head Start. However, compensatory funding was provided through the Supplemental Education Grant (SEG) and the 200 or so former Head Start employees were transferred to the Education Department in FY2006. In addition, FY2001 and FY2002 marked the return of Majuro and Ebeye elementary school teachers to the MOE, adding approximately 100 employees and 50 employees, respectively. Fig. 9 thus overstates the increase in government payroll. After making suitable allowances for these adjustments, government employment increased by 565 employees, or 38%, over the twelve-year period.




| | FY99 | FY00 | FY01 | FY02 | FY03 | FY04 | FY05 | FY06 | FY07 | FY08 | FY09 | FY10 | FY11 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Public servants | 1,475 | 1,486 | 1,522 | 1,771 | 1,892 | 1,999 | 2,151 | 2,402 | 2,363 | 2,400 | 2,346 | 2,388 | 2,389 |
| Payroll cost | $16.0 | $16.6 | $17.9 | $20.6 | $21.8 | $26.4 | $27.4 | $30.1 | $29.9 | $30.3 | $30.6 | $31.0 | $31.5 |

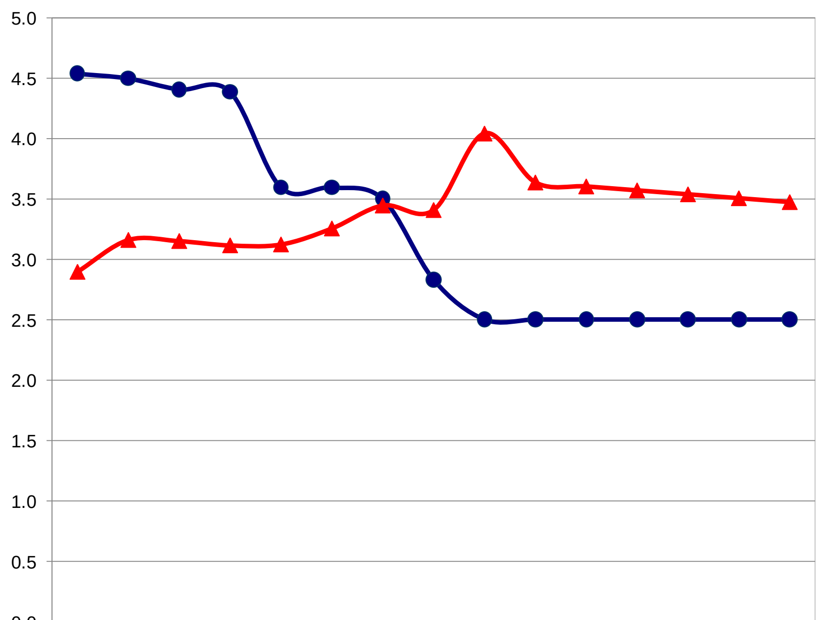
Figure 9 Government Payroll and Employees, FY1999 – FY2011.

Although expansion in government payroll came to a halt in FY2006, total government payroll costs have continued to expand, reflecting overall increases in wage rates. While a policy of freezing payroll costs has been in place during much of the period, in fact a hidden 1% annual wage drift has occurred. Moderate annual increases in wage rates can represent sound policy intended to attract and maintain a qualified work force; however, this pattern has added to the overall cost of government in an environment with limited fiscal space. Although there now appears to be control over the recruitment process, the size of the expansion in government during the first part of the 2000s suggests significant overstaffing. A more critical issue is thus 'right' sizing to a level that adequately maintains government services. The level of public service that existed at the start of the decade appears to provide a reasonable benchmark (see Fig. 9).

Need for resizing of government payroll to levels existing in FY2000.

## External Debt Management and Policy

External debt management in the medium term presents a major challenge. There are two major components of debt service: government debt on concessional terms to the ADB, and government guaranteed debt incurred by the SOE sector. Fig. 10 indicates the projected trend in debt service for the two types. For government




| | FY11 | FY12 | FY13 | FY14 | FY15 | FY16 | FY17 | FY18 | FY19 | FY20 | FY21 | FY22 | FY23 | FY24 | FY25 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Gov guaranteed debt service | 4.5 | 4.5 | 4.4 | 4.4 | 3.6 | 3.6 | 3.5 | 2.8 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 |
| ADB debt service | 2.9 | 3.2 | 3.2 | 3.1 | 3.1 | 3.3 | 3.4 | 3.4 | 4.0 | 3.6 | 3.6 | 3.6 | 3.5 | 3.5 | 3.5 |

Figure 10 External Debt, Total Debt and ADB Debt Servicing, $M's

While debt servicing of the MEC has improved, extension of the RUS loan to fund the new Fiber Optic Cable has placed the NTA in a precarious position.

guaranteed debt there is a projected decline from the current service level of $4.5 million to $2.5 million by FY2019 when the debt service schedule stabilizes. However, the external debt of the SOEs occurs at higher interest rates and shorter terms, thus incurring a proportionately higher service commitment. Current debt service levels of the NTA, AMI, MIDB, and MEC are $2.5 million, $0.3 million, $0.5 million, and $1.1 million, respectively. The financing of the new fiber optic cable through extension of the existing Rural Utilities Service (RUS) facility has placed the NTA in a precarious financial position requiring grants and loans from the government to remain operational. The recent ADB Public Sector Program loan enabled the MEC to refinance a high-interest loan from the Bank of Guam with concessionary finance. As a result, its debt service level of $3.1 million in FY2010 has now dropped to a more manageable level of $1.1 million. Negotiations with the RUS have now been completed with the MEC to enable a two year deferment of capital payments, which will ease the MEC's cash flow over the medium-term.

External debt service on ADB loans has posed a major challenge to fiscal management.

RMI is developing an external debt strategy to provide a framework for improved management.

In order to make debt payments to the ADB, the government will be required to set aside between $3 and $4 million annually over the next 15 years—roughly 10% of its $36 million general fund. In previous years, nearly all of the RMI debt was in an initial grace-period, which made debt service obligations insignificant. However, in the last few years, principal repayments for many of the loans have fallen due, and debt service has contributed to significant fiscal pressure. In FY2006, the government experienced its first problems in servicing ADB debt, defaulting on several loans, and although the situation has improved, maintaining regular payments has proved difficult. The problems experienced with debt service underscored the need for a well-articulated debt management strategy, which has now been developed and approved by cabinet. It is understood that the RMI is currently conducting public hearings and preparing legislation to provide a legal framework for debt management.

### State Owned Enterprise Reform

The operations, profitability, and subsidies to the State Owned Enterprise (SOE) sector have become a major and pervasive problem for the RMI. During FY1999-FY2001 the average level of subsidy and capital transfer was $4.5 million. During the FY2009-FY2011 period this level had risen to $8.2 million, representing 23% of general fund revenues. Once merely an important financial issue, the RMI government's level of subsidy to the SOEs has now reached a critical level, indicative of the need for reform. In 2010 the RMI government, aware of this growing problem, requested the ADB to undertake a review of the SOE sector and recommend options for reform.

State owned enterprise required an average subsidy of $8.2 million in FY2009-FY2011 or 23% of general fund revenues.

Fig. 11 provides an overview of the SOE sector by each of the major enterprises and indicates the change in level of net operating profits from the averages of FY1999-FY2001 to FY2009-FY2011. The largest group of loss-making SOEs has been the utilities, comprising both the MEC and KAJUR, which now average an annual loss of $3.1 million. The next group of entities comprises SOEs that provide social obligations to the outer atolls: Air Marshall Islands (AMI), the Marshall Islands Shipping Corporation (MISC) and Tobolor (responsible for coconut oil production), have collectively incurred losses averaging $3.2 million in the last three years. A third group comprising the Marshall Islands Resort (MIR) and Marshall Islands Port Authority (MIPA) record annual losses but receive no subsidy. In effect, this last group is making a return insufficient to provide for the depreciation of capital.

The National Telecommunications Authority (NTA) has recently become a center of focus with the recent World Bank support to

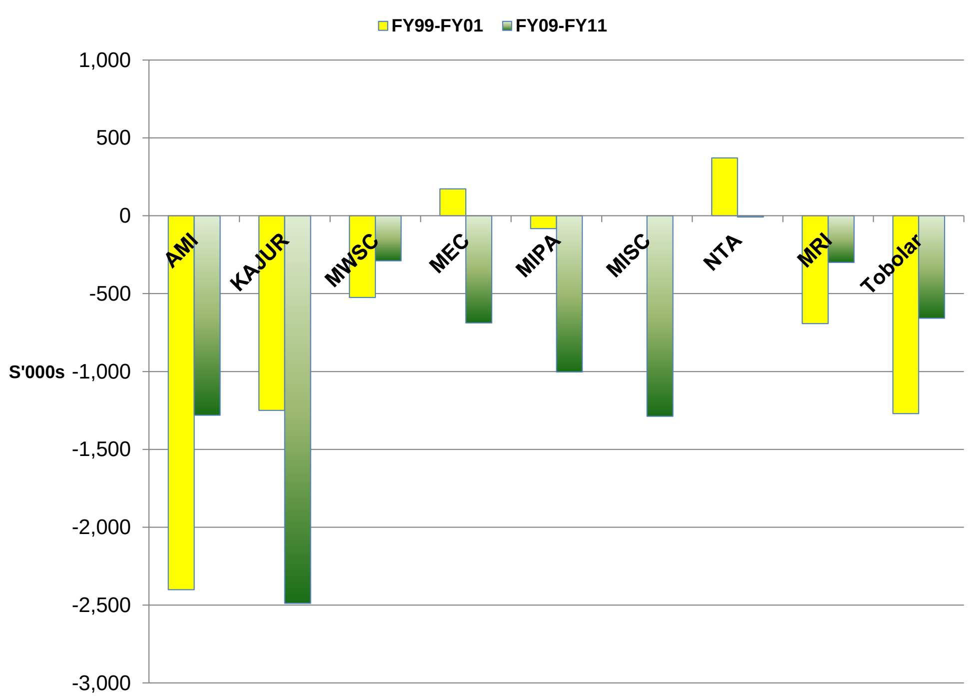



Figure 11 State Owned Enterprises, average net operating profit.

encourage greater liberalization and competition in the telecommunications market. While the NTA was financially viable during most of the 2000s, rapid changes in telecom markets and problems with billing systems have reduced profitability, resulting in operating losses over the last two years. With increased debt service financing an extended loan to support the new submarine fiber optic cable, the entity required an initial subsidy of $1 million in FY2010 and a further loan of an additional $1 million in FY2011 to remain operational. The World Bank program is proposing a series of grants totaling $13 million of budgetary support in return for liberalization of the telecommunications sector. In order to qualify for the first tranche of $3 million, the government is required to:

World Bank initiates telecom sector reform through a series of grants totalling $13 million in budgetary support.

Existing telecom sector is not financial viable and services are poor. Reform is required, but needs careful implementation to avoid previous failed attempts at privatization.

- adopt a new information and communications technology policy,
- draft new telecommunications legislation for introduction to the Nitijela, and
- publicly advertise the on-going developments.

Currently the policy paper has been adopted by cabinet and advertised. The new sector legislation is currently under discussion among cabinet. Once the program is underway a new telecom regulator will be established and the NTA prepared for competition. It is further proposed, if feasible, to relocate management of the fiber optic cable outside of NTA, in a newly created SOE that would be accessible to new competitors. The project clearly has significant challenges, not least being the cost of financing the existing RUS loan, the establishment of a sustainable on-going regulatory body, and the provision of services to remote areas of the RMI. Granted, the existing setup at NTA is not financially viable and services are poor. However, any reform efforts need to be well developed and implemented in order to avoid the same fate as previous privatization efforts sponsored by the ADB in the late 90s.

SOE policy adopted by Cabinet and new SOE Bill under preparation for introduction to the Nitijela before year end.

SOE reform constitutes a major component of the ongoing ADB-supported Public Sector Program (PSP). To signal its intention to strengthen governance of SOEs, in 2010 the RMI Cabinet passed a set of good practice principles. In 2011 a further ADB regional report stated that, "While the foregoing is helpful and if implemented will provide useful guidance, the principles are too short on detail to be sufficient on their own. The government should adopt a more detailed SOE policy that could then be used to guide the development of an SOE Act." With ongoing technical assistance support from ADB, a new SOE policy has been drafted and adopted by Cabinet. Based on the policy, a new SOE Act is being prepared and is planned for introduction to the Nitijela before year end.

### *The Medium Term Budget and Investment Framework and Decrement Management*

MTBIF adopted as the medium term framework for the annual request for Compact funding.

At the onset of the amended Compact, the RMI adopted a medium-term framework to guide the preparation of the annual budget and requests for Compact sector grant funding. The framework is known as the Medium-Term Budget and Investment Framework (MTBIF). The MTBIF was written into the language of the Compact in the following requirement:

> *The Government of the Republic of the Marshall Islands shall prepare and maintain an official medium-term budget and investment framework. The framework shall be strategic in nature, shall be continuously reviewed and updated through the annual budget process, and shall make projections on a multi-year rolling basis.*

MTBIF fails to provide a meaningful process for annual budget preparation.

The MTBIF is described in government planning documents as a five-year, medium-term budgeting framework. It contains two past review years, the current fiscal year and two future trend years, and is to be updated twice annually. The MTBIF has been prepared by non-resident consultants and to date there have been no local staff capable of managing, updating, or communicating the results of the MTBIF to policy makers in time to affect budget preparations. As a result the MTBIF approach has not been adopted as a meaningful budget planning tool or an active component of fiscal and macroeconomic planning.

JEMFAC request decrement management plan.

During the annual Compact JEMFAC meeting in September 2009, resolution JEMFAC 2009-1 Sustainability of Sector Budgets was unanimously passed:

> *JEMFAC resolves that the RMI Government develop a plan for managing annual decreases in Compact direct assistance and/or general fund support, and use those plans as the basis for Fiscal Year 2012 budget decisions. The plan should include an evaluation of the ability of the health and education sectors to fulfill their strategic outcomes in fiscal years 2012-2014.*

RMI submits MTBIF for decrement management to preserve education and health services while scaling back delivery of other government activities.

In response to the U.S. request, the RMI issued an update to the the MTBIF and submitted a report entitled “Decrement Strategy & MTBIF Policy Framework Paper, FY11-14” in March 2011. The approach adopted by the MTBIF was a simple one: implement recent reform efforts to reduce expenditures (through a Comprehensive Adjustment Program, or CAP, outlined below), and adopt a modern tax regime (through a Tax Reform and Modernization Commission, or TRAM, detailed below). The subsequent improved fiscal position would enable education and health expenditures—adopted as priority by the RMI government—to be maintained in real terms over the medium term, while scaling back the remainder of government expenditures. The RMI decrement strategy presents a financially viable process and is based on previously endorsed documents. However, it is understood that the FY2013 budget request for Compact sector grant funding is inconsistent with the MTBIF. As a result the RMI government is currently attempting to build capacity in the MTBIF and provide a consistent framework with the JEMFAC resolution.

Longer term planning process required to address decrement management and CTF issues through end of the amended Compact.

In the case of the FSM, the counterpart body to JEMFAC, known as JEMCO, required the FSM to prepare a long-term decrement management plan. Clearly, the adjustment problem being faced by the RMI is a long-term issue, and it is unclear why the RMI was only required to prepare a medium-term response. There thus remains a need to develop a long-term framework to address the annual decrement and required fiscal adjustment through the end of the amended Compact in 2023. This need is even more pronounced in recognition of the likely insufficiency of the Compact Trust Fund.

### *The Comprehensive Adjustment Program (CAP)*

Government initiates a series of internally conceived reform initiatives.

In response to the emerging world economic crisis in 2008, rising fuel and food prices, onset of global recession, and most importantly the imminent financial collapse of the MEC, the Cabinet created two groups and commissions tasked with fiscal reform initiatives. In April 2009, an RMI Comprehensive Adjustment Program (CAP) Advisory Group was created to develop an internally conceived and designed program. The second group created by Cabinet was the Revenue and Tax Reform and Modernization Commission (TRAM). Following the development of these internally generated reform initiatives, the ADB was asked to provide support through a Public Sector Program (PSP) aimed at consolidating the reform process and, in particular, the provision of resources to refinance MEC debt on concessional terms.

Cabinet creates a Comprehensive Adjustment Program Advisory Group.

The Minister of Finance, with the endorsement of Cabinet, created the CAP Advisory Group on April 22, 2009. Two broad goals were identified for the program: (i) provide the Government with a well-defined series of actionable measures to recover from the recent deterioration in the fiscal position and, following a period of fiscal restraint, to put the Government on a path toward long-term fiscal sustainability, and (ii) to provide the Government with an internally designed program that can better guide its relations with the external donor community. Although the CAP Advisory Group outlined the general principals of reform, the measures specified were almost entirely related to expenditure reduction, and followed a detailed examination of the major areas of expense. The two major areas of cost savings identified were payroll and subsidies to the SOE sector.

Group recommends a RIF and cost savings of between $7 and $8 million.

In the RMI the civil service represents nearly 50% of the cost of current operations. The Advisory Group recommended the implementation of a Reduction-In-Force (RIF) with possible cost savings ranging from $0.7 to $5.6 million. The group proposed a reduction of 300 positions equivalent to about one third of the public service employed under the general fund and far less than the 565 jobs created since the implementation of the earlier RIF in FY1999. The Advisory Group did not directly make any recommendations regarding the savings that could be generated from reduction in subsidies and transfers to the SOEs and other government agencies, as this would be a long-term process requiring development of broad-based plan. Overall, the CAP group recommended a reduction in expenditures of $7 to $8 million over the next 1-3 years to address the structural deficit position. This corresponds to a similar level recommended in a recent IMF Article IV consultation.

None of the specific adjustments proposed by the CAP have been implemented.

Fiscal constraint has occurred through across the board dilution rather than prioritization and rationalization.

More than three years following the development of the CAP, none of the recommendations have been implemented. In the various budgets since the CAP recommendations, across the board cuts have been implemented together with some wage constraint. While information on public service payroll has been presented above, the absence of the FY2011 audit makes assessment of recent expenditure performance difficult. The non-specific reductions that have prevailed in recent budgets, however, are diluting in nature and exactly the type of approach to revenue loss that the request for a decrement management plan was intended to avoid. Decrement management was intended to be an approach to maintaining output delivery through efficiency gains, prioritization of key services, and reduction in non-essential services.

Cabinet creates a Tax and Revenue Reform and Modernization Commission (TRAM)

PFTAC outlines tax reform initiative including introduction of a VAT and net profits tax.

## *Tax and Revenue Reform and Modernization Commission (TRAM)*

Complementing the creation of the CAP Advisory Committee, cabinet created the Tax and Revenue Reform and Modernization Commission (TRAM) in July 11, 2008. While the CAP was created to investigate ways to save costs in the operations of government, the TRAM was created to: (i) prepare a proposal for reform of the tax system and structure, (ii) strengthen the capabilities and effectiveness of the revenue collecting administration, and (iii) to ensure effective implementation. In order to support the recommendations of the TRAM, a request was made to PFTAC for technical assistance for the development and design of the tax reform package. The essence of the reforms proposed by PFTAC was the introduction of a modern tax system which was equitable, efficient and simple, while raising sufficient revenue to meet future fiscal challenges. The package of reforms would broaden the tax base, while attempting to keep rates low. The major elements of the system included the following:

- replacing the GRT, hotel and resorts tax, local sales taxes, and standard import duties with a broad based consumption tax;
- replacing the special import duties and local government taxes on alcohol, tobacco, motor vehicles and fuel with similar excises;
- introducing a net profits tax for large businesses;
- retaining the GRT for businesses with turnover less than $100,000; and
- modifying the wages and salaries tax by broadening the tax base to include items currently exempt, modifying and expanding the current tax-free threshold, and introducing a higher tax rate for high income earners.

TRAM initially objections to the VAT have now been overcome.

Tax reform laws have been drafted and while delayed by the 2011 elections are ready for consideration by Cabinet and the Nitijela.

The PFTAC tax reform proposal was well received by the TRAM Commission and, barring one major exception, was largely recommended to the Government without modification. The major exception was the introduction of the VAT, which had initially been attempted and failed in the early 1990s. After a set of public awareness meetings, these objections have been overcome and the former Minister of Finance agreed to include the VAT in the tax reform initiative. Laws have been drafted for a series of tax reforms including a Net Profits Tax, a Marshall Islands Consumption

Tax, and a Revenue Administration Act. The intention had been to submit the bills to the August 2011 session of the Nitijela, but this was delayed due to the elections in November 2011. The process is now once again underway and the Bills are ready to go to Cabinet and the Nitijela for the September session. A tax administrator has been recruited under AusAid for a two year period to drive the process. Assistance has also been provided through PFTAC for the identification of IT systems suitable to the RMI.

The RMI government requests ADB for a Public Sector Program loan to consolidate reform initiatives.

### *The Public Sector Program (ADB Loan)*

Based on the recent internally-designed reform initiatives developed by the CAP Advisory Group, the TRAM Commission and SOE report endorsed by Cabinet, the Government requested the ADB to assist the RMI with a Public Sector Program (PSP) loan. The total initial value of the loan was $9.5 million of which $8.4 million was devoted to refinancing of the existing MEC debt to the Bank of Guam. A second tranche is planned conditioned on progress with attainment of the loan covenants. The loan became effective in September 2010 with a planned review for second tranche release in February 2012, which has been delayed. The PSP is designed to support the government in the achievement of its reform initiatives through the delivery of 5 outputs:

- Improved medium term fiscal outlook,
- Restraint of recurrent expenditure,
- Increased tax revenue,
- Improved SOE performance, and
- Increased stakeholder participation.

While the program is achieving success, the weakness on the fiscal side is noticeable.

Whether sufficient progress has been achieved for 2nd tranche release is yet to be determined

The PSP loan has now been effective for nearly two years. The loan design drew heavily on the RMI's own reform programs: CAP, TRAM, and SOE reform. It was also based on recommendations of the IMF concerning long-term macroeconomic stability and reforms needed in the utility sector to ensure the long-term viability of the MEC. A detailed discussion of various targets is presented in the main report. In brief, the first two outputs relating to fiscal policy and restraint will be the hardest to achieve. The inclusion of the IMF proposal for the RMI to achieve a fiscal surplus of 3% of GDP in FY2011 and FY2012 appears overly optimistic, as is the intended annual contribution of $2.5 million to the CTF. Restraint of current expenditures draws on the CAP proposals, which have not been implemented. However, progress in other areas is on-going with the tax reform, proposed SOE reform Bill, external debt management legislation and work force audits. There is also no doubt that the main feature of the PSP, assistance to the MEC, is largely successful. Although stakeholder awareness and participation has not been widespread, the CAP, TRAM and PSP programs are now better known than they were when the program started. While the program is achieving success, the weakness on the fiscal side is noticeable.  It will be interesting to see if the ADB finds sufficient progress for 2nd tranche release.

## III. The Compact Trust Fund

### *Background*

The establishment of the Trust Fund for the People of the RMI (the Trust Fund) was a major feature of the amended Compact. The Trust Fund was created "to contribute to the long-term budgetary self-reliance of the RMI… [and] to provide the Government of the RMI with an ongoing source of revenue after FY2023." The design of the Trust Fund specifies distributions from FY2024 forward that are explicitly tied to the fully inflation-adjusted value of the Compact annual grant assistance provided in FY2023. Notwithstanding this design feature, the U.S. Government has, on several occasions subsequent to the outset of the amended Compact period, made clear their position that the amended Compacts and their subsidiary agreements contain no commitments, either express or implied, regarding the level of revenue that will be generated by the Trust Funds, nor is there any commitment regarding the degree to which the revenue will contribute to the long-term budgetary self-reliance of the RMI and FSM.

The Compact and its subsidiary agreements include no guarantee that that the Trust Fund will achieve any specific level.

Given that the U.S. Government is not underwriting the investment risks associated with the Compact Trust Fund, it is important that the RMI Government makes every effort to monitor the progress of the Trust Fund and to assess performance against a sensible goal. That goal is suggested by the authors of this report to be the projected ability of the Trust Fund to support a smooth and sustainable transition from direct, U.S.-appropriated, annual grants to annual Trust Fund distributions to the RMI. Such a "sustainability estimate" is presented herein to inform key decision makers well in advance of the beginning of the Trust Fund's distribution period. A monitoring procedure is presented below—for the third consecutive year through this report—that estimates the sustainability value at the end of FY2023.

There is only one variable that affects the actual annual contributions and the projected direct grant level in FY2023 — the rate of inflation. More precisely, that one variable is the cumulative inflation adjustment, pursuant to Compact Section 217, for the 20-year period beginning in FY2004. In the projections below actual inflation adjustments provided to the RMI through FY2013 are included, and thereafter a U.S. inflation rate of 3.0 percent is assumed.

The RMI began the amended Compact period with an annual direct grant drawdown rate of $35.2 million. That stream of direct grants is adjusted annually in two countervailing ways: annual grant levels are adjusted upward by the addition of two-thirds of inflation, and adjusted downward by the subtraction of the so-called "decrement" of $500,000.

The RMIt Trust Fund is valued at $158 million as of June 30, 2012, $25 million short of being "on track" with the sustainability estimate.

Using actual inflation adjustment data through FY2013 and projecting forward based on inflation at 3.0 percent, a direct grant level of $37.0 million is projected for FY2023. Using that value, allowing for full inflation adjustment of subsequent withdrawals, and maintaining the real value of the Trust Fund *corpus*, there is one other variable required in order to determine the size of the Trust Fund at the outset of FY2024, namely the rate of return on investments in the combined "A" and "C" accounts (essentially, the primary and buffer accounts).

It is assumed that the RMI investment strategy at that time would need to provide for a prudent balance of risk while allowing for long-term growth. From FY2024 onward, a balanced investment allocation is assumed, with 65 percent of assets in equities with an assumed real rate of return of 6.5 percent annually and 35 percent in fixed income with an assumed real rate of return of 2.5 percent annually. The blended real rate of return for the distribution period is thus estimated at 5.1%. If inflation were to average 3 percent, a nominal rate of return of 8.1 percent would thus be required. All rates are assumed to be net of investment and Trust Fund management costs.

## *Trust Fund Performance Monitoring*

The projected growth path to achieve sustainability by FY2023 is presented along with actual results through June 30, 2012, in Figure 12. The sustainability estimate for the end of FY2023 is a Compact Trust Fund value of $748 million. The current value of the RMI Trust Fund is significantly below the level consistent with a smooth growth trend line. In order to be precisely "on-track" to achieving that level as of June 30, 2012, the value would have grown to $183 million; however, the actual value of the RMI Trust Fund at that date was $158 million. This difference of $25 million leaves the Trust Fund fully 12.9 percent short after 8.75 years of the projected 20-year accumulation period. Even if the returns from this date forward were to average the (initially required) trend line rate of 8.0 percent annually, the final value of the fund at the end of FY2023 would be just 92.2 percent of the sustainability estimate, falling short by $58 million.

A range of factors have combined to result in an RMI Compact Trust Fund value that is below the projected path to achieve the sustainability estimate. The most important factor is the investment climate that prevailed for the entire period from FY2004 through June 30, 2012. During that period the relevant benchmark return from assets invested according to the prevailing RMI Trust Fund policies would have delivered a 5.3 percent rate of return—below the 8.0 percent annual compound rate of growth required to achieve the sustainability estimate.

Given actual Trust Fund performance to-date and assuming an 8.0 percent rate of return for the remaining Compact period, the Trust Fund is projected to fall below the sustainability estimate by $58 million.

What is also clear from the performance analysis undertaken by the authors of this report is that the performance of the market was favorable in the early period—during which the RMI Trust Fund assets were either not yet deposited or not yet exposed to the identified investment strategy. Conversely, the performance of the market turned extraordinarily negative in the middle period from FY2008 through the first half of FY2009. During this period the Trust Fund assets were fully invested, and thus fully exposed to extraordinary losses through that market period. Finally, there has been substantial market recovery throughout the period after March 2009 through June 30, 2012. It is, of course, unfortunate that the Fund has experienced such a historically volatile and negative period so early in the 20-year accumulation period planned for the Trust Fund. This type of risk is called "sequence of returns"

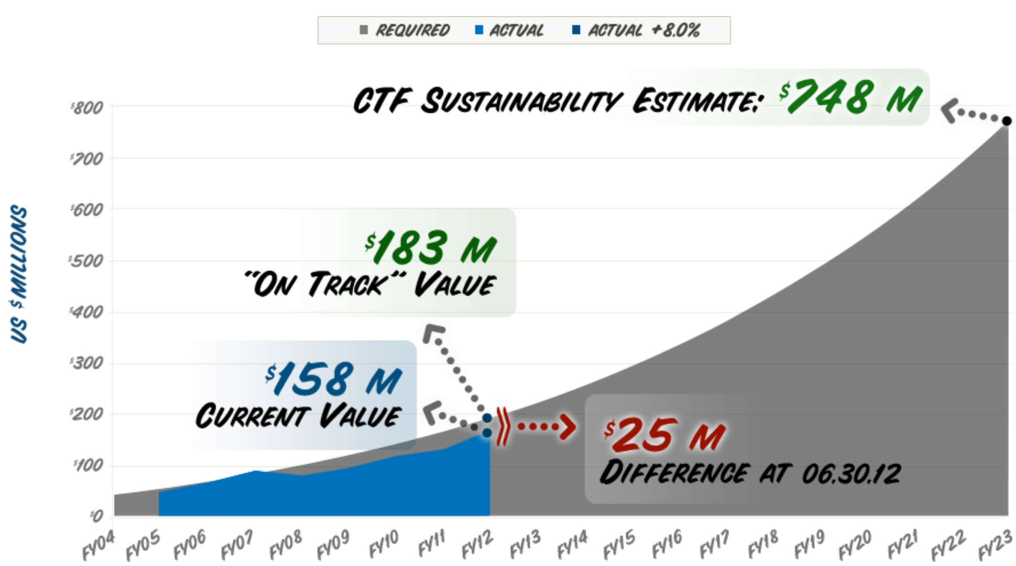



Figure 12 RMI Trust Fund Values, Current and "On Track" Levels at June 30, 2012.

risk and the impact of the unfortunate timing will persist throughout the accumulation period as there is a smaller *corpus* upon which to achieve the initially projected compound rate of growth.

Several other factors that were not "market-driven" follow below.

- The RMI was unable to deposit in a timely manner its required $30 million contribution; although the RMI was allowed to split its contributions over the initial year ($25 million) and the two subsequent years ($2.5 million each in FY05 and FY06), this did have a detrimental impact on growth. For projection purposes, at the time the amended Compact was negotiated, the full sum was anticipated to be available to invest on October, 1, 2003. In fact, the RMI deposited $25 million on June 1, 2004, nine months late. The remaining deposits were made as follows: $1.5 million on February 17, 2005, $1.0 million on May 19, 2005, and the final $2.5 million on October 5, 2005. Finally, the U.S. chose to delay its deposit awaiting the initial RMI contribution and made its initial deposit of $7 million on June 3, 2004.
- The above delays were, in large part, due to the fact that the U.S. and RMI did not establish the Trust Fund on schedule. Although anticipated (for projection purposes) to be established on October 1, 2003, the RMI Trust Fund was incorporated as a non-profit corporation on April 28, 2004, and the amended Compact did not go into effect until May 1,

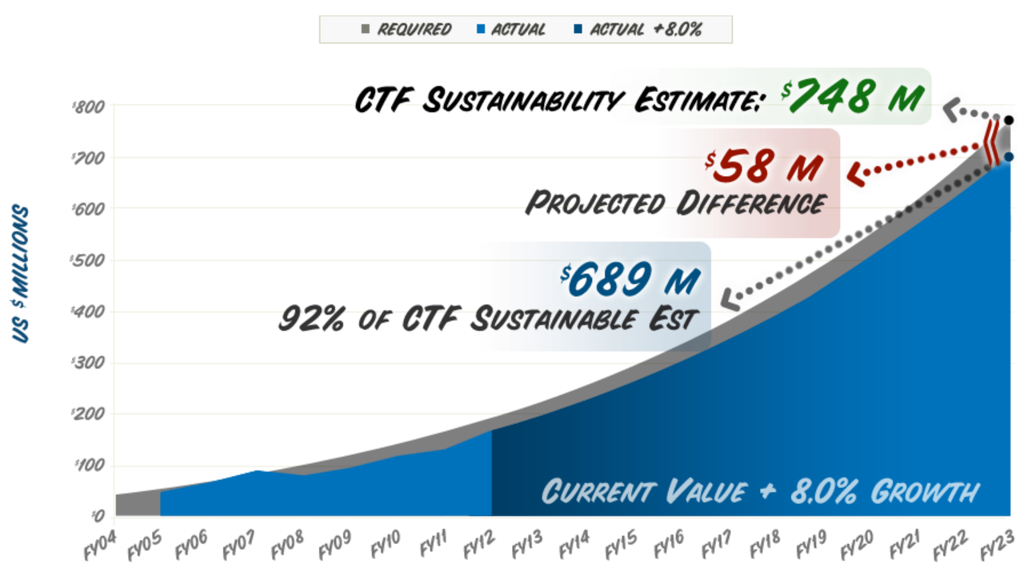



Figure 13 Projected RMI Trust Fund value through FY2023.

2004. Despite the delays, no changes to contribution commitments or anticipated withdrawal dates appear to have been discussed, although it should be noted that a 20-year accumulation period has been truncated as a result of legal requirements (i.e. the coming into effect of the Compact eight months after the beginning of the projected accumulation period) and the accumulation period was cut short even further by technical implementation issues.

- The allocation of deposited funds to the asset classes identified in the RMI Investment Policy Statement did not occur until September 30, 2005, fully 24 months into the amended Compact period. This failure to invest according to the RMI's investment policy was ill-timed, as the markets performed well during the period of delay.
- While invested in the asset allocation identified in the Investment Policy adopted on August 19, 2005, and implemented on September 30, 2005, over the period from that implementation through June 30, 2011, it appears that the actual results have lagged, by a substantial margin, the weighted returns of the benchmarks for each asset class. The shortfall due to under-performance relative to its benchmark is $4.1 million or roughly 17 percent of the total difference of $25 million. Since the investment choices for most of the period studied involved passive instruments designed to track index performance, any under-performance is believed to be primarily the result of fees and expenses, combined with the effects of timing and tactical execution of the strategy.
- One factor that has proven positive for the RMI is the contributions from the Government of Taiwan, which have augmented the balance of the Fund. Taiwan has committed to total funding of $40 million over the period of the amended Compact. Taiwan has deposited $13.6 million thus far—exactly equal to its stated intent. Contributions planned for FY2013 – FY2023 at $2.4 million annually would complete the stated intent. Should these additional contributions be fully realized, the projected value of the RMI Trust Fund using the 8.0 percent rate of return would be 97.7 percent of the sustainability estimate. Clearly, the value of third-party contributions is substantial and the allowance for third-party contributions to the Trust Fund, with mutual consent, is an enlightened feature of the amended Compact.

The allowance for third-party contributions to the Trust Fund is an enlightened feature of the Compact.

The RMI Trust Fund has under-performed its benchmark by a total of $4.1 million.

A decomposition of the negative and positive factors is shown in Figure 14. As noted above, the most important factor over the initial 8.75-year period is the fact that actual market performance was far below the required 8.0 percent annual return. The market analysis utilized index comparisons against the initial and subsequent investment strategies adopted by the Trust Fund Committee.

It is worth simply presenting the basic return performance of the RMI Trust Fund as of June 30, 2012. So far, contributions received have been $131 million, while the market value of the Trust Fund was $158 million, reflecting a total gain of $27 million. This computes to a compound annual growth rate of 3.7 percent which is just slightly less than the 3.9 percent achieved by the FSM Trust Fund, though the two funds have differed in terms of exposure to the markets and timing of additional deposits for the RMI. The authors estimate that the RMI Trust Fund actually under-performed its benchmark by a total of $4.1 million. The benchmark would have delivered a compound annual rate of return of 4.3 percent versus the actual rate of 3.7 percent.

As shown in Figure 15 the catch-up rate required for the RMI Trust Fund to achieve the estimated sustainability level by the end of FY2023 is projected as a 9.0 percent compounded annual return for the remaining 11.25 years of the originally projected 20-year accumulation period. Given the historically poor initial period—and the likelihood of a sustained period of above-average performance following the downturn—it is certainly plausible that the RMI Trust Fund will achieve such a result, though success is by no

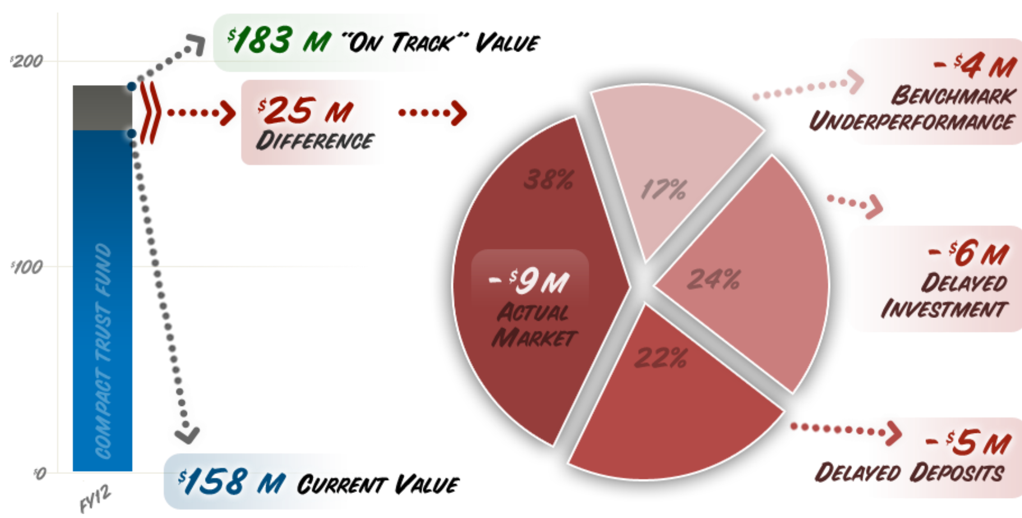



Figure 14 Decomposition of factors resulting in "below track" value.

means assured.

## *Trust Fund Administration and Design*

Over the past two years the Trust Fund Committee has successfully streamlined the management of the Trust Fund for the RMI (and for the FSM) by switching to the use of the same custodian (State Street Bank and Trust) for each Trust Fund and by utilizing the same investment advisor/manager (Mercer Global Investments) as well for each Trust Fund. While consolidating the service providers, there was no loss of flexibility to enable the two funds to implement differing investment strategies. The administration and governance of the funds also appear to have improved, based on the quality and comprehensiveness of the annual report (since FY2011) and the timeliness of the audits of the funds.

Trust Fund governance and administration improved over recent years.

Still substantive technical issues remain for consideration by the Trust Fund committees looking forward. First, the accounting for the "C" account within the Fund is now being addressed, albeit in a way that results in a consistent downward bias in the amount that is periodically recorded in the "C" account. The rationale for the technical methodology undertaken should be revisited; however this is not a matter of great urgency. As noted below, the authors of this report recommend that the "C" account be examined as part of a broader reform of the Trust Fund procedures for both the accumulation period and the distribution period.

Trust Fund needs to grow at the plausibly achievable annual rate of 9.0 percent for the remaining 11.25 years to meet the sustainability estimate.

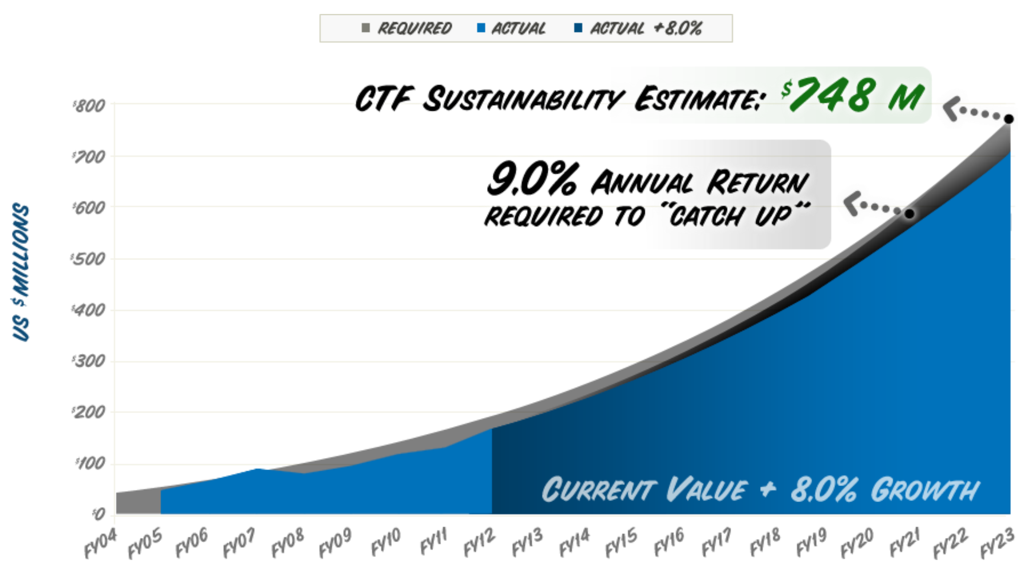



Figure 15 Projected Rate of Return for the RMI Trust Fund to "Catch Up."

The current Trust Fund rules will likely result in immense and repeated fiscal shocks that could be reduced in severity and frequency through better design.

Second, while the FY2011 Annual Report represents an impressive improvement in terms of professional presentation, comprehensiveness of the information shared, and the responsiveness of the report to the requirements of the Trust Fund Agreement, the final section of the report could be improved through better guidance to the service providers involved in providing the analysis. Specifically, the section addressing "Effectiveness to Achieve Purpose" provides insufficient background on the calculations to be useful to readers outside of the core Trust Fund committee members. The value of the professional analysis by Mercer is diminished by the use of comparisons to unrealistic and poorly specified FY2023 grant levels.

Finally, the authors want to repeat an earlier call for the parties to the Trust Fund to consider changes to the Trust Fund Agreement. The current Trust Fund rules are likely to result in immense and repeated fiscal shocks that could be reduced in severity and frequency through better design. Specifically, consideration should be given to modifying the operations of the "B" account which, as described now, provides no benefit, and of the "C" account, which would be more reliably functional if it were created by *fiat* at the outset of FY2024, perhaps at a higher level. Most importantly, consideration should be given to amending the basic annual withdrawal rule, which provides no feedback mechanism to relate the annual withdrawal rate to the actual size—and therefore sustainability—of the Trust Fund. Clearly it would be better to protect the real value of the Trust Fund while also ensuring greater stability of the projected annual flows from the Trust Fund. As currently structured, only the nominal value of the Trust Fund is likely to be protected, while instability of annual distributions is virtually assured.