Republic of the Marshall Islands

Fiscal Year 2010 Economic Review

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CURRENCY EQUIVALENTS

Currency Unit – United States Dollar (US$)

ABBREVIATIONS

ADB	—	Asian Development Bank
Amended Compact	—	Second Phase of the Compact, FY2004–FY2023
AMI	—	Air Marshall Islands
BoP	—	Balance of Payments
c.i.f.	—	Cost, insurance and freight
CIP	—	Capital Improvement Project
Compact	—	RMI Compact of Free Association with the United States
Compact I	—	First 17 years of the Compact, FY1987–FY2003
CPI	—	Consumer Price Index
CTF	—	Compact Trust Fund
CMI	—	College of the Marshall Islands
DoRC	—	Division of Revenue and Customs
EPA	—	Environmental Protection Agency
EPPSO	—	Economic Policy, Planning, and Statistics Office
EEZ	—	Exclusive Economic Zone
f.o.b.	—	Free on board
FDI	—	Foreign Direct Investment
FMS	—	Financial Management System
FSM	—	Federated States of Micronesia
GDP	—	Gross Domestic Product
GNI	—	Gross National Income
GNDI	—	Gross National Disposable Income
IMF	—	International Monetary Fund
JEMFAC	—	Joint Economic Management and Financial Accountability Committee
KAJUR	—	Kwajalein Atoll Joint Utilities Resources
KALGOV	—	Kwajalein Atoll Local Government
MALGOV	—	Majuro Atoll Local Government
MEC	—	Marshalls Energy Company
MTN	—	Medium Term Notes (Compact-backed bonds)
MIDA	—	Marshall Islands Development Authority
MIDB	—	Marshall Islands Development Bank
MIITF	—	Marshall Islands Intergenerational Trust Fund
MIMRA	—	Marshall Islands Marine Resources Authority

MISC	—	Marshall Islands Shipping Corporation
MISSA	—	Marshall Islands Social Security Administration
MIVA	—	Marshall Islands Visitors Authority
MoF	—	Ministry of Finance
MoE	—	Ministry of Education
MoH	—	Ministry of Health
MoJ	—	Ministry of Justice
MoPW	—	Ministry of Public Works
MoTC	—	Ministry of Transport and Communications
MTBI	—	Medium Term Budget Investment Framework
NESS	—	National Economic and Social Summit
NGO	—	Nongovernmental Organization
NTA	—	National Telecommunications Authority
PIER	—	Pacific Island Economic Report
PM&O	—	Philippines Micronesia and Orient Line
PMOP	—	PM&O Processing Plant
PSRP	—	Public Sector Reform Program
R&D	—	Ministry of Resources and Development
RIF	—	Reduction in Force
ROC	—	Republic of China
RMI	—	Republic of the Marshall Islands
SOE	—	State Owned Enterprises
TA	—	Technical Assistance
U.S.	—	United States
USDA	—	U.S. Department of Agriculture
VAT	—	Value Added Tax

NOTE

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

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FOREWORD

This report has been prepared to assist the Government of the Republic of the Marshall Islands (RMI) and U.S. Department of Interior in fulfilling their respective reporting obligations under the Compact of Free Association with the United States. In the case of the RMI, the nation is required, under Title One, Section 215, to report to the U.S. President on the use of sector grant assistance and on progress in meeting mutually agreed program and economic goals. 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 has been prepared under a grant from the Department of Interior and is administered through the Graduate School. However, 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 present a 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.

The report contains three sections: (i) a description of economic developments in the RMI; a (ii) a discussion of policy developments and issues; and (iii) a section on prospects over the medium term with economic projections. The descriptive section takes a standard macroeconomic approach and includes economic growth and employment; monetary developments and prices; the external sector; and fiscal developments. Instead of a comprehensive policy review, the policy discussions address key topical areas,. Discussion focuses on fiscal issues and policy, public sector reform, and private sector development. The prospects section provides forecasts of GDP by industry over the medium term, describes the nation's fiscal position under current policy conditions, and discusses the external and monetary accounts. After the descriptive and analytical sections, there is a comprehensive set of economic statistics.

This report and statistical appendix have been prepared by a team: Mark Sturton, Ben Graham, and Glenn McKinlay. Mark Sturton, with support from Ben Graham, prepared the economic report, while Glenn McKinlay coordinated the statistics. Thanks to Casten Nemra, Chief Secretary; Geelong Bing; and Director Jefferson Barton and his staff at EPPSO. We are also grateful to Boris Anni and Bruce Bilimon of the Ministry of Finance; Junior Patrick, the public auditor; and many other RMI businesspeople who all supported the preparation of the report and statistical appendix.

This report is available online at http://econ.pitiviti.org.

I. BACKGROUND AND SUMMARY

1. BACKGROUND

This report has been prepared to assist both the RMI Government and the United States in fulfilling their respective obligations under the Compact of Free Association with the United States. In the case of the RMI, the amended Compact states, under Title One, Section 215 that:

> *"The Government of the Republic of the Marshall Islands shall report annually to the President of the United States on the use of United States sector grant assistance and other assistance and progress in meeting mutually agreed program and economic goals. The Joint Economic Management and Financial Accountability Committee shall review and comment on the report and make appropriate recommendations based thereon."*

Similarly, the President is required to submit, to the Congress, a report on economic developments in the RMI:

> *(1) REPORT BY THE PRESIDENT. Not later than the end of the first full calendar year following enactment of this resolution, and not later than December 31 of each year thereafter, the President shall report to Congress regarding the Federated States of Micronesia and the Republic of the Marshall Islands, including but not limited to—*
>
> > *(A) general social, political, and economic conditions, including estimates of economic growth, per capita income, and migration rates;*
> >
> > *(B) the use and effectiveness of United States financial, program, and technical assistance;*
> >
> > *(C) the status of economic policy reforms including but not limited to progress toward establishing self-sufficient tax rates;*
> >
> > *(D) the status of the efforts to increase investment including: the rate of infrastructure investment of U.S. financial assistance under the U.S.-FSM Compact and the U.S.-RMI Compact; non-U.S. contributions to the trust funds, and the level of private investment; and*
> >
> > *(E) recommendations on ways to increase the effectiveness of United States assistance and to meet overall economic performance objectives, including, if appropriate, recommendations to Congress to adjust the inflation rate or to adjust the contributions to the Trust Funds based on non-U.S. contributions.*

The report contains three main parts: a review of economic developments, a section on policy developments and issues, and a discussion of economic prospects over the medium term. While this report relates to Fiscal Year 2010, analysis of developments in that year alone would provide a limited and one-sided view. The approach has been rather to review developments in a broader context so that a more informed assessment can be made. The review of economic developments follows a standard macroeconomic approach: growth and employment; monetary developments and prices; the balance of payments and external debt; and fiscal developments. The policy and issues part of the report covers selected topics and is not intended to review the whole range of public and private sector policies. The first section discusses fiscal issues and trends in public sector payroll, external debt management, the operations of state owned enterprises, and the viability of the Compact Trust Fund. The next section identifies appropriate considerations in the design of fiscal policy and implementation. The third section follows up on last year's report, with discussion of progress on implementation of recent public sector reform initiatives: the Comprehensive Adjustment Program (CAP); Tax, Revenue Reform and Modernization (TRAM); and the ADB Public Sector Program (PSP). A final brief section deals with the need for private sector development. The prospects part of the report contains a set of forecasts of possible developments in the RMI economy over the medium term. A forecast of economic growth provides a framework for discussion. There is also a projection of the fiscal account and the implications, assuming no change in current policies. This section also includes a projection of the balance of payments and a banking survey.

2. WHAT'S NEW IN THE FY2010 REPORT

The annual economic review of the RMI economy follows a format that is now well developed and reflects the RMI and U.S. annual reporting needs. Much of the material is thus an update of former reports; new data for the current year is presented as it becomes available, and the analysis changes as the situation develops. For the reader familiar with the report, much of the material is not new; accordingly, the rest of this section identifies new features and areas requiring emphasis.

In the first section on GDP growth, this year's report includes an analysis of GDP by industry. During the last year, additional information has made it possible to present the GDP data series, formerly focused on the income approach, in a more normal format, by industry. The new data resulted in revisions to the GDP series and a significantly different private sector growth path has become evident. The remainder of the first part of the report updates the former editions. In the policy part of the report, progress on the implementation of the CAP, TRAM and ADB Public Sector Program (PSP) loan is updated. In the case of the PSP, current progress (one year into the program) is presented against the loan policy matrix. The section on reforms at the MEC is also revisited as a key element that was identified in prior reports as a threat to fiscal stability.

The last part of the report, featuring economic prospects, is new. The four major accounts of an economic system -- GDP by industry, the fiscal account, the balance of payments, and monetary account -- are projected over the medium term, FY2011-14. The projection starts from consideration of likely developments in GDP by industry and in overall economic growth. Assuming these developments and no change in policy, we can project government revenues and compare them with expenditures. The result is continuing fiscal pressure, although expanded revenues will ease the situation. The balance of payments is projected although the overall result is volatile, suggesting that further work is needed on the external account. Finally, the emerging picture of the banking sector is projected. Overall, the presentation of the four economic sector accounts provides a first attempt at an integrated macroeconomic framework. Such a framework is well suited to budget preparation if information sources can be made available in time.

3. SUMMARY

Earlier economic reports had indicated that the initial period of the amended Compact (FY2003-07) was a period of sustained fiscal expansion and public-sector-led growth, with overall GDP growing by an annual average of 2.6%. However, revisions to the national accounts and derivation of GDP by industry now show that growth faltered in the early part of the Compact, averaging only 1.9%. In FY2008-09 growth turned negative, with the onset of the international recession. However, FY2010 has turned out to be a particularly favorable year, with strong growth of 5.2% resulting from low inflation and from expansion in the fisheries sector. This trend is likely to continue in the next three years, as investment in fisheries enterprise and airport improvements continue. Employment data indicates that the economy has managed to generate a number of additional jobs (an increase of 0.9%) during the amended Compact. Both the private and public sectors have grown, despite the declines in employment 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.

After a period of fiscal stagnation at the end of Compact I, the public sector expanded rapidly from the start of the amended Compact through FY2007. Public expenditures grew by an annual average rate of 12% between FY2003 and FY2007, and employment in the public sector expanded by 507 jobs (an annual average rate of 6%) 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 with a tight cash flow. Total public expenditures have been held in check since that time, but the government underwent periods of default on debt service; delays in vendor payments and payroll; and negative unreserved general fund balance. The fiscal position is now less stressed, but huge challenges remain. Debt service now represents 8% of general fund revenues, and general transfers, including subsidies to the SOE sector, 37%. At the same time, the annual decrement in Compact funding is eroding the real value of the sector grants, requiring an increasing proportion of general fund revenues to support essential services in education and health.

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 U.S. Government has made it clear that neither the terms of the amended Compact nor the terms of the Trust Fund Agreement make any guarantee, or even a commitment, that after 2023 the Trust Fund will be able to sustainably achieve the distributions necessary to maintain the real value of the annual sector grants. It is thus imperative that the RMI Government make every effort to assess the Trust Fund's performance against a sensible goal. That goal is proposed by the authors a Trust Fund sufficient to support a smooth and sustainable transition from direct, U.S.-appropriated annual grants to annual Trust Fund distributions to the RMI. In order to accomplish this transition, the Trust Fund will have to amount to $748 million at the outset of FY2024. Comparing actual performance to a smooth trend line signifying on-track performance, the Trust Fund should have reached $157.3 million as of June 30, 2011; however, the actual value was just $141.9 million. The projected growth rate required to catch up is 8.6%. This rate of return remains achievable, though by no means assured. It is recommended that policymakers mobilize additional contributions—from domestic and external sources—to the Trust Fund to more reliably support the RMI's long-term fiscal stability and sustainability.

Realizing the economic and financial circumstances facing the nation, the RMI leadership initiated a series of reforms. The Comprehensive Adjustment Program (CAP) Advisory Group and 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 the Public Sector Program, including loans 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 sector and tax reform, are on track, others, such as generation of a sustained fiscal surplus and expenditure compression, are not. While there is an election in November and some leeway may be granted, there remains the question of whether the RMI has the resolve necessary to implement the commitments it has made. The donor community indicated its support at the recent Development Partners Meeting, but credibility will undoubtedly be lost if, once a new government is formed, no further progress is made.

II. REVIEW OF ECONOMIC DEVELOPMENTS

A. *Growth and Employment*

1. GDP, GROWTH, AND STRUCTURAL CHANGE

i Overall trends in economic activity

1. The RMI economy has experienced periods of boom and bust since the late 1990s (Fig. 1), an extended period of contraction and fiscal instability resulting from the reduction in Compact grants to fund government operations and the need to repay bonds issued in the early 90s. A Public Sector Reform Program (PSRP) was initiated with assistance from the Asian Development Bank (ADB), to help with the fiscal adjustment. A reduction in force (RIF) was the major component of the reforms intended to reduce the cost of government. There were further objectives: to improve tax administration, reform public enterprises, and improve the environment for the private sector. While the PSRP of the late 90s is now more than 10 years old, it remains especially relevant to the current circumstances facing the RMI.

2. By the start of FY2000, circumstances began to improve. In 1999, the RMI formally recognized the ROC and was to receive $10 million annually in grant assistance, which significantly eased fiscal pressure and permitted an expansion in government expenditures. By FY2002, repayment of the prior bond issues was complete; Compact funds that had in prior years been absorbed in debt repayment were now available.

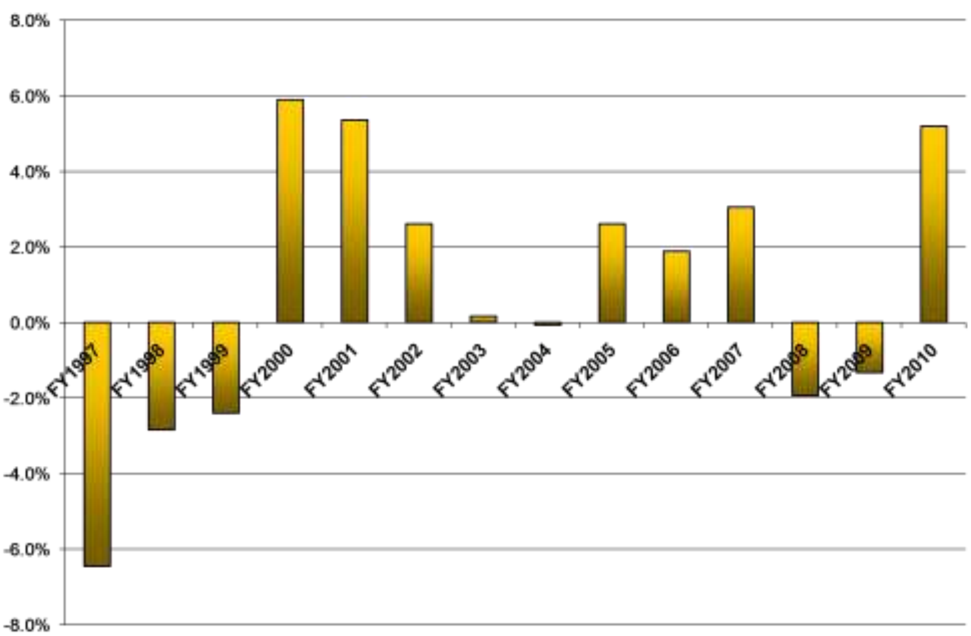


Figure 1 RMI real GDP growth (percent)

FY2002 and FY2003 were also the "bump-up" years of Compact I, which meant the infusion of additional resources. However, the RMI had committed and contributed $25 million to a Compact Trust Fund at the start of FY2004; the effect of this commitment and contribution was to neutralize most of what otherwise would have been a very sizeable infusion of resources. FY2004 was the start of the amended Compact, and the RMI had negotiated a favorable assistance package that resulted in an increase in funding of $10 million above the pre-bump-up levels. However, with the closure of the PMOP fish loining plant, plus capacity constraints in utilizing the additional fiscal resources, the economy stagnated.

3. By FY2005, the very substantial increase in Compact resources over the FY1999-FY2004 period had reached a peak. However, 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 Taiwanese-funded convention center, and reconstruction of the Majuro fish loining plant, with a new owner who saw the potential to revitalize the activity. GDP grew by 2.6%, 1.9% and 3.0%, in the three years from FY2005-07.

4. By FY2008, the economy had peaked, and GDP fell by 1.9%. The large number of construction projects had come to fruition, and further expansion in government was no 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 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.

5. In FY2009, while inflation eased back to 0.7%, reducing the erosion in household incomes, the same general economic forces exerted themselves, and GDP fell by a further 1.3%.

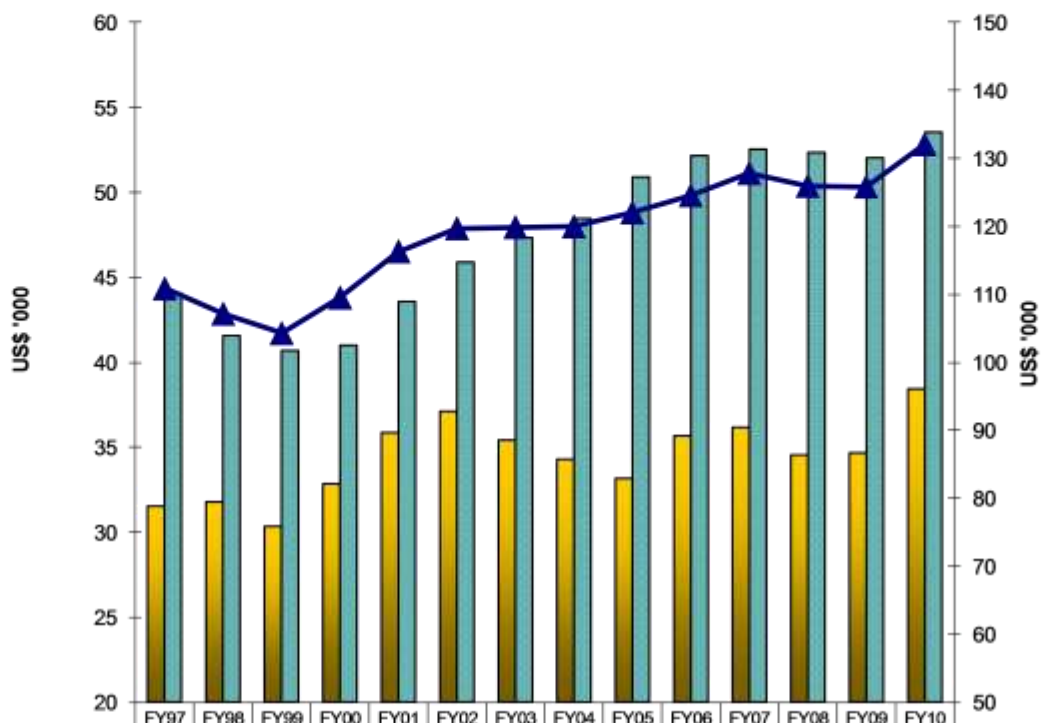
6. In FY2010 the economy -- perhaps surprisingly, given world economic conditions -- grew by 5.2%. The main driver was the expansion in the fisheries sector, which contributed 2.6% of the overall growth and represented increased output from the reopened loining plant and addition of new purse seiners to the fishing fleet. Education and health services also continued to expand and with the general flow-through to other sectors, the outcome was a positive result. Improved tax collections also contributed to growth, although this was offset by increased subsidies to the SOE sector.

ii GDP by institutional sector

7. Fig. 2 elaborates the story, indicating the performance and contribution of the private and government sectors to the economy. The contribution of the government is de-

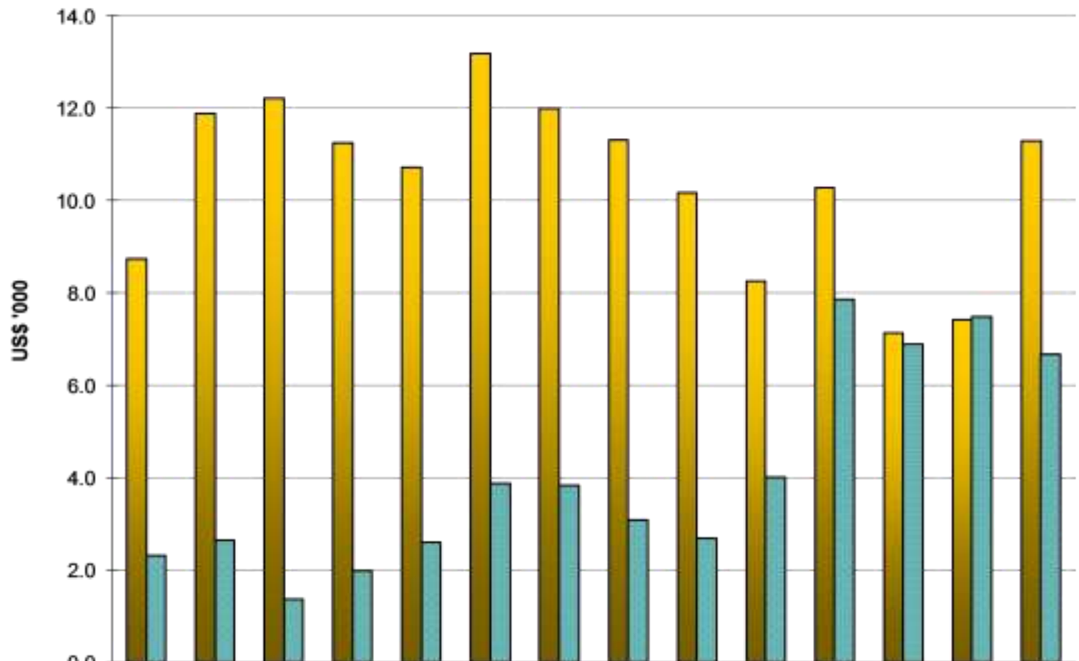
termined through the employment of public servants. The trend in constant prices indicates compression during the late 1990s, coinciding with the RIF, but this is followed by a continuing expansion of 4% per annum in real terms from FY2001-06, the result of the additional infusion of funds. By FY2007, the potential for further employment of public servants peaked, and it fell in FY2008 and FY2009, although government activity expanded by 3% in FY2010. Analysis in prior reports had suggested a clear association between growth in the public sector and a dependent private sector. However, revisions in the statistics indicate this assumption to have been incorrect. While the private sector has grown over the period indicated in Fig.2, performance has been lackluster, and growth has come either from increased fisheries activity or from construction of infrastructure and building projects. Greater details on the private sector are taken up below on the contribution to (*or:* composition of) GDP by industry.

8. The SOE sector is a particularly significant in the RMI because of its large and frequently negative impact on GDP. Fig. 3 provides a snapshot of recent trends. During the late 1990s and up to around FY2003, performance was relatively consistent, and although the level of current subsidies was a concern, it was within bounds. From this point on, the situation began to deteriorate with value-added falling through FY2006, when the situation changed radically (subsidies were unusually high in FY2010 due to high copra



	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Private Enterprise	31.5	31.8	30.4	32.8	35.9	37.1	35.4	34.3	33.2	35.7	36.2	34.6	34.6	38.4
Government	44.0	41.6	40.7	41.0	43.6	45.9	47.3	48.5	50.9	52.1	52.5	52.4	52.0	53.5
GDP at Factor Cost (Gross)	110.8	107.1	104.3	109.5	116.3	119.7	119.8	119.9	122.0	124.5	127.8	125.9	125.8	132.0

Figure 2 RMI real GDP by private and public Sector (FY2000 prices, US$ millions)



	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Value added	8.7	11.9	12.2	11.3	10.7	13.2	12.0	11.3	10.2	8.2	10.3	7.1	7.4	11.3
Subsidies	2.3	2.6	1.4	2.0	2.6	3.9	3.8	3.1	2.7	4.0	7.9	6.9	7.5	6.7

Figure 3 Public enterprises value added and subsidies ($ Millions)

prices and large operating surplus of Tobolor). With the deterioration in the financial viability of many SOEs, the need for government subsidy increased. From an annual average level of government subsidy of $2.8 million over the FY1997-FY2006 period, the level of subsidy increased to an average of $7.2 million in FY2007-10. This result was due to a variety of forces but was heavily influenced by the impact of high energy prices on the financial position of the Marshall Energy Company and the Kwajalein Atoll Joint Utilities Resources. Capital subsidies to these two entities alone reached $6.8 million in FY2009. However, the finances of many other SOEs have also deteriorated: both Air Marshall Islands and the Majuro Water and Sewer Company have required continuing and increasing subsidies. The creation of the Marshall Islands Shipping Corp in FY2007 has required an annual average subsidy of $1.1 million. The impact of the rising level of subsidies provided to the SOEs continues to be a major policy issue, and has threatened the financial viability of the nation, as the government is faced with a decline in the real value of Compact grants. A special section in the policy part of this review provides continuing discussion of the SOE sector and the situation of selected enterprises.

9. While the Government of the RMI is the largest player in the public sector, government agencies and institutions, including the College of the Marshall Islands (CMI), and local government are also significant. Taken together, the two local governments (KALGOV and MALGOV) represented about 20% of the national government in FY2010 (by value-added). In the last few years, growth in local government has been

negative, reflecting the contraction in employment at the Kwajalein U.S. base, the cyclical downturn in the economy, and the consequent impact of falling tax revenues on local government. Government agencies grew rapidly between FY1997–FY2001, primarily as a result of growth in the CMI. Since that time, the contribution of the government agencies has stabilized at around 10% of GDP, although it declined significantly in FY2006, with the amalgamation of the former U.S. Federal Program, Head Start, into the national government.

10. The household sector makes an important contribution to GDP, producing mixed incomes from copra, fishing, and handicrafts. Non-marketed production (subsistence) and home ownership are the main components and are estimated to grow in relation to population growth.

iii GDP by industry

11. The national accounts estimates are now constructed by industrial sector in the RMI, and further discussion of economic developments is based on the GDP tables in the statistical appendix (Table S2). The primary industries sector comprises agriculture and fisheries. Agriculture is of two kinds: production for home consumption with small sales to the local markets, and production of copra, which provides income to the outer atolls. Copra production has grown recently with the improved shipping services of the newly-created Marshall Islands Shipping Corporation, a state owned enterprise, in FY2007. In FY2010, coconut oil prices rose to very high levels, encouraging production.

12. The fisheries sector in the RMI economy has been a strong driver of growth commensurate with the economy's comparative advantage. However, growth has been erratic, reflecting the opening and closure of the PMOP loining plant and replacement with the Pan Pacific Foods (PPF) operation in FY2008. The Pan Pacific Foods loining plant (considered as part of the fishing -- not manufacturing -- sector) is operated at a loss, but this is offset by access to RMI fishing rights. PPF initiated fishing activities with the launching of a first purse seiner in FY2009. Two more boats were commissioned in August 2010. Two more are scheduled to start operations in FY2012, and a final, sixth boat, in FY2013. In addition to the PPF operations, the sector comprises the Marshal Island Fishing Venture, a longline operation run by Luen Thai; four purse seiners operated by Koos; and another purse seiner which is a joint venture between Koos and the RMI government (MIFCO). In addition, there are series of small operators exporting aquatic fish and producing for home consumption in the outer atolls. There is a small commercial fishing market in Majuro.

13. The manufacturing sector consists of a few small local activities producing for the local market and Tobolor, the copra processing plant. General manufacturing for the domestic market has stagnated since the start of the 2000s, but Tobolar has increased production in recent years, driven by the same factors that have led to an increase in copra production. The utilities sector comprises the three SOEs: the Majuro Water and Sewerage Company (MWSC), the Marshalls Energy Company (MEC), and KAJUR the Kwaja-

lein Atoll Joint Utilities Resources. While the MWSC has shown growth as the capital Majuro has grown, production by the two utilities has stagnated because of increasing fuel costs and tariffs. Construction activity includes private business activities, operations of the Public Works Department (PWD), and home construction. Private construction businesses have grown and fallen, depending on the availability of large scale building and infrastructure projects. The PWD was reinitiated in FY2001 (having been disbanded as part of the PSRP), and home building has been expanding in recent years.

14. The wholesale and retailing sector is dominated by retailing to households and has generally stagnated during the amended Compact era. The MEC operates a fuel farm and sale of fuel to fishing enterprises but output has fluctuated significantly reflecting the precarious state of MEC operations. The private hotel and restaurant sector has suffered a prolonged decline averaging 9% per annum since FY2001, despite the potential of the Marshall Islands as a tourist destination, a subject which is taken up in more detail below. The value-added of the Marshall Islands Resort (MIR), a SOE, has trended up by 3% per annum since the start of the industrial GDP statistics.

15. The transport and communications sector contains a series of different activities: general private–sector-operated services and a series of publicly owned operations: the Marshall Islands Ports Authority (MIPA), MISC, Air Marshall Islands (AMI), and the National Telecom Authority (NTA). Most transport and communications activities (private transport, MIPA and the NTA) have stagnated during the amended Compact period:. The MISC commenced operations only recently, in FY2007, and output has remained static. AMI has declined since beginning of the current the statistical series. The individual components of the transport sector display a variety of different trends; thus, overall sector activity is difficult to analyze.

16. Financial intermediation, primarily the banking sector, has grown continuously throughout the period, reflecting a thriving business in consumer lending despite erratic lending to the commercial business sector since the departure of the Bank of Hawaii from the RMI marketplace in the early 2000s. Ownership of dwellings has grown strongly during the FY2000s, reflecting (increased?) home construction, while business services have stagnated. Private personal services have also grown in recent years.

17. Earlier analysis indicated a growing public sector through FY2006 and a largely static picture since that time. But this analysis masks a series of developments in the different components of government activities in administration, education and health. Administration of the national government reflects the trends described in Fig. 2: an upward trend during the amended Compact, peaking in FY2008. Local government, on the other hand, has declined during the same period. Government agencies have stagnated, with the replacement of the Head Start program through the Special Education Grant (SEG), which is now administered by the national government. General education has grown continuously through the amended Compact period, reflecting the switch in Compact assistance to the sector grant approach. The College of the Marshall Islands (CMI), with its

accreditation problems resolved, has expanded during the period. Health services also grew at the start of the amended Compact, but reached a peak in FY2006 and have since remained at that level.

18. GDP also includes the receipt of indirect taxes and payment of subsidies to the SOE sector. Import taxes have been stagnant since the start of the 2000s, reflecting certain concessions, as well as reductions in the tax base. In FY2008 and FY2009, changes in import taxes led to a decline in indirect tax collection of 3% and 11%, respectively. The MEC was exempted from import taxes on fuel resale to overseas shipping vessels, and certain food items were exempt because of large increases in world prices. Also, the fuel import tax was switched from an *ad valorem* basis to a specific (or volume) basis. The Gross Receipts Tax (GRT), which is not subject to the same forces, represents a growing trend since the start of the 2000s. Local government sales taxes mirror the trend in local government GDP: rising in the late 1990s, stagnating during most of the 2000s, and declining in FY2009 and FY2010. As noted above, provision of subsidies to the SOE sector remained constant during much of the period, but took a dramatic jump in FY2007, with the onset of the MEC problems.

19. Finally, an adjustment is made to GDP for FISIM (financial intermediation services, indirectly measured), which is the difference between interest receipts and payments of the banking sector relating to productive activities.

iv Structure of the RMI economy

20. Changes in the structure of the RMI economy during FY1997–FY2010 are summarized in Fig. 4. Not surprisingly, given its rapid rates of growth, government's share has grown from 31.5% in FY1997–99 to 35.4% during FY2008–10. In the case of the SOEs, the share of the sector has fallen from 10.2% to 5.5%, reflecting the large increases in subsidies and negative impact on sector value-added. As a result of deteriorating position of the SOEs, the share of the public sector (including both government and SOEs) has actually fallen from 41.7% to 40.9%. The private sector has increased its contribution, but the small increase reflects its inability to break out of its dependant status and assume a more dynamic role as the engine of economic growth. The share of the household sector, which represents subsistence and home ownership, has increased slightly. With low rates of population growth (on which the household sector estimates are based), a decline might have been expected, as growth in the cash economy outstripped the growth in population. The fact that the share of the household sector has remained largely unchanged reflects the relatively low growth in the modern sector. The share of indirect taxes has fallen, reflecting recent discretionary reductions in tax rates, and weak collections resulted in lower tax revenues. The finance (or commercial banking) sector has increased its share and now represents 5.1% of GDP, while that of NGOs has fallen slightly.

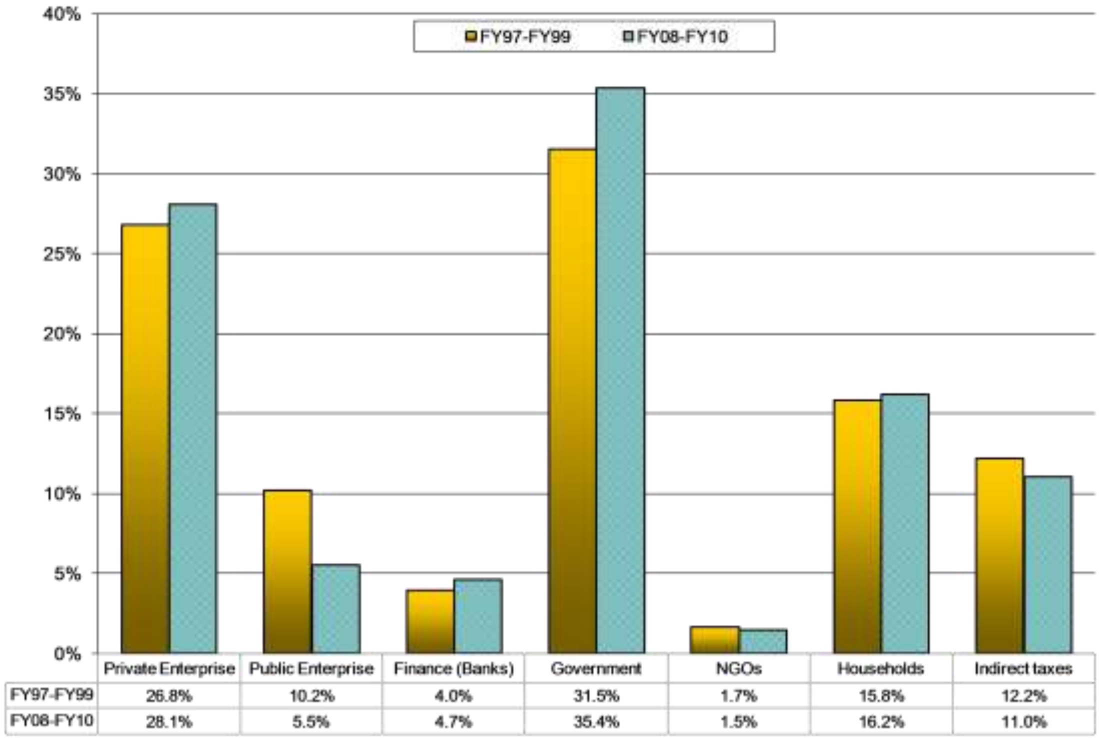


Figure 4 Structure of the RMI economy by institutional sector

2. Population, Incomes, Distribution, and Poverty

21. Population in the RMI has historically grown at very high rates. From 1980–88, in the lead-up to Compact I, the annual average rate of growth was 4.3% (Table 1). Population in Majuro grew at 6.6%, reflecting the emergence of a modern economy and the availability of jobs and public services such as health and education. Population in Ebeye was slightly below the nation's average, and the outer atolls (the "other" category) were below average and reflect internal migration. This pattern changed radically between the next two census points in 1988 and 1999. Population growth slowed significantly to 1.5%, reflecting a reduction in fertility rates and the emergence of large out-migration to neighboring U.S. territories, Hawaii, and the U.S. mainland under the migration provisions of the Compact. While the results of the 2010 population census have yet to be released, current indications are that the population in Majuro has grown rapidly, and there has been increased inward migration from the outer islands. While overall population growth has been moderated by out-migration, inward migration from Asia has been significant.

22. Limited job opportunities and the depressed nature of the economy during the latter part of Compact I encouraged large-scale migration to seek employment opportunities and better rates of remuneration in the United States. Migration plays an equilibrating role: as incomes decline, outward migration compensates, improving the average income

Table 1 Population by major centers and population growth, 1967–1999

	Population				Population Growth			
	Total	Majuro	Ebeye	Other	Total	Majuro	Ebeye	Other
1967	18,925	5,249	3,540	10,136	3.3%	4.9%	11.9%	0.8%
1973	25,045	10,290	5,123	9,632	4.8%	11.9%	6.4%	-0.8%
1980	30,873	11,791	6,169	12,913	3.0%	2.0%	2.7%	4.3%
1988	43,380	19,664	8,324	15,392	4.3%	6.6%	3.8%	2.2%
1999	50,840	23,676	9,345	17,819	1.5%	1.7%	1.1%	1.3%

Source: Census Reports

levels for those remaining. However, outward migration will have a distorting impact on the local economy if it is achieved through a loss of economically active and skilled individuals. Such a loss of human capital would reduce the long-run productive potential of the economy.

23. Table 2 provides further information on current migration rates and net movement of passengers between the RMI and various U.S. destinations. Since the destination of nearly all flights originating from within the RMI is a U.S. point of entry, the figures provide a very useful indicator of net migration. The table indicates the average rates of migration since 1990 in three groups: expansionary phase of Compact I, contractionary phase, and Compact II. The table confirms the reduction in population growth indicated by the census data between 1988 and 1999, which are the result of increasing out-migration. The outward migration rate of 0.8% during the early Compact years accelerated to 2.3% during the depressed era of Compact I and continued at the lower rate of 1.7% during the improved period of Compact II. The table also implies that out-migration from Majuro has been more rapid than from Kwajalein.

24. Fig. 5 indicates the changes in constant-price GDP and real GNDI per capita in 2000 prices. The constant-price GDP estimates are derived from chaining the earlier GDP

Table 2 Net movement of air passengers between the RMI and U.S. ports of entry and percent population

	1990-1996			1997-2003			2004-2010		
	Net Departures	Population	Net Migration	Net Departures	Population	Net Migration	Net Departures	Population	Net Migration
Kwajalein	-25	8,775	-0.3%	-211	9,446	-2.2%	-87	10,168	-0.9%
Majuro	-360	21,408	-1.7%	-970	24,093	-4.0%	-822	27,114	-3.0%
RMI	-384	47,147	-0.8%	-1,181	50,546	-2.3%	-909	52,992	-1.7%

Source: U.S. Department of Transportation "TRANSTATS" database
Notes: Population estimates based on average projected levels between census points.
Only includes air passengers to/from RMI and U.S. air points (Guam, Hawaii, Saipan).
Passengers to/from RMI and other countries (e.g., FSM) are excluded.

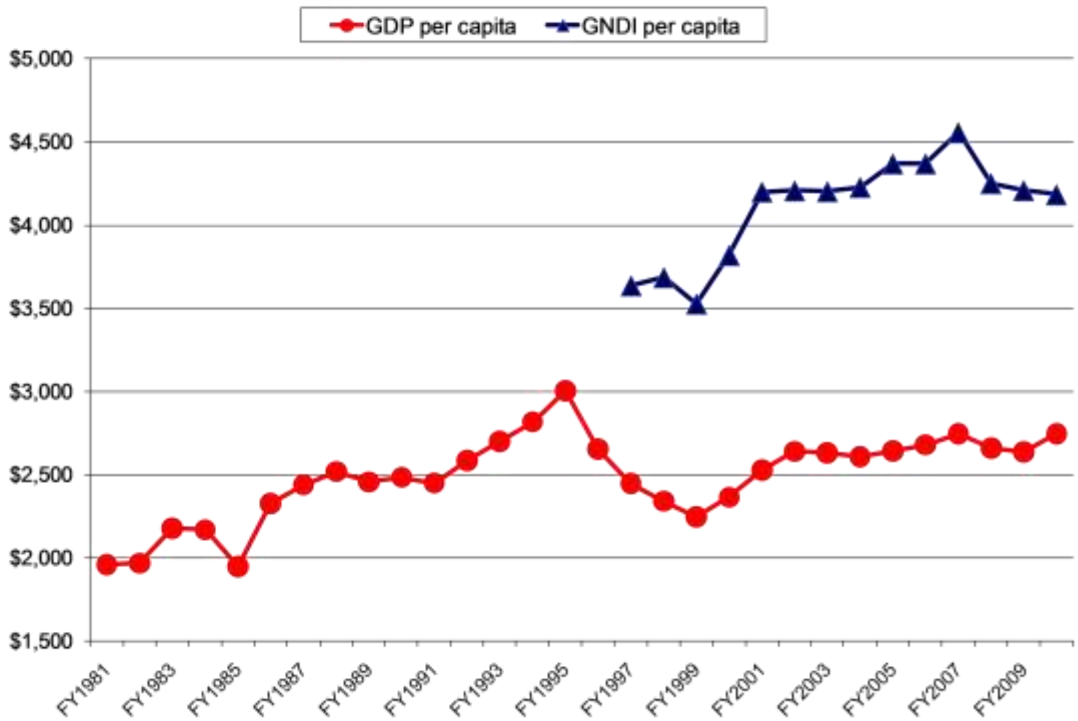


Figure 5 GDP per capita, constant prices 2000, $'s 1981–2008

series with the current national accounts series, and real GNDI includes the primary and secondary incomes received and paid to the rest of the world. The major differences between the two measures are the compensation of Marshallese workers at the Kwajalein base, rent received by Kwajalein land owners, and the receipt of current transfers from the U.S. and other donors (see "Balance of Payments" for a list of primary and secondary income flows). The GNDI estimates begin in FY1997 and indicate the far higher level of disposable incomes when the additional flows are taken into account. In FY2010, GNDI per capita was $4,195, 52% higher than the current price GDP per capita of $2,746.

25. Fig. 5 provides a clear picture of the developments in average real incomes. The advent of the Compact marks a clear and significant improvement in GDP per capita during the run-up and early years of the Compact. Growth was boosted by the new receipts of Compact funds and the series of bond issues that enabled the nation to fast-track public expenditures (including embarking on a series of risky public projects and 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 the former extravagances. In 2000, matters improved, as fiscal stability was restored with new donor assistance, repayment of the debt, and a favorable financial outcome of the amended Compact negotiations. Between FY2000 and FY2007, GDP per capita expanded by $382, an average rate of 2.5% in each year, but failed to regain the level achieved in the mid 1990s. In FY2008

and FY2009, GDP per capita faltered and took a sharp downward turn as the economy went into recession, but regained the ground lost in FY2010.

26. Fig. 5 also includes the trend in GNDI per capita from FY1997. While the trend matches that of the GDP series, the rate of increase during FY2000-07 has been more rapid; GNDI per capita increased by a total of $739 in FY2000 prices, an annual average growth of 3.0%. In FY2008 and again in FY2009, GNDI per capita took a strong downward dip, reflecting the world economic recession and loss of purchasing power due to rapid inflation. In FY2010, unlike the trend in GDP, GNDI per capita continued to fall, reflecting offsetting changes in primary and secondary incomes -- in particular, a large increase in dividend outflows resulting from the increased fishing activity.

27. While this review is macroeconomic in nature, it would be remiss not to comment on income distribution issues and their impact on the economy. Drawing on discussions raised in the 2002 Assessment of Hardship and Poverty (ADB), the 2005 Social and Economic Report (ADB), and the recently completed 2009 National Millennium Development Goals (MDG) Progress Report (UNDP/EPPSO), we note that while abject poverty, starvation, and destitution may not yet be present in the RMI, there are clear signs that certain groups are facing increasing hardship. RMI is demonstrating mixed progress on MDG1 (eradicate extreme poverty and hunger), and there are growing concerns over high unemployment, financial hardship (including declining real incomes coupled with staggering consumer debt), hunger, and poor nutrition.

28. According to 1999 census data, two-thirds of outer islanders have an income of less than $1 a day (in 1993 purchasing power). Fig. 6 provides an overview of average per-capita cash income in the various atolls of the RMI. The data are drawn from the 1999 census and exclude substance production and home ownership, which are usually included in the definition of income. In the outer islands, subsistence production compensates for the lack of cash income, and the emerging picture of income distribution is thus more extreme than the reality on the ground. Economic activity clearly differs between the urban centers of Majuro and Kwajalein— the centers of the nation's cash economy and labor market— and the outer atolls. Cash incomes in Majuro and Kwajalein are four times those of the outer atolls. However, within the outer atolls, the cash incomes of the nuclear-affected communities of Enewetak and Kili are substantially above those in the other islands. In the non-nuclear affected islands, average per-capita incomes range from $71 a year on Lib to $672 on Jaluit; on average, this equates to slightly less than $1 a day. Clearly the lack of income earning opportunities has provided a strong incentive to migrate to the two major urban atolls and, externally, to the United States.

29. While Fig. 6 provides an important picture of the spatial distribution of income, it says little about the characteristics of the distribution of income. According to 1999 census data on household income, the RMI has a Gini coefficient of 0.54 (a standard measure of income inequality ranging between 0 and 1, with higher levels indicting greater inequality). The level of inequality in the RMI is greater than Fiji (0.46), PNG (0.46),

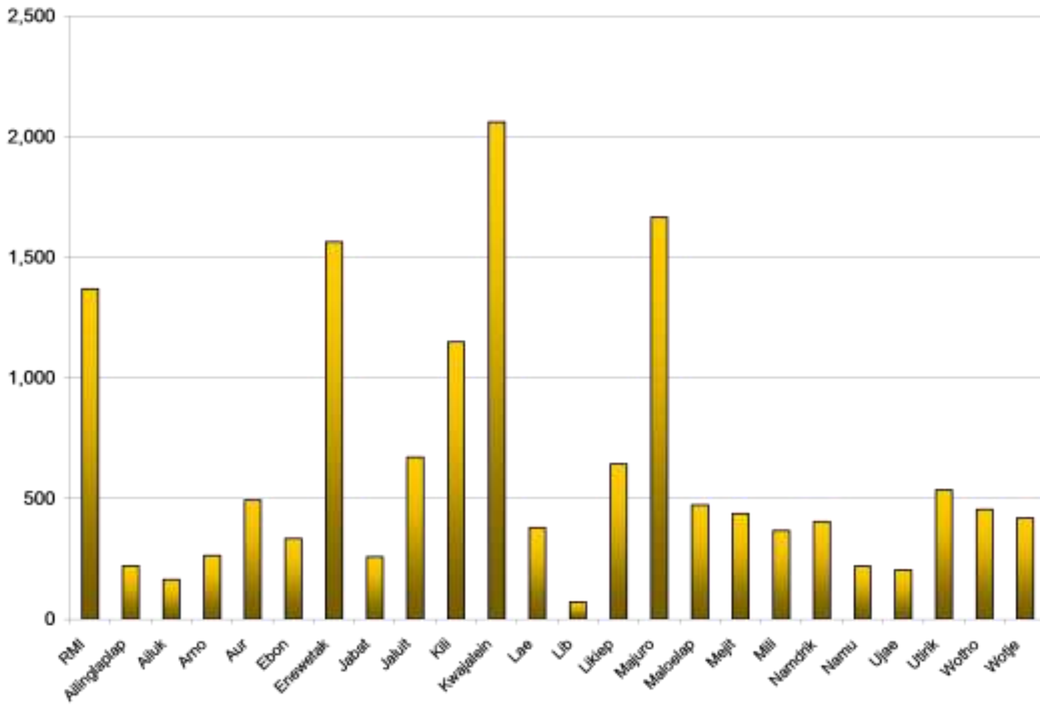


Figure 6 Average per capita income by island, $'s (1999; population census).

Samoa (0.43), Tuvalu (0.43), Tonga (0.42) and the FSM (0.41) for the similar period 1999-2000. While strict comparison between countries may not be appropriate, as other Pacific Island measures may include subsistence, the figures for RMI nevertheless indicate a high degree of inequality.

3. Employment, Earnings, and Wages

i Employment

30. At the end of the 1990s the economy underwent significant stress because of the need for significant reform, and it undertook a series of painful adjustments. These trends are reflected in Fig. 7 and are based on quarterly data collected by the Marshall Islands Social Security Administration (MISSA), adjusted by EPPSO. The figures are estimated from the returns submitted to MISSA by employers, and employment is measured by a count of individuals, regardless of how many hours each individual may have worked during the quarter. Two prominent trends are discernable from the data: the recent growth in numbers employed by the public sector—specifically, the RMI government—and similar but erratic growth in private sector employment.

31. Developments in private sector employment in the first part of the 2000s have been dominated by public-sector-led expansion in the economy, the opening of the PMOP fish loining plant in FY2000, and its subsequent closure in FY2004. In FY2005, employment in the private sector fell by 14% (575 employees), to a level of 3,621, the

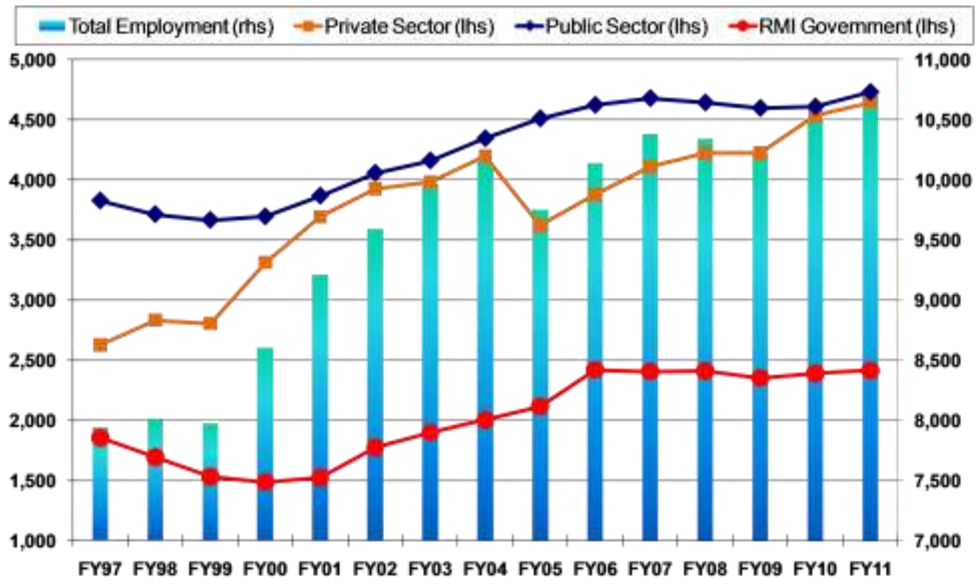


Figure 7 Employment in the private, public and RMI government sectors.

lowest since FY2000, when the PMOP plant first opened. However, in the remainder of the period, private sector employment continued to expand, despite the weak private sector GDP. In FY2006 and FY2007, construction activity created strong additional demand for labor, and in FY2008, the fish loining plant reopened, creating an additional 948 jobs by FY2011.

32. From a declining level of employment in the late 1990s, public sector employment expanded strongly from FY2000 and peaked in FY2007. Public sector employment (including public enterprises, agencies, and local and central government) grew by 28% between FY1999 and FY2007, an annual average rate of 3%. Of the four components of the public sector, the RMI government, which in FY2010 represented 52% of total public sector employment, has been the dominant force in the expansion. It is important to note the impact of the switch in funding of Head Start, which provided preschool education administered by the national government, through an independent unit, to the SEG. Also, in FY2007 the government created the Marshall Islands Shipping Corp., and there was a decline in national government employment as well as an offsetting rise in the SOE sector. In FY2008-11, while government employment maintained its level, employment in the two local governments and agencies has fluctuated, resulting in minor changes in the overall level of public employment.

33. The result of these trends is that employment in the economy as a whole expanded strongly between FY1999 and FY2007, at an annual rate of 3.3%. In FY2008 and FY2009, retrenchment in the US base at Kwajalein offset the reopening of the loining plant, and employment fell by 0.4% and 1.2%, respectively. However, in FY2010, employment at the plant expanded strongly and compensated for the declines in the prior

two years. The combination of fiscal expansion, creation of substantial new jobs in the public sector, and expansion in the private sector, despite the closure and reopening of the fish loining plant, has provided gainful employment to a large number of Marshallese. Since FY1999, employment has grown by an annual rate of 2.5%. However, public sector employment has peaked, and some retrenchment may be unavoidable, as current fiscal pressures require adjustment. It is thus clear that generation of future employment opportunities will require a switch in strategy to private-sector-led growth, if the rate of out-migration is to decline.

34. Fig. 8 indicates the structure of employment, excluding government, education, and health. The wholesale and retail trade sector (34%) employs the greatest number, with fishing-related activities now making a relatively large contribution (18%) since the reopening of the loining plant in 2008. Other activities, such as banks and real estate (7%), hotels and restaurants (4%), and construction (9%), provide much of the nation's private sector employment. Manufacturing and agriculture ("others") are insignificant employers. The Kwajalein U.S. base is included in the data set and represents a significant proportion of total private sector employment (15%). Employment at the base was projected to fall by 669 jobs out of a total of 1,239 in FY2006 because of advances in technology (such as the recently completed fiber optic connection) that enable operations to be conducted from the U.S. mainland. However, current data indicates that the original anticipated reduction has been much less severe than expected, and jobs have actually fallen by only 306. Nevertheless, future retrenchment is in the pipeline, with further mili-

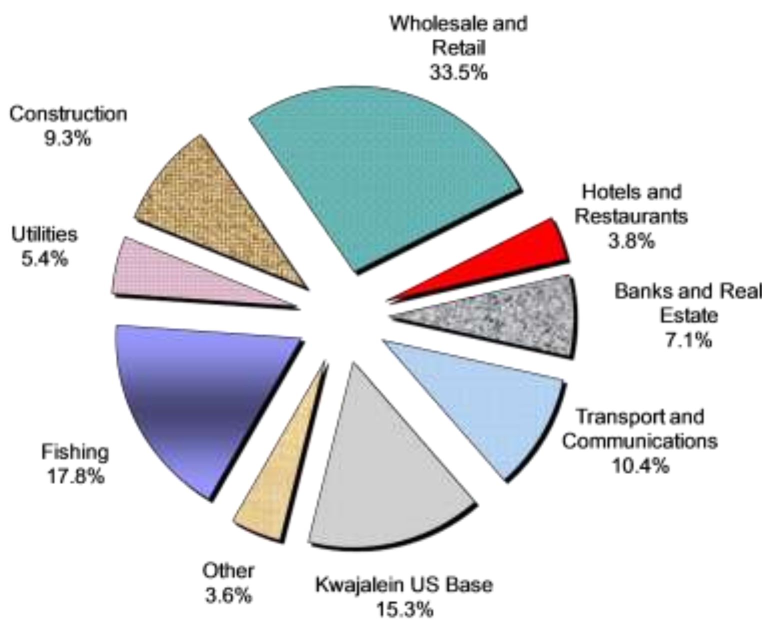


Figure 8 Employment in the Private Sector by Major Industrial Sector, FY2009

tary downsizing at the base, and it is expected that another 60 employees will lose their jobs in FY2011.

ii Wage Rates

35. The data on nominal and real wage rates is derived from dividing the MISSA-sourced reported earnings levels by employment numbers. Although this is not an exact estimate of wage rates, it should closely approximate change in wage levels. Fig. 8 reveals a series of interesting trends. First, public sector nominal wage rates rose during the late 90s, reflecting the fact that the RIF involved a disproportionate loss of low-paid workers. In the first part of the 2000s, nominal wage rates continued to rise rapidly, at an approximate annual average rate of 3.3% in the FY2000-04 period, reflecting the relative abundance of resources. In the FY2005-FY2011 period, as the fiscal situation tightened, public sector wages moderated and grew by 1.4%. For the private sector, the pattern is different. The PMOP plant depressed average rates when it began operation in FY2000, but wages continued to fall through FY2004 until the plant ceased operations, and average wages rose in FY2005. During the later period, through FY2010, nominal wage rates have grown modestly, but did not experience any significant dip till FY2010, when the fish loining plant started operating at capacity.

36. It is not possible to conclude that public sector wage rates for similar skills are higher than in the private sector. However, it is clear that the wage difference between the sectors has widened significantly. In FY1997 it was 51%, but by FY2004, it had in-

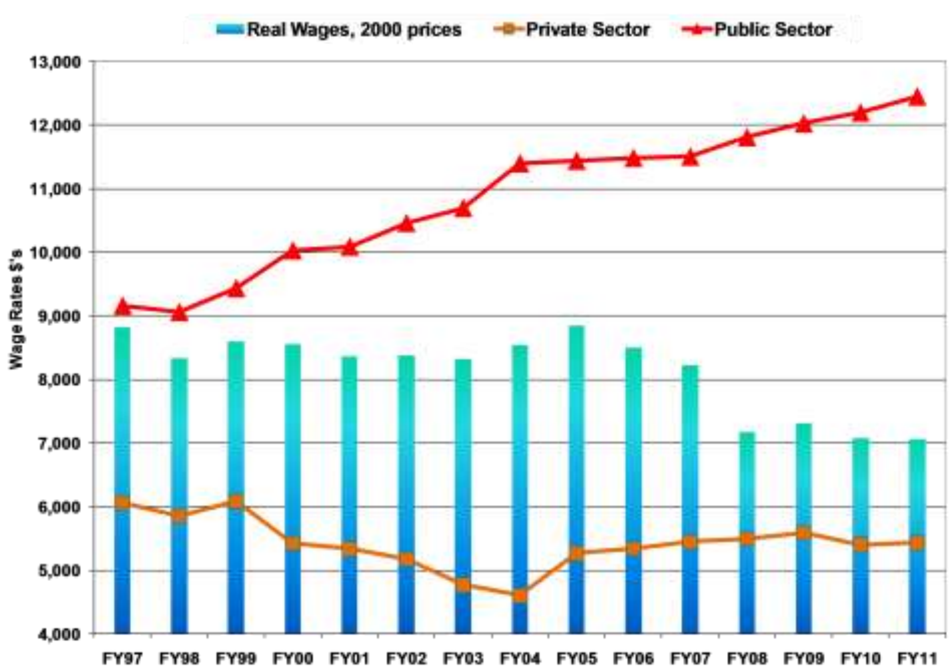


Figure 9 Nominal and real wage rates by major institutional sectors

creased to 148%, though it fell back to 129% in FY2011. The widening disparity encouraged a shift of resources (i.e., labor) to the public sector. Fig. 9 also indicates that real wages largely held their value through FY2007. However, in FY2008 the inflation increased rapidly, reflecting rising worldwide food and fuel prices, which significantly eroded real living standards. The average real wage fell by 13% in FY2008, but has since stabilized as prices returned to more normal levels, reflecting the onset of recession in the world economy.

4. Sectoral Developments

i Agriculture

37. ***Policy overview***: Policies and priorities surrounding agricultural activity and production have varied over the years. While the importance of agriculture for basic subsistence and nutrition has always been maintained, national agricultural policy has increasingly emphasized the potential of agriculture as a commercial and value-adding economic activity. Copra has been the dominant commercial agricultural activity in the RMI now for over 100 years, with productivity and export levels reaching their pinnacle during the 1920s and 1930s under Japanese administration. In 1976, while still under Trust Territory Administration, the RMI established a Copra Stabilization Board Act, which was in 1992 subsequently replaced (by Act), by the Tobolar Copra Processing Authority, which remains in effect today.

38. Policy and planning for agriculture and related activities fall under the Ministry of Resources and Development (R&D), whose Strategic Plan for 2005-2010 articulated numerous objectives: increasing domestic food production and consumption (including establishment of new farmers' markets in the two urban areas); ensuring adequate supply of agricultural inputs for the production of coconut, as well as handicraft, medicine, and other non-food products; protection against the introduction and spread of injurious pests and diseases; increasing exports of niche and value-added products; increasing the value of coconuts and coconut products; and reducing dependence of outer island communities on imported fuel and copra subsidies. With limited national investment into agriculture (aside from annual subsidies to the copra industry), the majority of activities and projects are funded by development partners. A new strategic plan for R&D is to be developed by the end of 2011.

39. In 2011, at the request of the RMI Government and the Tobolar Board and Management, technical assistance was provided by the ADB to support the development of a medium-term strategic plan for Tobolar. The ultimate aim of the plan is to improve the commercial and financial viability of the company and thus reduce its dependence on government subsidies. Work on the plan will begin in late 2011.

40. ***Trends and developments***: Domestic (non-copra) agricultural production and consumption data are very limited. A household survey in 2006 conducted by EPPSO

showed that a large portion of rural households continue to rely on home production for own consumption, and well over half relied on copra as a source of income.

41. Occasional spikes in global prices for coconut oil translate into boom years for local copra production and sales. In 2008, with high global prices, total copra production reached 7,182 tons (well above the recent average). This moderated to 6,567 and 5,405 tons in 2009 and 2010, respectively, when global prices subsided. Early 2011 saw another sharp rise in global prices, which allowed Tobolar to make a record sale of coconut oil worth some $3.8 million. The cash generated from this sale might reduce Tobolar's annual government subsidy (around $1 million) in the coming two to three fiscal years, but it remains to be seen whether this will occur.

42. In late 2009, management of Tobolar reverted to the government, after the private company that had run the processing plant since the late 1970s announced it would discontinue its management role. Shortly after this, in early 2010, an independent assessment of Tobolar conducted by U.S. firms (Hawaii-based Oceanic Companies, Inc. and Pacific Biodiesel of Maui) documented significant deterioration in the main plant facilities and very poor policies and practices in place for physical maintenance, safety, personnel, and other areas of management and operations.

43. In 2010, an Asian Development Bank (ADB) and Government of Japan grant was approved for the trial of a coconut-oil and diesel blended fuel for the main power plant in Majuro. This project is now underway and should provide initial results in early to mid-2012. If the trial is successful, the use of the blended fuel for power generation would help to stabilize Tobolar's revenue source (and therefore the revenues of copra farmers) and possibly reduce costs for the Marshalls Energy Company. A second ADB grant was approved in 2010 to support a national coconut tree replanting project, beginning in late 2011, to replenish ageing coconut plantations and provide income support for outer islanders. Meanwhile, domestic production of niche agriculture products (both edible and non-edible) has increased, the result of greater private sector interest and investment, as well as stronger technical assistance and training programs facilitated by Taiwan, the Ministry of Resources and Development, and non-governmental organizations.

44. The high inflation in the prices of imported rice and other staple foods in 2008 prompted the government to reconsider and refocus efforts to strengthen basic food security, which is now a key strategic priority of the Ministry of Resources and Development. Recent technical assistance, partly from the United Nations Food and Agriculture Organization, aims to strengthen domestic crop production and self reliance. The recently completed Majuro fish market (see fisheries section below for more information) has improved cash-earning prospects for rural fishermen and farmers. The operation is run by MIMRA, with technical support from Japan, and includes two new vessels that regularly call on outer islands to purchase fish and produce and transport them for marketing and sale in Majuro. More time and analysis will be required to determine whether the operation can be fully self-sustaining.

ii Fisheries

45. ***Policy overview:*** Fisheries policy has evolved significantly since the beginning of the Compact. Through the early 1990s, the perception in RMI and throughout most of the Pacific was that it was government's role to directly own, operate or tax the means of production, including the vessels, processing plants, and other facilities. Moreover, local participation in fisheries was strongly favored over foreign involvement and investment. But by the mid-1990s, after a number of costly government-led fisheries projects had failed (including a major ADB-financed fisheries venture in the RMI), it became clear that this approach was not working. The RMI thus had to rethink its policy, and with additional support from the ADB, a new direction was taken. The RMI's first National Fisheries Development Plan (NFDP 1997) aimed to create an environment more conducive to private-sector–led fisheries development. The plan, which included an organizational overhaul of the Marshall Islands Marine Resources Authority (MIMRA), helped establish the RMI as a business-friendly fishing nation and port. The adoption and implementation of the NFDP, along with improvements in MIMRA management in the late 1990s, has, since 1999, led directly to a turnaround in the fisheries sector and ushered in significant new investment and growth.

46. The RMI maintains its business-friendly policy, but greater regional concern has emerged over several key issues, including (i) the sustainability of the tuna stocks (particularly yellow-fin and big-eye tuna); and (ii) the strong perception that the resource-owning Pacific states are not equitably benefiting from the $4 billion annual tuna harvest in the central and western Pacific. The Parties to the Nauru Agreement (PNA), the group of eight countries, including the RMI, which now provide an estimated one-third of the global supply of tuna, have become increasingly vocal over the effectiveness of the current fishery model and established their own intergovernmental body, based in Majuro, to begin pursuing new policies and approaches to address their concerns. As noted in the trends and developments section below, the PNA has made significant progress on a number of fronts.

47. The RMI's ongoing, overarching policy priorities are to conserve, sustain and assert more influence on the performance and economic impact of the fishery, including pushing for better economic returns to all PNA states. Moreover, a key priority is to secure access to RMI's domestic based vessels, which supply the expanding onshore processing sector in Majuro. Seasonal shifts in tuna migratory patterns heavily impact the RMI, requiring its domestic fleet to have access to neighboring fishing zones.

48. ***Trends and developments:*** The new PNA Secretariat was established on Majuro in 2009, and the group has made significant advancements in the past two years, including successfully closing off fishing in high seas pockets (adjacent to PNA EEZs), enforcing a vessel day scheme (VDS) for purse seiners, setting a 'hard limit' of total allowable vessel days, and setting a minimum benchmark fee for foreign fishing vessels, among other achievements. For 2011, the PNA agreed to a maximum of around 28,000 vessel days (the "hard limit"), with each party allocated a portion of this based on historical

catch records and other criteria. In 2010 and again in 2011, the RMI was able to sell a portion of its allocated vessel days to other PNA parties, raising significant incremental revenue to MIMRA. In mid 2011, RMI sold 1,500 of its total 2011 allotment of nearly 2,500 vessel days to PNG and the Solomon Islands, which will net MIMRA over $3.75 million.

49. It remains unclear whether this incremental revenue to MIMRA will be shared with the national government. What is fairly clear, nonetheless, is that the practice of trading days within the PNA is set to become a regular process, enabling parties to allocate vessel days more efficiently to take advantage of periods when demand is highest, while still imposing a limit on the fishing effort. Collaboration among PNA members in recent years has already delivered ‘game changing’ results in the world’s last healthy tuna fishery. Continued efforts by the PNA, including the possible introduction of a new VDS for long-liners and the possible further raising of vessel day minimum fees, are likely to provide additional revenues in the coming years.

50. A new Economic Partnership Act, under negotiation with the EU, could potentially include fisheries access and fisheries trade components. Access to the European market could provide value-adding and export opportunities for the RMI. While the RMI has expressed its intention to sign onto the Interim agreement, the comprehensive agreement is being negotiated, with the Forum Secretariat and the Secretariat of the Pacific Communities taking the lead.

51. A major issue confronting the PNA and other members of the Pacific Forum Fisheries Agency is the expiration, in 2012 of the region’s only multilateral fisheries access treaty, with the U.S. Several PNA members, including PNG, have expressed dissatisfaction with the treaty terms (which allows 40 U.S. vessels free reign within Pacific member EEZs) and have signaled their desire not to renew the treaty.

52. The RMI’s commercial fishery sector has been a primary source of employment and economic growth in recent years. Formal fisheries employment peaked at over 1,100 in FY2010, the highest level thus far, although this overestimates the full-time-equivalent employment. The Pan Pacific Foods (PPF) tuna loining plant has been the primary driver of this growth. PPF now employs a daily average of 473 persons.

53. The sector has grown and diversified in recent years. Currently, four Majuro-based operations are engaged in the harvesting, processing and export of skip jack (for the canned tuna market), yellow-fin, and big-eye (for the sashimi market). Fish exports from the RMI totaled $8.8 million in FY2010, plus an additional $3.7 million in fish processing and vessel support service exports. At least two of the firms have expressed their intentions to expand their operations; such an expansion should continue to sustain growth in this sector in the coming years.

54. In 2009, a Taiwanese firm was granted clearance to establish a large-scale drydock with capability to service purse seiners in Majuro. A site for the new drydock

was identified in 2010, but the project remains in limbo because of land disputes at the new site. A new Japanese-funded fish market opened on Majuro in early 2011. The market, which includes two new cargo/transport vessels, aims to help to regularize inter-island trade and commerce and will improve prospects for outer islands to sell fish, produce, and other products to consumers in Majuro. A pending bill in the Nitijela will ban shark fishing and trade in the RMI and will establish the RMI (along with FSM and Palau) as part of the world's largest shark sanctuary. There remain questions as to the effects of this measure on the longline industry.

55. Through the Western and Central Pacific Fisheries Commission (WCPFC), based in Pohnpei, the RMI and other members have pushed for continued reforms in the management of highly migratory fish stocks. Some of the issues of RMI interest in the WCPFC include:

- Investing in and further developing the National Observer Program to meet requirements under the Commission rules and also to take advantage of employment opportunities in the sector.
- Developing further its Flag State regime in order to more effectively discharge its responsibilities for fishing vessels flying the RMI flag.
- Developing a competent authority base, in order to inspect, certify and issue national, regional and international standards for fishery export products from the RMI.

56. A pending bill in the Nitijela will amend the MIMRA Act to reflect these changes.

iii Tourism

57. ***Policy overview***: Tourism has long been identified as a priority sector for development in the RMI. Tourism's potential as an economic driver was recognized in the early development plans of the first Compact, and in 1991, the Nitijela enacted the Marshall Islands Visitors Authority (MIVA) Act to facilitate tourism planning and development. Technical assistance from the ADB helped to strengthen MIVA in 1997-98 and provided the RMI with its first medium-term marketing and development strategies (focusing on niche markets). In 2008, with support from the U.S. Department of the Interior, the RMI completed its first National Tourism Development Plan (NTDP). The plan diagnoses the country's key strengths and weaknesses and articulates a number of goals and objectives to more effectively facilitate tourism investment and growth over the medium term (2008-11).

58. The NTDP identifies three spatial and sequencing priorities: (i) to further develop Majuro into an attractive and well functioning hub and gateway to the rest of the country; (ii) to begin laying the foundation for opening up Kwajalein Atoll for tourism development, with the longer-term goal of developing Kwajalein into the second international

hub and gateway; and (iii) to catalyze tourism growth in the outer islands by improving domestic air transport, reducing barriers to sea-based tourism, and facilitating assistance for small scale tourism development in the outer islands. Over the medium to long term, the NTDP intends to focus on the development of a high-end, private-resort tourism industry.

59. ***Trends and developments***: As of 2011, progress on the key goals and objectives of the NTDP remain limited. Major constraints identified in 2008, including limited access to secure land for investment and poor domestic airline service, remain valid as of 2011.

60. The industry remains small and has contracted in recent years. Total arrivals peaked in 2004 and 2005 with each of these years recording more than 9,000 air and sea visitors. But arrivals have fallen sharply in recent years, with 2008, 2009 and 2010 averaging just over 5,000 arrivals. Cruise ship arrivals remain sporadic and special charter flights from Japan in 2007, 2008 and 2009 have been discontinued. Hotels and restaurant formal employment has contracted slightly in recent years, totaling 255 in FY2010.

61. In mid 2010 a new Continental "mini-hopper" airline service began operations, adding one weekly direct flight from Guam and Honolulu to Majuro, increasing the number of available inbound seats by 33 percent. It was hoped that this service's direct Guam-Majuro weekly connection would help boost travel from Asia, but this does not appear to have occurred, and Continental (now United) has announced it may discontinue the service in late 2011. This flight carried some traffic between Guam and Honolulu, but an aircraft upgrade on the Guam-Honolulu sector is expected to reduce the need for the Guam-Majuro-Honolulu mini-hopper.

62. The accommodation base saw some expansion in 2008 and 2009, with new facilities in Majuro (on the main island and in the northern islands) and Rongelap. In 2008, a new live-aboard operator began offering seasonal tours in the RMI, and in late 2011 the same operator will begin construction of a resort on Ailinlaplap Atoll. In 2008 one of the RMI's key tourism attractions, Bikini Atoll Dive Resort, terminated operations, due in large part to the unreliability of Air Marshall Islands. In 2010, Bikini Atoll was accepted by the United Nations Education, Scientific and Cultural Organization (UNESCO) as a World Heritage site, and it is anticipated that this recognition will spark interest in re-establishing resort operations on Bikini.

63. Domestic air service remains a key constraint to tourism development in the RMI. The poor performance of Air Marshall Islands continues to prevent any real prospects for outer island tourism development, aside from sea-based tourism. An ADB-supported analysis of AMI in early 2011 provided a clear picture of the company's poor and unsustainable financial and operational performance and offered policy options for reforming the airline. It remains unclear whether the government will act on any of these options. A mid-2011 policy advisory letter sent from the Chamber of Commerce to the RMI President recommended a set of actions for reforming and improving AMI, including man-

agement change, removal of all elected officials from the Board, and discontinuation of political interference in the day-to-day operations of the airline. It remains to be seen whether these recommendations will be considered and implemented.

64. In 2009, the government announced its intentions to sell the Marshall Islands Resort (MIR). Two initial bidders for the facility subsequently retracted their offers, partly because of a clause in the government's land lease for the property site that guarantees additional payments to landowners (derived from gross and net income revenues) in the event that controlling interest of the business no longer remained with government. Moreover, in recent years, the facility (which is less than 20 years old) has seen major dilapidation and corrosion because of poor construction quality; heavy and costly ongoing maintenance and repairs have been required.

65. The NTDP's intentions to foster the development of a high-end private resort industry will require significant and complementary improvements in air and sea accessibility (both to and within the country), access to secure-titled land and islands for development, and supporting infrastructure. A planned tourism summit in late 2011 will revisit the NTDP and re-chart a course to help grow this still-fledgling sector.

B. Monetary Developments and Prices

1. Prices

66. Fig. 10 indicates the annual percent changes in the RMI CPI since FY1990. It might be expected that inflation in the RMI would follow trends in the United States, given the close historical ties, although in recent times the emergence of strong ties with the ROC has resulted in changed sources of supply. Inflation in the RMI has mostly been moderate, although in the mid-1990s, rates were above U.S. norms. The early part of the 1990s was a period of rapid growth in GDP, and expansion in demand would likely have resulted in acceleration of inflation. In more recent times, from FY1999-FY2004, the rate of inflation in the RMI moderated significantly and fell below U.S. rates, despite the pick-up in economic growth and additional demand in the economy. More recently, between FY2005 and FY2007, inflation in the RMI was very similar to inflation in the U.S. In FY2008, the rate of inflation rose to 15%, reflecting very large increases in food and energy prices. In FY2009 and FY2010, inflation dropped back to 0.5% and 1.5% in the two periods, respectively, as prices moderated in the U.S. and the economy went into recession. In general, Marshallese prices mirror U.S. prices, with differences reflecting the composition of the respective consumer baskets; the Marshall Island CPI contains a higher proportion of food and fuel items.

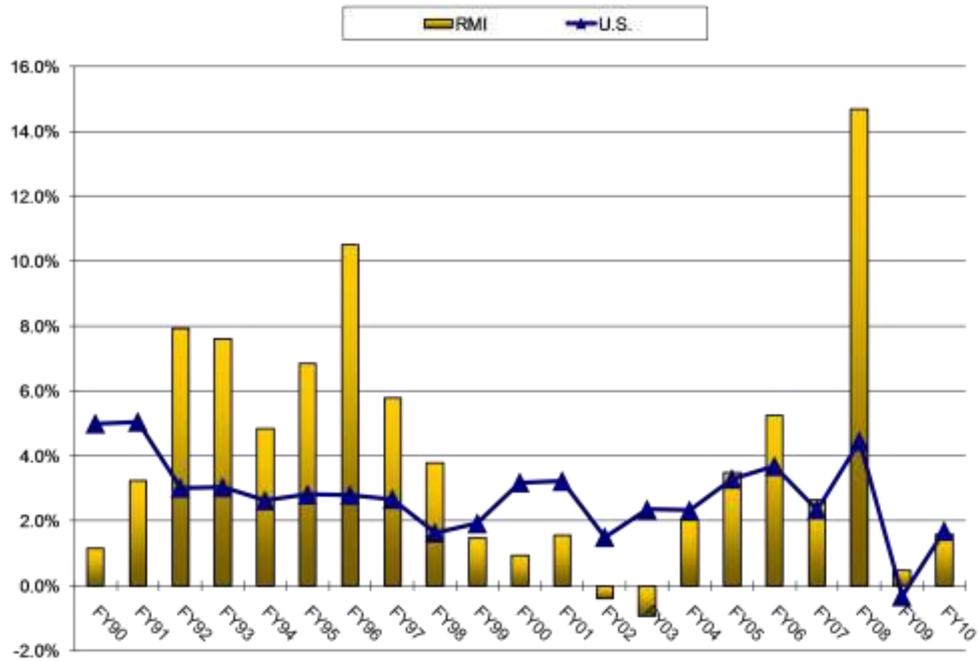


Figure 10 Change in CPI: RMI, FSM, and U.S. (percent); FY1984–FY2010

67. From the first quarter of 2003, the Economic Planning, Policy, and Statistics Office (EPPSO) initiated a new CPI series based on the 2002 Household Income and Expenditure Survey. Fig. 11 indicates changes in the new index for selected commodity groups since Q1 of 2004. 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 Q3 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 is more clearly identified in transportation prices, which rose by 42% in the same quarter. Reflecting the increases in world food prices, which have had serious consequences for developing nations, the food section of the CPI rose by 31%. The combination of these forces resulted in the CPI rising by 15%, to rates not experienced since the mid-90s. In 2009, food and fuel prices moderated significantly to levels below those of 2008. In the Q3 of 2009, housing and utility prices had fallen by 31%, fuel prices by 20% and food prices by 7%. During 2010, price changes were in general less erratic, with food prices continuing to fall and transport prices rising by a modest 1%. However, the housing and utility section again returned to the levels prevailing in 2009 and recorded a rate of inflation of 23% by the end of the fiscal year. Overall inflation was 4.4% by fiscal year-end.

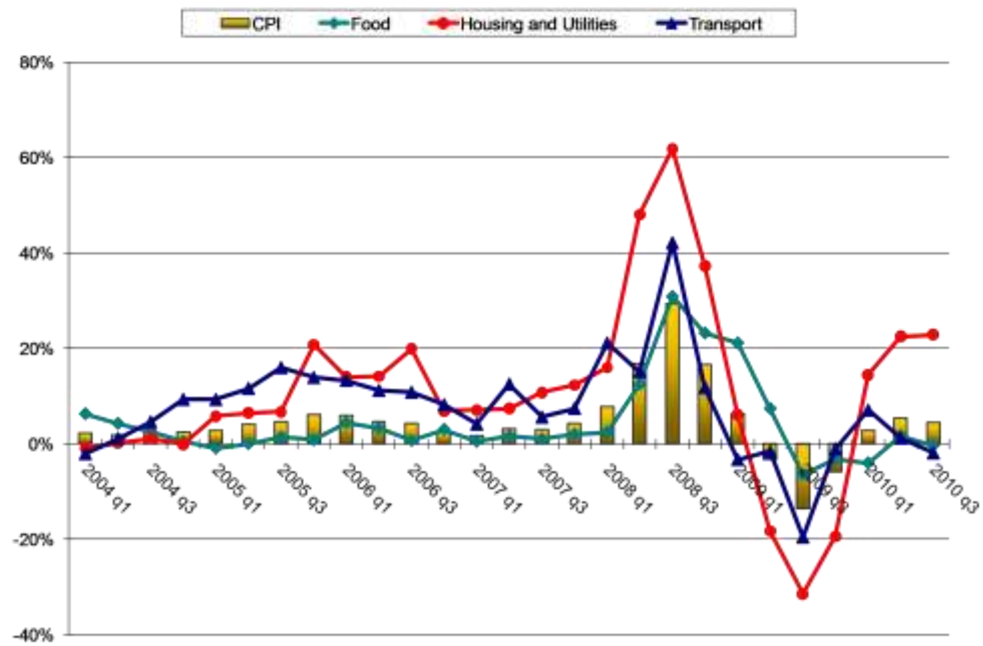


Figure 11 Change in CPI by selected major commodity groups; FY2004–FY2010

2. Money and Banking

68. With the adoption of U.S. currency in the RMI, macroeconomic policy and adjustment has been limited to fiscal policy. The use of a foreign currency is practiced in many other small island economies of the Pacific and has served the RMI well. While the range of macroeconomic policy options is limited, the use of U.S. currency has removed the potential to use inflationary monetary policy to adjust to changes and reductions in Compact funding. Consequently, the RMI has no means of adjustment to reduced levels of resource transfers, other than the more politically painful policy of directly cutting government expenditures, reducing public sector employment and wages, and increasing domestic revenues. Furthermore, the use of a foreign currency has removed exchange rate realignment, to encourage the export and traded goods sectors of the economy. At this stage of RMI economic development, with many underlying structural impediments, exchange rate adjustment without accompanying supporting policies would be unlikely to have encouraged a favorable supply response in traded-goods production.

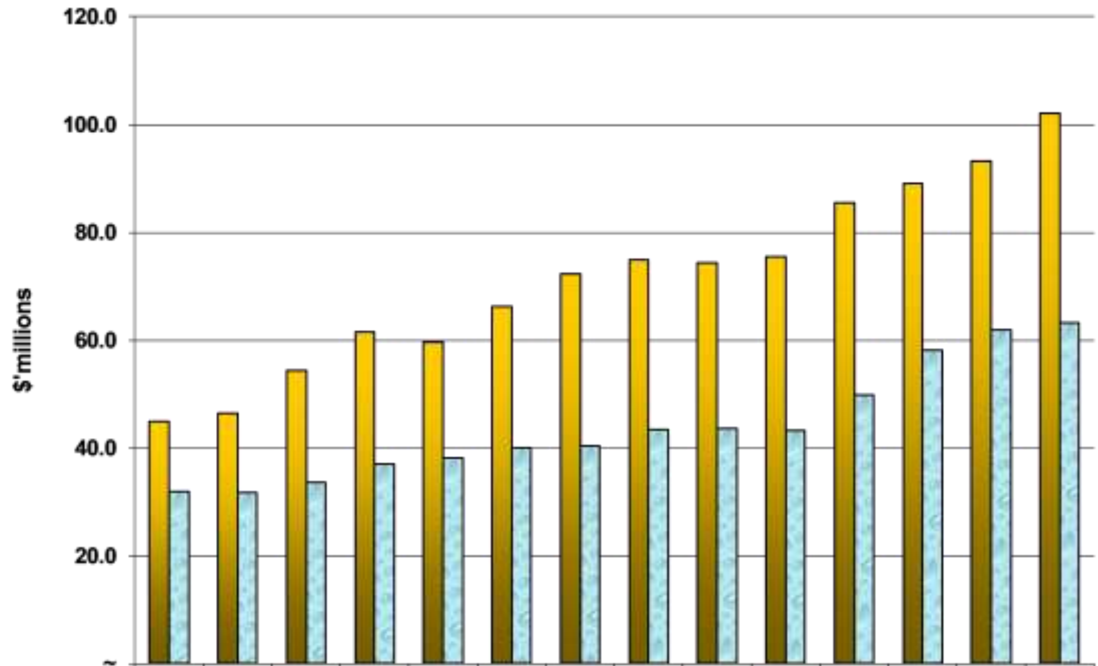
69. The banking system in the RMI is regulated by the banking commissioner, whose role includes licensing of domestic and foreign banks, on- and off-site supervision of all commercial banks, and consumer protection. The Marshall Islands Development Bank does not currently come under the regulatory inspection of the banking commissioner. Until December 2002, when the Bank of Hawaii withdrew from the market, there were two U.S. banks operating in the RMI. There is one locally owned bank, the Bank of the Marshall Islands. The remaining U.S. bank, the Bank of Guam, is a branch of its parent

registered in the U.S., comes under U.S. federal supervisory requirements, and is FDIC-insured. Although the financial system has provided satisfactory and secure banking services, the marketplace, because of its small size and lack of a well-developed supervisory capability, requires careful monitoring.

70. Since there is no independent monetary policy, domestic interest rates are closely aligned with those in the U.S. Deposit interest rates are broadly similar to those throughout the United States. From 1997–2000, average three-month deposit rates were just 4.1% (see Appendix, Table 6c), but they were subsequently reduced, following the general easing of monetary policy in the U.S. By 2004, the three-month deposit rate had fallen to 1.3%; it strengthened slightly in FY2005-FY2007 but fell back to 1.8% in FY2008 and in FY2010 stands at 2.0%. Lending rates, however, are generally higher, reflecting the additional risk, costs of doing business in the RMI, and limited competition. Interest rates on consumer loans averaged 18.5% during FY1997–FY2008, but have since moderated, falling to 14% in FY2010. Lending rates for commercial borrowing are significantly lower than unsecured consumer rates but have followed a similar pattern, averaging 11.2% through FY1997–FY2000 and falling to 8.9% in FY2010. As in many developing countries, financial intermediation is accompanied by a significant spread between lending and deposit rates.

71. Statistics on the RMI banking sector are available from 1992 onward (see Appendix, Table 6), and major trends in lending and the deposit base are shown in Fig. 12. On the deposit side, there has been a general steady increase, averaging 6.5%, between FY(?)1997 and FY2009. On the lending side, the picture is different. Commercial bank credit was stagnant in the late 1990s as a result of the financial crisis and the RIF of public servants. Confidence returned in 2000 till the end of Compact I, and bank lending grew steadily by an annual average of 5.2% between FY(?)1999 and FY2004. In 2002, Bank of Hawaii departed the RMI, but Fig. 12 suggests that the runoff in business was picked up by the remaining banks. Certainly, the departure of Bank of Hawaii had much less financial impact on the RMI than on the FSM, where lending dropped by more than half. At the start of Compact II, lending was largely static during the first three years through FY2006, but has since grown very rapidly, by an annual average rate of 10% between FY2006 and FY2010.

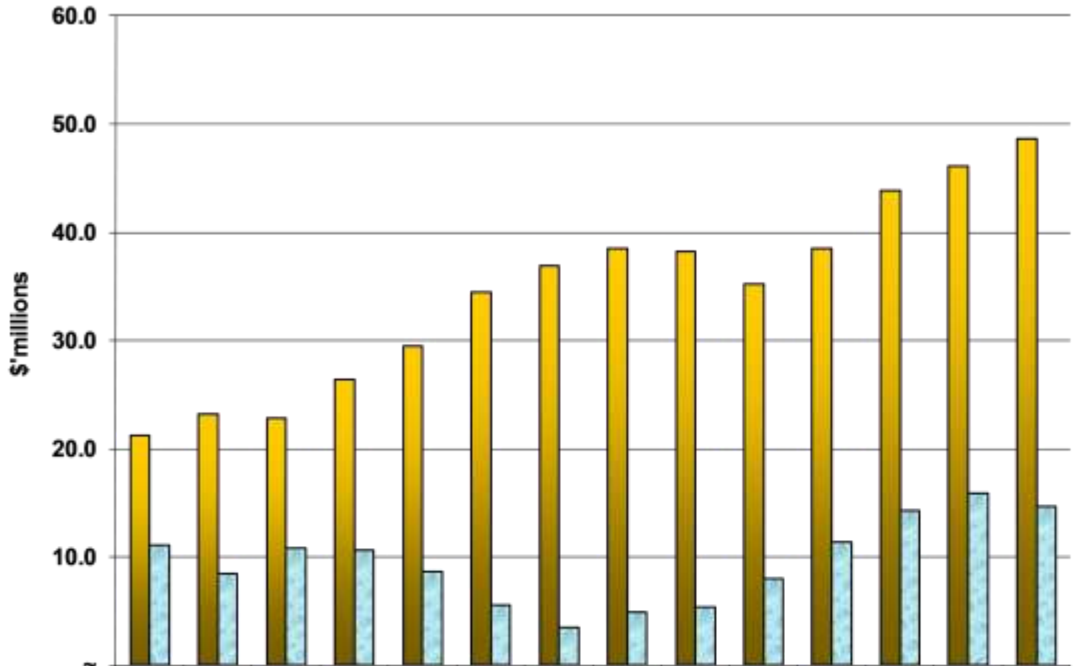
72. The difference between loans and deposits indicates the large level of liquidity in the RMI banking system and is another example of a widely observed phenomenon in the Pacific Islands region: capital is not a factor of production in short supply. Reflecting the trends described above, with deposit growth outstripping the increase in lending, the loans-to-deposit ratio fell from 77% in 1997 to 57% in FY2006. In the last four years, from FY2006-10, the ratio has increased to 66%, with the rapid growth in lending. The large difference between the level of deposits and loans is invested offshore, and, mirroring the trends in credit, the level of foreign assets rose from $19 million in 1997 to $72 million in FY2010 – an annual average growth rate of 11%.



	CY1997	CY1998	CY1999	CY2000	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010
Deposits	45.0	46.4	54.3	61.4	59.6	66.2	72.2	74.9	74.3	75.5	85.5	89.0	93.3	102.1
Loans	32.0	31.7	33.6	37.0	38.1	40.1	40.4	43.4	43.6	43.2	49.9	58.2	62.0	63.3

Figure 12 Commercial bank loans and deposits (end of period)

73. Fig. 13 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 early 2000s, as confidence in the economy returned, and the government embarked on a rapid increase in the size of the public service sector. In 2005, lending opportunities for consumer credit took a dip but returned to their upward trend in FY2007. Between FY(?)1999 and FY2010, consumer credit grew by an annual average of 6.6%. As pointed out in the recent IMF Article IV mission report, consumer lending as a percent of total compensation of employees is very high in the RMI (47% in FY2010). Deducting payments for taxes, social security, and health insurance, the ratio to household disposable income is even higher. While there may be some misclassification of consumer loans that may in fact be for business purposes, the figures indicate a high level of household indebtedness, which will not only place stress on household finances, but also poses a threat to the banking system. In 2011 the Banking Commissioner imposed regulations to reduce the maximum ratio of household debt service, from 80% of disposable income to 60% and then 40% over a staged period. Although this requirement was original endorsed by the Cabinet, it was subsequently retracted after complaints were voiced by the banks, and it was determined that the policy had not followed the requirements of the Administrative Procedures Act.



	CY1997	CY1998	CY1999	CY2000	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010
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
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

Figure 13 Commercial bank credit by sector

74. While growth in consumer credit has been rapid, the opposite happened in the commercial sector, which collapsed after 2000. This segment of the market was indeed affected by the loss of Bank of Hawaii. The remaining two banks failed to pick up the released business, in certain cases because of a lack of solvency. From a figure of $10.6 million in commercial lending in 2000, the market fell to $3.5 million in 2003. There has been improvement since that time, and outstanding commercial credit stood at $14.7 million at the end of FY2010. However, commercial lending to the private sector has been lackluster and reflects lack of collateral, poor business management, and the many impediments to lending.

C. Balance of Payments and External Debt

1. Balance of Payments

75. The current account of the BoP is presented in abbreviated form in Table 3 and in more detail in the statistical appendix. The trade account is composed of imports and exports. Exports comprise three main items; fuel re-exports (MEC off-shore fuel sales), fish, and others (coconut products, and a few other small items). Up through FY2008, fuel represented 75% of total exports. In FY2009, with the reopening of the fish loining plant and commissioning of a new purse seiner by Pan Pacific Foods (PPF), fish exports rose to $2.8 million. In FY2010 with a full year of operation (two further "seiners" were

commissioned in August 2010) fish exports rose to $8.8 million and will rise significantly further in the medium term. Estimates of imports are based on customs duty collections and divided by an estimate of the average tariff rate. Detailed trade data by commodity is not produced in the RMI and has been a major weakness in the nation's statistical systems. During the FY2010 review mission, the implementation of the PC Trade system adopted in many other small Pacific islands nations was recommended to the government. If the PC Trade system is implemented, it will enable improved tax collections, monitoring of information on imports, and the analysis of supply by commodity.

76. The service account on the receipt side comprises a series of small items: processing and transshipment of fish owned by non-residents, travel expenses of visitors to the RMI, and a group of other exports, including port facilities, telecommunications, and others. In total, these flows have been largely static in recent years. On the payment side,

Table 3 Balance of payments, current account (FY2002–FY2010, US $'millions)

(US$ millions)	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010
Current account balance	***-5.7***	***-8.9***	***-5.1***	***-3.5***	***-3.9***	***-26.2***	***-40.5***
Goods and services balance	*-87.0*	*-100.5*	*-100.4*	*-108.6*	*-109.3*	*-127.4*	*-136.1*
Goods balance	*-53.2*	*-61.7*	*-64.1*	*-69.6*	*-69.8*	*-73.3*	*-93.3*
Exports of goods	18.8	23.5	17.9	18.3	20.2	20.8	32.3
Fish 1/	0.4	0.4	0.4	0.7	0.8	2.8	8.8
Other	18.4	23.1	17.5	17.6	19.4	17.9	23.5
Imports of goods f.o.b.	72.0	85.1	82.0	87.9	90.0	94.1	125.5
Services balance	*-33.8*	*-38.9*	*-36.3*	*-39.0*	*-39.5*	*-54.1*	*-42.8*
Exports of services	10.8	10.2	10.2	10.0	10.2	10.5	11.3
Fish processing	3.7	2.0	2.3	2.3	3.0	3.3	3.7
Travel	3.0	3.1	3.1	2.9	2.7	2.8	2.8
Other	4.1	5.1	4.8	4.7	4.5	4.5	4.8
Imports of services	44.5	49.1	46.5	49.0	49.8	64.6	54.1
Transport	22.5	25.5	26.0	27.2	28.0	25.9	25.6
Freight and postal services	12.2	14.4	13.8	14.4	15.1	13.7	14.6
Passenger services	10.3	11.1	12.2	12.9	12.9	12.2	10.9
Construction services	~	~	~	~	~	12.9	1.8
Other	22.0	23.6	20.5	21.8	21.7	25.7	26.7
Primary income balance	*36.6*	*40.7*	*40.8*	*43.1*	*43.2*	*40.9*	*34.7*
Primary income, inflows	46.4	51.2	55.2	56.8	56.1	53.1	51.4
Compensation of employees	20.6	21.2	23.3	22.3	19.9	20.1	19.0
Rent (Kwajalein landowners)	15.0	15.2	15.4	15.8	16.2	17.1	16.7
Ship registration fees	1.0	1.0	1.0	1.8	2.0	3.3	3.3
Fishing licence fees	0.9	1.4	1.6	0.8	1.7	1.4	1.0
Dividends and interest	8.2	11.6	13.0	15.4	15.4	10.3	10.0
Other	0.7	0.8	0.9	0.8	0.9	1.0	1.3
Primary income, outflows	9.8	10.5	14.4	13.7	12.9	12.1	16.6
Secondary income balance	*44.6*	*50.9*	*54.4*	*62.0*	*62.2*	*60.2*	*60.9*
Secondary income, inflows	48.0	54.5	58.1	65.8	66.3	64.6	66.2
Government grants	40.1	46.0	49.6	53.6	57.2	54.4	56.2
Compact current grants	17.4	22.9	26.0	30.8	39.7	43.1	42.5
Other budget and off-budget grants	22.8	23.1	23.6	22.8	17.5	11.3	13.7
College of Marshall Islands	3.2	3.3	2.9	3.3	3.2	3.9	4.4
Other 3/	4.7	5.2	5.7	9.0	5.9	6.3	5.6
Secondary income, outflows 3/	3.4	3.6	3.7	3.9	4.1	4.4	5.3

the large item for freight and insurance represents the adjustment made to imports c.i.f. to estimate imports on an f.o.b. basis. Payments for passenger services represent payments for air travel, and construction services reflect payments for a new fiber optic connection to the RMI. The remaining item, “other,” includes personal travel expenses overseas, business services, medical referrals, and technical assistance.

77. On the primary income account, the two major items are the compensation of Marshallese workers on the Kwajalein military base and the receipts for rent by the Kwajalein landowners. With the reduction of workers at the Kwajalein base, earnings have declined since FY2006 and are set to fall further. A substantial number of the Kwajalein landowners live in the U.S., and only the transactions related to residents are included in the flows. Although small, fees received by the ship registry and fish license fees have been separated from the other data. Both of these are items are likely to grow in the future, and a new agreement with the company managing the registry will result in the growth of receipts to $5 million by FY2014. Dividends and interest are an import source of earnings and represent earnings on the Compact- and nuclear-related trust funds. In FY2009, earnings fell, reflecting poor market returns in the U.S., as markets crashed and remained low in FY2010. On the payments side, primary income flows are mostly represented by interest payments on external debt.

78. The secondary income account provides a very major source of income to the RMI. Budget grants include both the very sizeable Compact grants and other transfers received from the ROC and U.S. federal programs. Since the start of the amended Compact, grants have shown an upward trend, which reflects the increase in the absorptive capacity of the RMI to implement the grants in the early years rather than any increase in available funds. “Other” receipts include inward remittance flows to households, which is an important item, but for which little reliable data exists. The College of the Marshall Islands also receives relatively large transfers from Pell grants. Remittance outflows are mainly household transfers and are estimated to be larger than inward remittances of Marshallese living in the U.S. Included in outward transfers are payments not only from Marshallese families but also from the sizeable Chinese and other Asian communities living in the Marshall Islands.

79. The capital and finance accounts of the balance of payments are shown in Table 4. The capital account includes Compact capital grants, which reflect the use of the infrastructure sector grant. In the early part of Compact II, capacity constraints limited the use of this grant, but performance has improved, and now most of the available funds are being used in capital projects. “Other” capital grants include funds for the Compact Trust Fund, which is matched by a contra *(counter-?)* entry in the finance accounts. The “other” category also includes FAA grants to the Ports Authority for airport improvement.

80. As regards the financing account, direct investment flows have generally been small, but improved starting in FY2007 through FY2010 because of the reconstruction of the fish loining plant and investment in three purse seiners by Pan Pacific Foods. Portfolio investment represents a series of important items. First, contributions to the Compact Trust Fund from the RMI, U.S. and ROC reflect the sizeable investments in the Fund (note that increases in assets are shown as negative in the BoP, while increases in liabilities are positive). Second, The U.S. paid sizeable reparations and funds for relocation to the islanders of Bikini, Enewetak, Utrik and Rongelap atolls affected by the nuclear testing in the 1950s. Table 4 shows the sizeable recent drawdowns from trust funds and raises the question of sustainability in the longer term. Third, the Marshall Island Social Security Administration, MISSA, holds significant reserves for future pension payments. In most years, the figures indicate a buildup in funds, but in FY2008, a large positive item was recorded, reflecting drawdown of funds. The remaining item on the finance account—"other investment"—represents changes in commercial bank foreign assets, which has generally shown a significant increase, and net changes in liabilities on external debt.

81. The structure of the balance of payments is a large trade account deficit matched by substantial inflows on the primary and secondary income accounts. In essence, the level of imports and services consumed is matched by earnings of Marshallese workers at the Kwajalein U.S. base, rent of the base, and current Compact transfers. The current account has recorded deficits in each year during the FY2002-08 period, averaging $5.4 million, and a substantial deficit in FY2009 and FY2010. In the latter two years, imports of investment goods and construction services had a significant impact on the current ac-

Table 4 Balance of payments, capital account (FY2002–FY2010, US $'millions)

(US$ millions)	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010
Capital account balance	***10.3***	***22.7***	***35.6***	***34.7***	***30.1***	***36.2***	***31.6***
Capital inflows	10.3	22.7	35.6	34.7	30.1	36.2	31.6
Compact capital grants	3.2	4.7	9.5	16.6	11.3	13.2	13.3
Other capital grants to government	7.2	18.0	26.1	18.1	18.8	22.9	18.3
Net lending/Borrowing (Curr + Cap)	***4.6***	***13.8***	***30.4***	***31.1***	***26.2***	***9.9***	***-8.9***
Financial account balance	***16.7***	***-16.5***	***8.2***	***-14.1***	***8.8***	***13.2***	***18.5***
Direct investment	*1.1*	3.3	*-1.1*	*7.0*	5.7	*14.6*	*37.1*
Portfolio investment (increase in assets: -)	*17.9*	*-14.6*	*3.2*	*-16.5*	*4.1*	*-6.1*	*-6.4*
Assets	17.3	-14.4	3.3	-15.1	4.7	-6.9	-6.8
Trust Funds, National Government	-7.0	-15.6	-10.5	-11.4	-10.5	-14.9	-13.5
Trust Funds, nuclear related	29.7	6.1	17.3	2.8	7.2	10.8	10.5
Social Security	-5.9	-4.8	-3.8	-6.4	8.0	-2.8	-3.8
Other public sector investments 2/	0.5	0.0	0.3	0.0	0.0	0.1	0.1
Liabilities	0.6	-0.3	-0.1	-1.5	-0.6	0.8	0.4
Other investment (increase in assets: -)	-2.3	-5.2	*6.1*	*-4.6*	*-1.1*	*4.7*	-12.2
Assets (bank deposits)	-2.7	-2.6	-4.0	-3.2	3.6	-6.5	-8.2
Liabilities (public sector loans)	0.3	-2.5	10.1	-1.4	-4.7	11.2	-4.0
Errors and omissions	***21.3***	***-2.7***	***38.6***	***17.0***	***35.0***	***23.1***	***9.6***

count balance, but were matched by foreign direct investment and external borrowing on the financing account. The capital account always makes a positive contribution, reflecting receipt of capital transfers mainly from the U.S. The finance account has indicated both negative and positive results, depending on the balance of the flows. Overall (and there may be errors and omissions), the difference between net lending and the financing account has averaged $20.3 million during the FY2004-10 period, suggesting a possible overestimation in the recording of current account payments such as imports.

2. GNI AND GNDI

82. The availability of the recent balance of payments enables us to generate data for Gross National Income (GNI) and Gross National Disposable Income (GNDI). In most countries, economic analysis tends to focus on GDP, which is usually the most accurate reflection of the economic circumstances of the country under investigation. However, in the RMI, the large inflows of primary and secondary incomes from the rest of the world indicate that analysis should also feature changes in GNI and GNDI. In the RMI, GNI and GNDI were 21% and 59% higher than GDP, respectively. While analysis of GNI and GNDI might be placed in the section on GDP, we thought it more appropriate to put it in the section following the analysis of the balance of payments, since the data to construct the additional series comes from the BoP.

83. Figure 14 provides a description of the trends in GDP, GNI and GNDI over the FY1997 through FY2010 period. Both the primary and secondary incomes of the BoP have been deflated by a composite index of the CPI and GDP deflator. For the GNI series, the figure indicates a growing trend, but at a slower rate than GDP; GDP grew by 26% between FY1999 and FY2010, vs. 13% for GNI. The main determinants of GNI growth were wages at the Kwajalein base, rent received by the Kwajalein landowners, and dividends and interest received on investments. In FY2008, retrenchments were made at the base as the new fiber optic cable was installed, reducing the demand for Marshallese labor. Receipts of dividends and investments also dipped in the same year, following the world recession. In FY2010, GDP grew strongly, stimulated by exports of fish products, but was offset on the primary income account through increased dividend payments. Thus, the growth indicated by GDP was compensated in the GNI series through dividend income outflows. Given the plans revealed by Pan Pacific Foods, these trends are likely to continue over the next few years.

84. In the case of GNDI, the data has been driven by the receipts of Compact and other recurrent grants. In FY2008, the level of grants had peaked, with completion of the FAA construction work at the airport and a reduction in the ROC grant in FY2009, at the level agreed in the original understanding. As in the case of GNI, the series dips below the GDP series in FY2010 because of the same outward flow of dividends. Taking the picture as a whole, it is clear that the additional source of income the RMI receives from the rest of the world stimulated the economy through FY2007, but since that time the process has peaked. Since the receipts from many sources of income from the rest of the world is fixed in nominal terms, it is likely that the trajectory of GNDI will fall below

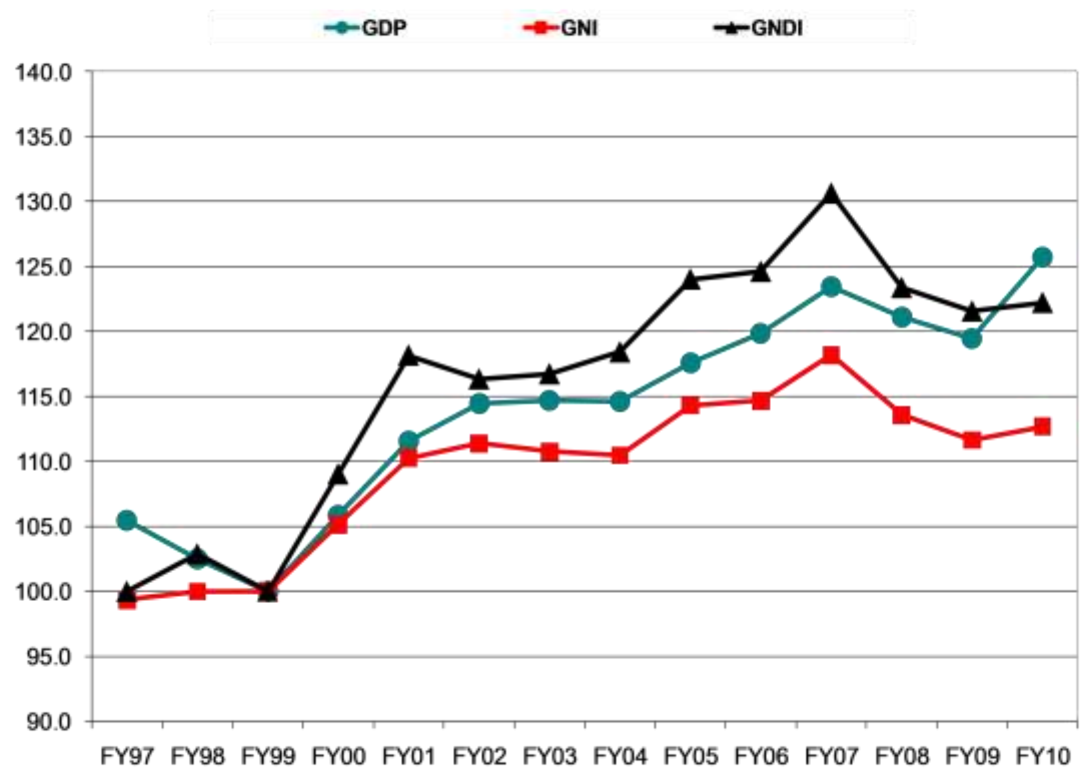


Figure 14 GDP, GNI and GNDI, indexed at 100 = FY1999, constant prices 2000

that of GDP. If the economy is able to invigorate the private sector, this may not be a bad thing, but without private-sector growth, the lack of external stimulus will be a drag on the economy.

3. External Debt and International Investment Position

i External debt

85. During Compact I, the government developed a substantial portfolio of loans from the Asian Development Bank (ADB; see Table 5). The RMI began borrowing from the ADB in 1993 with the funding of the Fisheries Development Loan, which focused on fisheries development in Ebeye. Subsequent loans have included water supply, social sector, and transport projects, including reform program loans. In total, the ADB has approved $85.7 million worth of loans since the RMI joined in 1991, including the Public Sector Program loan that was not disbursed until October 2010. After debt repayment and lack of full disbursement for some loans, outstanding ADB debt at the end of FY2010 was $56.7 million. All but $4 million of this outstanding amount is provided on highly concessional terms from the Asian Development Fund (ADF) resources of the ADB. These resources provide grace periods of 8–10 years and full repayment of principal over 40 years (inclusive of grace periods) for older loans and 32 years for more recent loans. No interest is applied to the principal of these loans, although a “service charge” of 1–

Table 5 External Debt by loan, commitment date, original debt and outstanding principal

Loan	Lender	Number	Year	Original debt, $'000	Estimated outstanding principal September 2010, $'000
Ebeye Fisheries Loan	ADB	1102-MAR (SF)	1992	3,522	2,888
Emergency Rehabilitation Loan (Typhoon Gay)	ADB	1218 MAR (SF)	1993	508	433
Basic Education Project Loan	ADB	1249 MAR (SF)	1993	8,383	6,787
Majuro Water Supply Project Loan No. 1	ADB	1250 MAR (SF)	1993	765	621
Majuro Water Supply Project Loan No. 2	ADB	1389-RMI (SF)	1995	8,400	7,473
Health and Population Project Loan	ADB	1316-RMI (SF)	1995	5,861	4,596
Public Sector Reform Program	ADB	1513-RMI (SF)	1997	12,000	10,500
Ebeye Health and Infrastructure	ADB	1694-RMI (SF)	1999	9,250	7,834
Skills Training and Vocational Education Project Loan	ADB	1791-RMI (SF)	2001	7,600	4,616
Fiscal and Financial Management Program Loan	ADB	1829-RMI (SF)	2001	8,000	7,865
Fiscal and Financial Management Program loan	ADB	1828-RMI	2001	4,000	2,569
Outer-Islands Transport and Infrastructure Loan	ADB	1948-RMI (SF)	2003	7,900	508
Public Sector Program	ADB	2659-RMI (SF)	2010	9,500	
Marshalls Energy Company - New Powerplant Loan	RUS		1997	12,500	6,328
Marshalls Energy Company - Consolidation Loan	BoG		2007	12,000	8,495
NTA Loan	RUS		1989, 1993, 2009	41,300	30,051
MIDB ICBC Loan	ICBC		2004	4,000	1,780
PRC Loan for Garment Factory	PRC		1991	1,900	
Air Marshall Islands	BoG?		2009		1,117
RMI Ports Authority	n.a.		2007	568	250
Total				157,958	104,709

1.5% is applied to the outstanding principal. New program loans, such as those through the Fiscal and Financial Management Program, now have a term of 24 years. The concessional nature of the lending means that the ADF loans have a significant grant component when valued on a discounted cash flow basis.

86. Other major external debt commitments represent government guaranteed debt to the SOE sector and include the Rural Utilities Service (RUS, formerly the Rural Electrification Administration), as well as loans for NTA and the Marshalls Energy Company (MEC). In 1989, the RMI guaranteed an $18.8 million loan for NTA to finance fiber-optic cable and administration facilities in Majuro. NTA extended this loan by another $4 million in 1993, though the extension of the loan was not guaranteed by the RMI. In 1997, MEC secured an RUS loan for $12.5 million to finance the new power plant on Majuro. More recently, in FY2004, the government guaranteed a loan issued by the International Bank of China to the Marshall Islands Development Bank, and in FY2007 the government guaranteed a loan in the amount of $12 million, on behalf of the MEC, to the Bank of Guam, to be refinanced by the ADB Public Sector Program loan disbursed in FY2011. In 2009, the NTA again extended the RUS facility by a further $14.5 million to finance the fiber optic link form Kwajalein to Majuro. In all cases of default by the state owned enterprises (SOEs), the RMI must meet debt service requirements..

87. Fig. 15 shows the substantial size of the RMI's external debt and the burden of the debt servicing from FY2002-10. In FY2002, the level of outstanding debt was $87 million (70% of GDP). External debt rose to $105 million in FY2010, but as a percent of GDP, it fell slightly, to 64%. Debt service, on the other hand, increased from $3.5 million

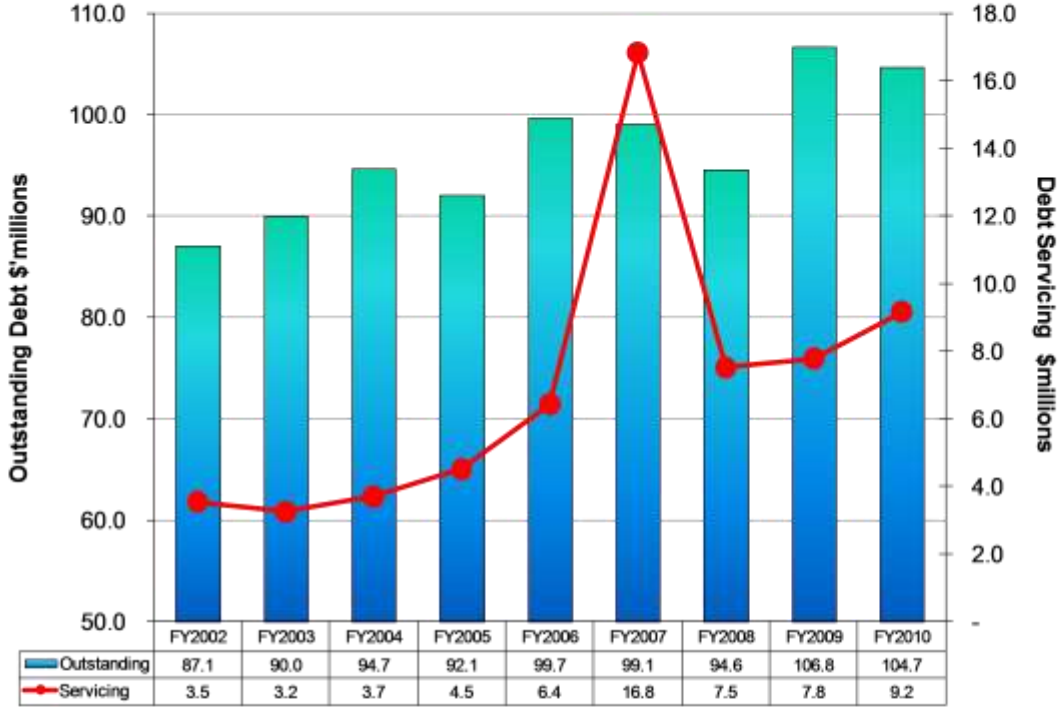


Figure 15 RMI external debt and debt servicing, FY2002–FY2009

to $9.2 million in FY2010. In FY2007, the sharp upward movement in debt service represents transactions relating to the MEC crisis; these transactions were consolidated through a $12 million loan from the Bank of Guam, thus bringing outstanding debt down to FY2008 trend levels. While much of the RMI external debt is on concessional terms to the ADB, there has been a substantial increase in debt service, the grace period of prior loans has now expired. Since external debt servicing is funded out of the government's discretionary resources (or general fund), there are significant implications for the RMI's fiscal policy. This issue is taken up further in the policy issues part of this report.

ii International Investment Position

88. The RMI International Investment Position or IIP is presented in Table 6. The data show stock positions at the end of each year corresponding to the financial account of the balance of payments. While no record of foreign direct investment is available, the table provides an important indication of the RMI's portfolio and other investments since the start of Compact II. The values of the Compact Trust Fund stood at $120 million at the end of FY2010; these are analyzed in further detail in the policy section of this report. While the volumes are large, they are nevertheless below the anticipated levels projected at the start of Compact II, because of late investment of the annual contributions and low market returns. The data also indicate the size of the RMI nuclear related trust funds that represent the largest single item in the IIP. The effort to document the size and flows related to the nuclear funds is ongoing, but the magnitude and impact of the transfers on the

Table 6 RMI International Investment Position, (FY2004–FY2010, US$ millions)

(US$ millions)	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010
TOTAL STOCKS, NET	***271.6***	***287.9***	***298.3***	***352.1***	***299.7***	***298.3***	***336.1***
Direct investment, net	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Portfolio investment, net	***315.0***	***326.2***	***344.0***	***394.0***	***340.4***	***344.0***	***369.7***
Assets	319.1	330.0	347.7	396.2	342.0	346.4	372.5
Trust Funds, National Government	40.6	55.4	71.9	90.6	82.6	97.0	119.5
Trust Funds, nuclear related	245.4	236.7	234.2	257.6	219.5	206.7	206.5
Social security portfolio	32.7	37.6	41.4	47.8	39.8	42.6	46.5
NTA portfolio	0.4	0.4	0.1	0.2	0.2	0.1	0.0
Liabilities	4.1	3.8	3.7	2.2	1.6	2.4	2.8
Equity: Capital and retained earnings of	4.1	3.8	3.7	2.2	1.6	2.4	2.8
Debt: Medium-term notes	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment, net	***-43.4***	***-38.3***	***-45.7***	***-41.9***	***-40.8***	***-45.7***	***-33.6***
Assets	51.0	53.6	57.6	60.7	57.1	63.6	71.8
Deposits, commercial banks 3/	51.0	53.6	57.6	60.7	57.1	63.6	71.8
Liabilities, loans	94.4	91.9	103.3	102.6	97.9	109.3	105.4
Government	64.5	63.2	63.6	62.4	61.3	59.6	57.4
Public entities	29.8	28.7	39.6	40.2	36.5	49.7	48.0

economy is clear. The data shows a declining trend, with the exception of FY2007, reflecting market performance and drawdown of the funds. Unlike the CTF, which is in the accumulation phase, the nuclear related funds are being actively disbursed. The Social Security Administration is the other major holder of portfolio investments. Under the "other investment" category, the commercial banks hold significant foreign assets, representing that portion of bank deposits that are not loaned out in the RMI. These amounted to $72 million at the end of FY2010. Lastly, the external debt of the government and public corporations represents the nation's major external liabilities.

D. Fiscal Developments

1. Fiscal Policy Framework

89. The RMI and U.S. governments' adoption of the amended Compact, which became effective in FY2004, initiated a new fiscal framework for the RMI. The structure entailed a series of sector grants earmarked for education, health, environment, private sector development, capacity building, and infrastructure. The innovative element of the amended Compact was the introduction of a Trust Fund, which was designed to provide a yield sufficient to replace the annual grants after 20 years. Table 7 indicates the aggregate structure of the annual Compact grants and the contribution to the Compact Trust Fund. Each year, over a 20-year period, the United States will contribute $57 million to the RMI, partially adjusted for inflation. The inflation adjustment factor remains as in the original Compact. The annual sector grants start at $35 million in FY2004 but are to be annually reduced by $0.5 million. The difference between the total contribution and the annual sector grant levels will be deposited in the Trust Fund to accumulate over the 20-

Table 7 U.S. annual Compact grants and contributions to the Trust Fund

	Annual Sector Grants	Trust Fund Contribution	Kwajalein Impact	Total Contribution
FY04	35.0	7.0	15.0	57.0
FY05	34.5	7.5	15.0	57.0
FY06	34.0	8.0	15.0	57.0
FY07	33.5	8.5	15.0	57.0
FY08	33.0	9.0	15.0	57.0
FY09	32.5	9.5	15.0	57.0
FY10	32.0	10.0	15.0	57.0
FY11	31.5	10.5	15.0	57.0
FY12	31.0	11.0	15.0	57.0
FY13	30.5	11.5	15.0	57.0
FY14	32.0	12.0	18.0	62.0
FY15	31.5	12.5	18.0	62.0
FY16	31.0	13.0	18.0	62.0
FY17	30.5	13.5	18.0	62.0
FY18	30.0	14.0	18.0	62.0
FY19	29.5	14.5	18.0	62.0
FY20	29.0	15.0	18.0	62.0
FY21	28.5	15.5	18.0	62.0
FY22	28.0	16.0	18.0	62.0
FY23	27.5	16.5	18.0	62.0

year Compact period. In addition to the sector grants and Trust Fund, the United States will contribute $15 million a year, for Kwajalein impact, to the Kwajalein landowners. The United States agreed to contribute a further $5 million to the RMI in FY2014, $2 million of which would be added to the annual sector grants; the remaining $3 million would be used for Kwajalein impact.

90. In comparison with the original Compact, the new arrangement avoids the need for large fiscal adjustments every five years. However, in order to establish the viability of the Compact Trust Fund, the United States instigated the annual decrement. While avoiding large shocks to the system, the decrement will still require annual adjustment. Coupled with the lack of full inflation adjustment, the annual reduction in real resources—estimated to be approximately 2%—will require active fiscal policy adjustments, unless the country can develop a policy regime that will attract and encourage private sector investment and economic growth sufficient to offset the decline.

91. A special condition agreed upon by both parties is that the RMI will devote between 30% and 50% of the total Compact sector grant specifically to infrastructure. Of the infrastructure grant, 5% must be set aside for infrastructure maintenance, and the RMI must contribute an additional 5% out of local revenues. In general, the implementation of the sector grant approach of the amended Compact did not impose on the RMI any effective fiscal constraint or need for restructuring. There are sufficient general fund revenues

to maintain operations without cutting back expenditures in non-Compact sectors. In FY2004-10, the use of the minor sector grants for private sector development, environment, and public sector capacity building was minimal.

92. In addition to the sector grants, Trust Fund, and Kwajalein impact, the amended Compact provides for the community needs of Kwajalein Atoll. Access to federal programs continues, with the exception of certain education programs, which were "cashed out" and have been replaced through the Supplemental Education Grant (SEG). Finally, the implementation of the amended Compact entails a whole new accountability regime that is specified in the fiscal procedures agreement (FPA). Taken as a whole, the new fiscal arrangements of the amended Compact have had an important impact on the conduct of fiscal policy and management in the RMI.

93. In addition to the special relationship the RMI enjoys with the United States, the RMI has also developed strong ties with the ROC. The ROC initially contributed $10 million to the RMI government, of which $4 million was transferred to the general fund and the remaining $6 million was available for special projects to be agreed upon between the parties. As fiscal pressures have mounted, more of the project money has been used for general activities, and, in effect, the project contribution now simply augments general fund revenues. Of special significance is the additional support provided by the ROC to the Compact Trust Fund. By way of a memorandum of understanding, the ROC has agreed to transfer $50 million to the RMI over the period of the amended Compact; $40 million of this will accumulate in the "A" account and $10 million in the "D" account. Funds in the A account may not be touched during the amended Compact period, while the RMI has the right to utilize the yield earned on the resources in the D fund once they have reached $10 million.

94. Fiscal policy in the RMI is conducted under the constitutional requirement of a "balanced budget." This, of course, does not guarantee that the final outcome will also be balanced: either revenue may fall short, or expenditures may exceed budget estimates. The execution of the budget operations is performed through a series of separate funds, the most important being the general fund. Expenditures from this fund are largely unrestricted, but there is limited flexibility or authority to use monies from the other funds. Under Compact I, a major part of the external assistance provided revenue to the general fund and thus was unrestricted. Under the amended Compact and sector grant approach, however, all such receipts are earmarked for specific purposes and must be liquidated if they remain unused at the end of the financial year. This requirement effectively inhibits deficit spending under the sector grants. Fiscal policy in the macroeconomic sense is thus executed only through the general fund. The structure of the standard Government Financial Statistics (GFS), which aggregates across funds and focuses on "above-the-line" revenues and expenditures and "below-the-line" financing, does not always highlight some of the additional constraints faced by fiscal policymakers.

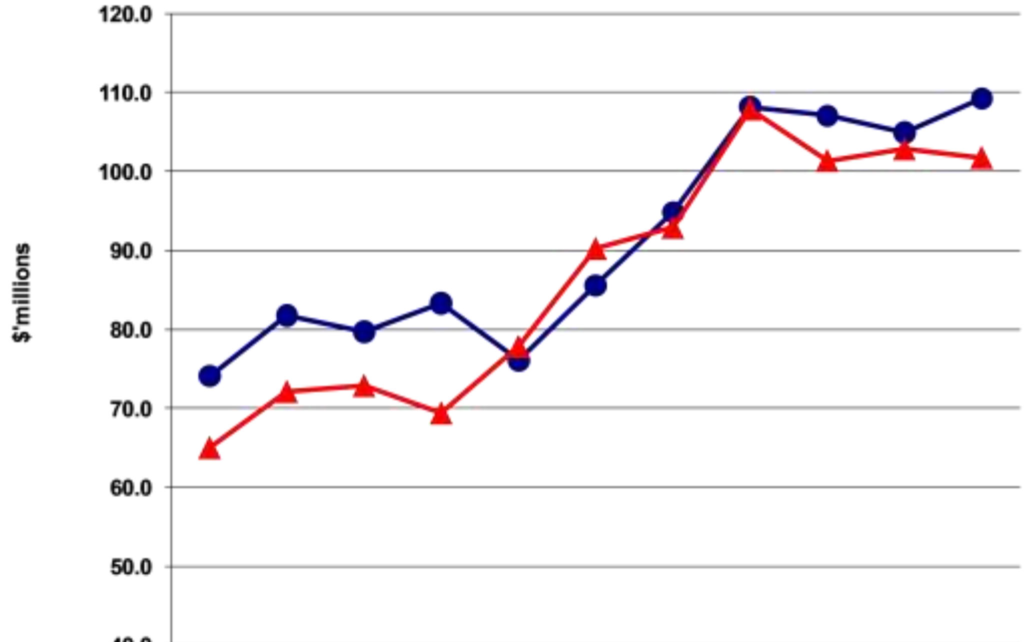
95. Government in the RMI consists of the national government; the urban local governments of Majuro Atoll Local Government (MALGOV) and Kwajalein Atoll Local Government (KALGOV); the nuclear-affected atoll local governments of Bikini, Ronelap, Enewetak, and Utrik; and other smaller atoll local governments. At present, local government provides services in administration, police, garbage collection, etc. Under the constitution, powers to raise taxes rest with the national government, but local governments may raise taxes, provided the increase has been authorized by law. The Local Government Act of 1989 provides the framework and limits the powers of local governments to levy taxes in specified areas -- notably, sales taxes, licenses, and other indirect taxes.

96. The RMI has a good record of timeliness in the preparation and publication of the annual single audits. This report is based on audit information through FY2010. In this part of the report, discussion will focus on fiscal developments during FY1997–2010. Analysis of the emerging fiscal situation and the fiscal outlook will be undertaken in Part III, "Policy Issues." Table 9a in the statistical appendix shows fiscal performance on a consolidated basis, and the presentation follows the standard Government Financial Statistics (GFS) format.

2. Recent Fiscal Performance

97. ***Fiscal Performance***: Fig. 16 depicts RMI fiscal performance and shows developments in total revenues and expenditures on a GFS basis, consolidating across the general and all other fund types. A detailed analysis of the components of revenue and expenditures will follow, but at this point we focus on the major forces behind the fiscal results. Towards the end of Compact I, the RMI underwent a difficult period of fiscal adjustment; the nation was forced to compress expenditures and lay off significant numbers of civil servants (see earlier annual reports for a fuller description). In FY1999, the RMI formally recognized the ROC and was to benefit from substantial contributions, both to the general fund and for capital projects. In FY2002 and FY2003, the nation entered the "bump-up" period and received a significant but temporary increase in Compact grants. As part of the amended Compact negotiations, the RMI had agreed to contribute $30 million of the additional funds to the Compact Trust Fund (CFT). In FY2002, the RMI set aside $17.5 million, and an additional $16 million in FY2003, to the Intergenerational Trust Fund, which was later transferred to the CTF. Fig. 16 indicates the impact of these forces, as revenues rose above expenditures, and the nation ran a significant fiscal surplus.

98. In FY2004-10, during the first seven years of the amended Compact, the fiscal account shows a more normal trajectory, with revenues and expenditures in closer alignment. Expenditures moved strongly upward, boosted by the higher levels of funding available under the amended Compact and, in later years, by the increasing capacity utilization of the infrastructure sector grant. In FY2004, revenues were mostly in line with expenditures, and the fiscal account records a small deficit of $1.8 million, or 1.4% of GDP. In FY2005, with the upward momentum in expenditures remaining in full swing, a



	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Total Revenues	74.1	81.7	79.7	83.3	76.1	85.6	94.8	108.2	107.1	104.9	109.2
Total Expenditures	65.1	72.1	72.9	69.4	77.8	90.2	92.9	107.8	101.3	102.8	101.7

Figure 16 RMI consolidated revenues and expenditures, FY1997–FY2010.

larger deficit of 3.4% of GDP was recorded. In FY2006 and FY2007, the fiscal situation continued to tighten, but the fiscal account recorded small surpluses of 1.4% and 0.2% of GDP, respectively.

99. By FY2008, the period of fiscal expansion had run its course, and total expenditures dropped by $6.5 million, reflecting lower transfer payments and a large drop-off in capital expenditures. Revenues were also weak, dropping by 1.1% , in contrast to the growth of earlier years. Overall, FY2008 indicated an apparently healthy surplus of 3.7 % of GDP. In FY2009, with continuing upward pressure on expenditures driven by large increases in transfers and subsidies to the SOE sector and a weakened revenue position, the fiscal results deteriorated, and a small surplus of $2.1 million, or 1.4% of GDP, was recorded. In FY2010, the fiscal situation at first sight appears to have strengthened, generating a surplus of $7.5 million (4.6% of GDP). However the general fund was finally balanced and the apparent surplus is represented by approximately $1.9 million of savings on health care funds, $0.7 million savings on the scholarship loan fund, $0.9 million underspend on the ROC project fund, and a similar $1.1 million underspend on the Compact sector grants. With the exception of the ROC project fund, these funds are not fungible and may not be used to finance general operations.

100. The close proximity of revenues and expenditures and small surpluses or deficits in relation to GDP provide a misleading impression of the fiscal situation in the RMI, as is shown by further analysis of the FY2010 results. 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. Because of 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, the nation is in a very precarious position.

101. ***The Fiscal Structure***: Table 8 provides a summary of the structure of the fiscal account. Grants as a percent of GDP averaged 42% during the last two years of Compact I. In FY2004, the level dropped significantly—by over 10%—reflecting the inability of the RMI to fully utilize the resources available under the amended Compact. Of a total FY2004 budget ceiling of $35 million, the RMI was able to utilize only $20.5 million. Absorptive capacity limitations were reached in both of the operational sector grants and under the infrastructure grant. In FY2005, there was some improvement, and Compact revenues rose to $27.6 million, reflecting better performance on the operational grants, but significant underperformance on the use of the infrastructure funds. By FY2006, capacity constraints had all but been eradicated in all grant streams, and total use of Compact funds reached $35.5 million. From FY2007-10, the level of Compact grants rose from $47.4 to $55.8 million, reflecting the greater use of the infrastructure grant and the use of carry-over funds from previous years. Grants as a percent of total revenues follow a similar trend, accounting for 63% in FY2010. There has been little change in the level of dependency on external transfers as a percentage of both total revenues and GDP. While the dependency on U.S. grants has fallen, this decrease has been offset by increased funding from the ROC.

102. Tax revenues remained relatively constant averaging, 17.4% of GDP between FY2002 and FY2007, but have subsequently fallen and in FY2010 represented 15.5% of GDP. This decrease reflects both discretionary changes in tax rates and the outmoded tax regime and lack of tax buoyancy in the RMI. While tax effort is above that of the FSM, it is below that of the majority of other Pacific Island economies and below the rate prevailing in the U.S. Public expenditure averaged 66% of GDP and has displayed an upward trend during Compact II as absorptive capacity improved. Clearly, the public sector, sup-

Table 8 Comparative analysis of fiscal structure FY2000–FY2009

	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Grants as % of GDP	41.8	43.0	32.5	36.4	40.8	46.5	44.5	44.3	42.3
Grants as % of Total Revenue	65.5	65.6	56.0	58.5	61.7	64.4	63.5	63.9	63.1
Tax Revenue as % of GDP	16.1	18.2	17.2	17.6	17.5	18.1	17.1	16.1	15.5
Total Expenditure as % of GDP	58.4	54.7	59.4	65.6	64.8	72.0	66.4	67.8	62.4
Current Balance as % of GDP	3.6	6.6	4.7	2.5	4.9	6.3	8.5	3.8	7.2
Overall Balance as % of GDP	5.4	10.9	-1.4	-3.4	1.4	0.2	3.7	1.4	4.6

ported by external assistance, continues to play a dominant role in the economy.

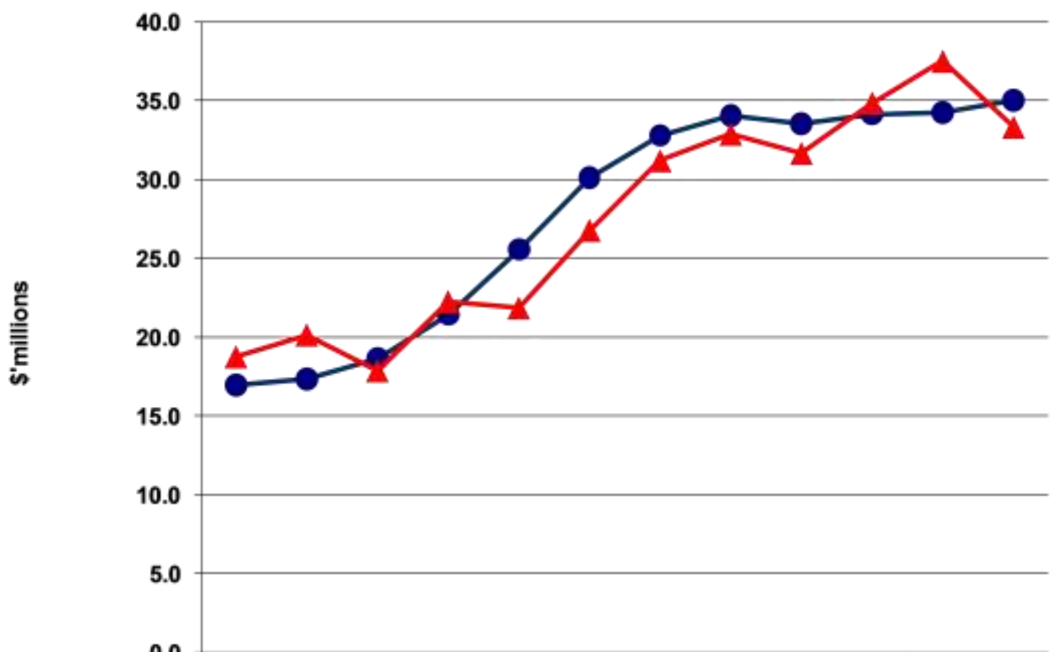
103. ***Revenues***: The tax regime in the RMI is based on a tax system inherited from—and largely unaltered since—Trust Territory days. The major source of tax revenue is a tax on wages, accounting for $11 million out of a total tax yield of $25 million in FY2010. The reduction in military presence on Kwajalein atoll in FY2008 and reduction in Marshallese employees was projected to erode the tax base, and a $1.6 million reduction was projected. While income tax receipts fell in FY2010, the loss has not been nearly as large as anticipated. Wage earners pay 8% of income, up to a threshold of $10,400, and above that, 12%. Those earning less than $5,200 have a tax-free threshold of $1,560. The gross receipts tax (GRT) is levied at 3% of business turnover and is intended as a proxy income tax, although the incidence (effect?) is comparable to that of a sales tax. The tax suffers from the well known cascading effect, such that each sale from one business to another multiplies the tax yield and distorts resource allocation. Fish and fish products have been exempted from the GRT to enable the fishing sector to remain competitive in international markets.

104. Customs duties provide the second most significant category in terms of tax yield and displayed surprising buoyancy in relation to GDP through FY2007, but since that time have dropped off significantly. In FY2002, import duties collected $6.3 million and had risen to $9.4 million in FY2007. In FY2008-10, collections slid back to $8.7 and $7.7 million, respectively, as the economy suffered the effects of the world recession, and special exemptions and reductions in taxes on basic items were granted. In FY2002, the general rate of import duties was 8%, which has remained unchanged, although food items attract a lower rate, and there are wide ranges of exemptions for different categories of importers. In FY2005, new higher rates were imposed on "sin" goods, with the additional revenues earmarked for the College of the Marshall Islands (CMI). In 2008, in a response to the high inflation in fuel and food prices, the government granted an import duty exemption to MEC for its imported diesel fuel (for generation and re-export) and to imports of basic food staples (rice, flour, etc.). Tax holidays continue to be granted by the Cabinet in special cases, including exemptions on GRT for the existing fishing operations. To spur growth in exports and foreign exchange earnings, taxing export-oriented business activities is usually discouraged. This principle has not been fully adopted in the RMI, and several exporters, including MEC, still pay GRT on their export revenues..

105. Other forms of national taxes on fuel and hotels make a minor contribution to the general tax revenues. Of non-tax revenues, fishing fees have raised an average $1.4 million during the Compact II period but have been a volatile source, depending on the location of the fishing stock. In FY2002, the rate of contribution to the health care fund was increased from 2.5% of gross pay to 3.5% for both employers and employees, bringing the total to 7%. In previous years these contributions had been collected and dispersed by the Marshall Islands Social Security Administration (MISSA). As of FY2002, the funds were directly allocated to the Ministry of Health, although MISSA remained in charge of collection. In FY2004, the funds were included in the audit for the first time and in

FY2009 contributed $6.7 million to local revenues. In the last few years, ship registration fees have been a growing source of revenue, rising from $1.0 million in FY2006 to $3 million in FY2010. In addition to fishing fees, the health fund, and ship registration fees, domestic revenues included a variety of smaller fees, including earnings on investments.

106. ***Expenditures***: Outlays on payroll and goods and services have grown rapidly, although they have tapered off in more recent years. Fig. 17 shows recent trends in these two important categories of cost. At the end of Compact I, payroll costs were reduced by the RIF, as the financial crisis and PSRP necessitated fiscal discipline. However, as the revenue position began to improve—with the new grants from the ROC and bump-up years—payroll expenditures were allowed to rise almost unchecked. The amended Compact also permitted increased public servant recruitment in education and health. Total payroll costs rose from $17.0 million in FY1999 to $35 million in FY2010,—a 106% increase. The apparent downturn in FY2007 reflects the creation of the Marshall Islands Shipping Corp., whose function was previously executed through the Ministry of Transport and Communications. Wage and other costs of the Department of Transport are thus now funded out of a subsidy to the MISC. Further elaboration on public servant payroll trends is provided in Part III. Payroll costs were not the only item to show a significant increase; expenditures on goods and services rose rapidly, from $18.8 million in FY1999 to over $33.3 million in FY2010, a 78% increase. Expenditures on goods and services continued to rise in FY2008 and FY2009 as the economy weakened but were



	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Wages and Salaries	17.0	17.4	18.7	21.5	25.6	30.1	32.8	34.1	33.5	34.2	34.3	35.0
Goods and Services	18.8	20.1	17.9	22.3	21.9	26.8	31.2	32.9	31.7	34.9	37.5	33.3

Figure 17 Expenditures on payroll and goods and services, FY2002–FY2010.

reduced significantly, by $4.2 million, in FY2010.

107. The rate of change in other major categories of cost has also been substantial, although of lesser magnitude. The level of current subsidy to the public enterprise sector has increased very significantly in the last few years. Fig. 3 shows that subsidies to the SOE sector have risen from $3.1 million in FY2004 (at the start of the amended Compact) to $6.7 million in FY2010. The level of subsidy now represents a substantial drain on government's uncommitted resources, and the issue of SOE policy is taken up in further detail in Part III. Interest payments appear to have remained at low levels in the audit, despite the increased need to service the RMI external debt. In previous years, the RMI was in default on its ADB loan repayments, although it is now up to date. The other major remaining item of expense, capital expenditures, fell back at the start of the amended Compact because of capacity limitations. In the following four years, capital outlays grew rapidly as the constraints were overcome, from $11 million in FY2004 to $26 million in FY2007. By FY2010 capital outlays had fallen to $18 million with the completion of the FAA funded airport renovation and reduction in ROC-funded capital projects, from $12.3 million in FY2008 to the normal level of $6.1 million in FY2009.

III. Policy Issues

A. Background

108. In the mid-1990s, the RMI embarked on a Public Sector Reform Program (PSRP), assisted by the ADB, to adjust to an emerging financial crisis precipitated by the need to repay various bonds issued in the earlier part of the decade. While the PSRP is now part of history, the various reform issues, the programs implemented, and the successes and failures, together with lessons learned, are exactly relevant to the situation the RMI finds itself in again today, 14 years later. This part of the review therefore starts with a brief review of the PSRP. The goals of the program were (i) to embark on a long-term reform program to avert a looming financial and economic crisis; and (ii) to set the economy on a more sustainable growth path. The program had four main elements: (i) fiscal stabilization and fiscal policies; (ii) privatization of public enterprises; (iii) public service reform; and (iv) a number of measures to stimulate private sector development. Three outputs were specified: (i) stabilization of the government's finances in the short term; (ii) long-term structural stability of government finances; and (iii) creation of an improved environment for the private sector.

109. Of the three outputs of the PSRP, fiscal stabilization was focused on revenue and expenditure policies. Improvements in tax collections were to come from increases in tax rates, removal of exemptions, and administrative strengthening. While tax rates remain at levels similar to those of the 1990s, administrative strengthening and removal of exemptions have not been achieved. Reduction in expenditures was to be accomplished through removal of SOE subsidies. However, efforts to reform and transform the sector did not prove successful. In the late 1990s a Private Sector Unit was established, and KAJUR, the utility corporation supplying Kwajalein, was contracted out to the private sector. However, no further SOE transformation took place, KAJUR has reverted to public management, and the private-sector unit was disbanded.

110. To achieve the second PSRP output -- long-run structural stability -- efforts to reduce expenditures focused on implementation of the RIF, restructuring of government operations, and a civil service wage freeze. The RIF was implemented, but the public sector today is much larger than before the PSRP. The work undertaken by the Ministry of Public Works and Ministry of Transport and Communications were to be managed by the private sector, and, although both were downsized during the PSRP, the Ministry of Public Works is once again sizeable, and the shipping operations of the Ministry of Transport and Communications were transferred to the MISC. On the revenue side, long-run gains were to be achieved through administrative strengthening and introduction of a modern tax regime, such as the value-added tax (VAT). Little progress was made with administrative reforms, and the VAT met with strong opposition, although the implementation of a modern tax regime focused on a VAT is now under consideration.

111. Regarding the third PSRP output—to create an improved environment for the private sector—the program was structured in two parts: reduction in the role of the government and improvements in the regulatory environment of the private sector. Reduction in the role of government focused on reducing subsidies to Air Marshall Islands (AMI) and on SOE reform. Although AMI still presents a significant risk, the Marshalls Energy Company (MEC), as discussed below, has had the potential to undermine fiscal stability. Improvements to the regulatory environment of the private sector focused on increasing transparency in company registration, work permits, and the foreign direct investment (FDI) regime, as well as legislation to ensure security in land leases.

B. Fiscal Issues

1. Public Sector Payroll

112. The RMI government's payroll has grown considerably over recent years since the completion of the Public Sector Reform Program and RIF. The sizeable reductions in public service achieved through the RIF were followed by the transitional "bump-up" years and the implementation of the amended Compact, which enabled expansion in payroll. Since FY1999, the number of public servants has increased rapidly (Fig. 18). The number of employees on the payroll fell to 1,475 in FY1999 but increased by 927 (63%) to 2,401 by the end of FY2011. The payroll cost over the same period increased by 99%.

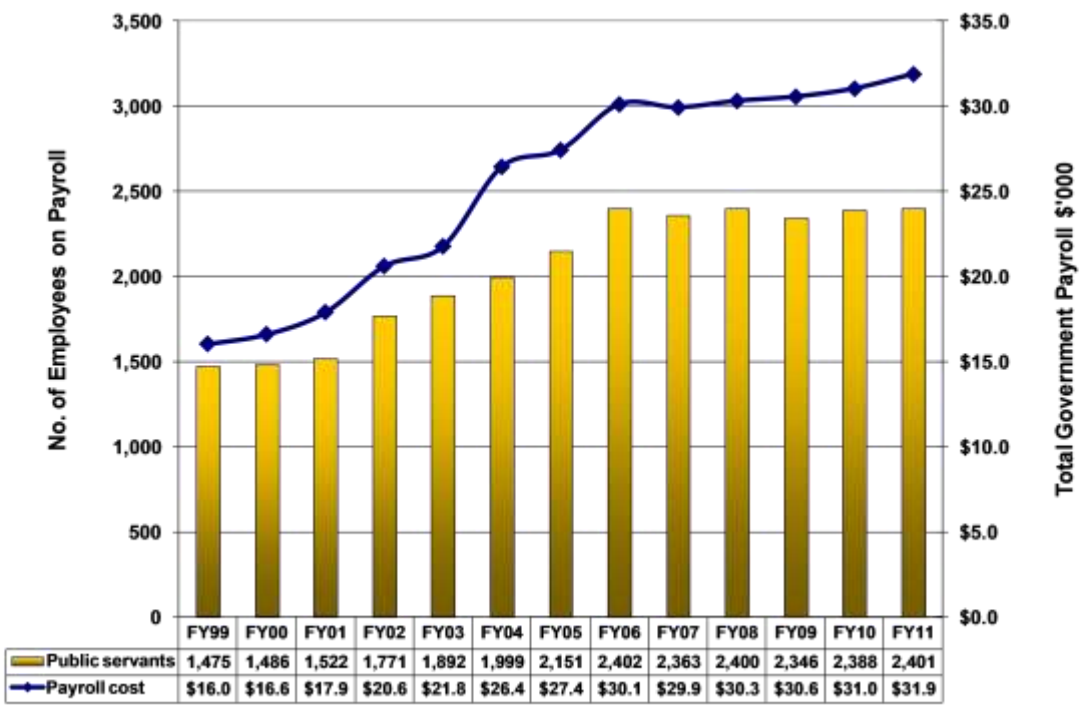


Figure 18 RMI government payroll cost and number of public servants, FY1999–FY2010

This very sizeable increase has been influenced by a number of extraordinary items that have accelerated the underlying growth.

113. Most of the growth in the payroll and in employee numbers has been in the Ministry of Education (MoE). This growth reflects a number of structural changes that have increased staff numbers as the ministry has taken on more responsibilities. The implementation of the kindergarten program funded out of the SEG (replacing the previously externally managed Head Start program) added more than 200 staff to the payroll in FY2006. In FY2001 and FY2002, both Majuro and Ebeye elementary school teachers were brought back under the MoE, adding approximately 100 and 50 employees to the payroll, respectively. Previously, elementary education in Ebeye and Majuro had been managed by the MALGOV and KALGOV under the community based governance system (CBGS), but these arrangements collapsed and were reincorporated under MoE. Once allowance is made for these anomalies, expansion in education payroll during FY1999-FY2011 was 58% and added an extra 273 positions. Where recruitment has taken place, it has supported delivery in front-line services, e.g., with increases in teaching staff and elementary school services and support.

114. Substantial growth in the payroll has come from outside the MoE. Employment in the Ministry of Health (MoH) increased by 146 positions, from 389 in FY1999 to 532 in FY2011 (Table 9). Significant staff increases occurred in the Majuro and Kwajalein Hospitals, suggesting a greater emphasis on curative care. The Ministry of Internal Affairs has doubled, while the Ministry of Public Works (MoPW) is not far behind, after scaling back its operations after the RIF. The MoPW had adopted a largely oversight and regulatory role at the end of the RIF, but has now taken on a more proactive role in outer-

Table 9 RMI government number of public servants by department, FY2000–FY2010

	FY2000	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008[1]	FY2009	FY2010	FY2011[2]
President & Cabinet	23	22	23	23	22	26	27	32	33	30	28	28
Chief Secretary Office	14	14	13	12	18	20	21	25	25	31	34	29
Special Appropriations	1	2	2	2	~	2	~	~	10	~	~	~
Council of Iroij	17	17	15	14	15	15	16	15	15	17	16	18
Nitijela	35	37	37	38	42	45	48	49	50	51	50	51
Auditor General	7	8	11	11	11	10	11	10	7	7	8	9
Foreign Affairs	56	34	34	33	32	36	34	37	37	39	37	36
Public Service Commission	11	12	11	11	13	13	14	15	15	15	16	16
Judiciary	21	22	22	20	30	35	40	40	37	35	34	41
Attorney General Office	10	16	18	24	25	25	26	25	22	23	23	24
Ministry of Education 3	474	478	671	706	720	800	1,028	1,032	1,067	1,073	1,086	1,094
Health & Environment	389	376	389	437	480	529	535	540	529	497	513	532
Transport & Communications	24	41	84	92	108	108	100	54	18	19	17	17
R & D	45	33	33	32	27	26	28	29	27	31	33	33
Internal Affairs	54	56	53	54	69	61	64	63	102	79	94	87
Justice	170	153	144	163	168	168	170	166	167	171	173	163
Finance	86	93	99	104	107	112	121	121	128	116	115	113
Public Works	50	111	114	115	99	100	99	90	91	92	90	85
Epa	~	~	~	~	16	18	19	19	19	19	17	18
Compact II Capital	~	~	~	~	1	2	3	3	3	5	5	8
Total	1,486	1,522	1,771	1,892	1,999	2,151	2,402	2,363	2,400	2,346	2,388	2,401

Note 1: Temporary election staff adjusted for full time equivalent basis.
2: Based on first three quarters of FY2011

island project implementation and maintenance. The Ministry of Transport and Communications (MoTC) was also scaled back during the RIF, with the intention of privatizing outer-islands shipping services. However, this policy was not successful, and the services were initially brought back into the public sector and later transferred to the newly-formed Marshall Island Shipping Corporation.

115. The overall trend in payroll, after allowing for the structural changes in the Ministry of Education, is upward, from $16 million in FY1999 to $32 million in FY2011. Associated personnel expenditures, such as the government's MISSA contributions and housing allowances for expatriate staff, are also significant. Housing allowances alone required a budget of $1.9 million in FY2010; nearly half was for MoH, which has a large number of expatriate medical staff. While the number of public servants has increased significantly, wage rates have also moved upwards. Average public sector wages increased by 22% during the period, while those in education and health rose by 30% and 36%, respectively.

116. While analysis of payroll trends by department is important, it is also useful to assess the impact of the amended Compact sector grant approach. Table 10 indicates public servant payroll by fund source during the amended Compact period. The table indicates a 14% increase in general fund employees (112 employees). It also indicates that the number of employees funded out of the Compact sector grants has increased by only 5% during the period. While not shown in the table, average public servants wage rates have remained largely unaltered, although this lack of significant change masks several important trends. General fund wages have risen by 10%, and health department wages, by 12%; average education sector wages have fallen by 4%.

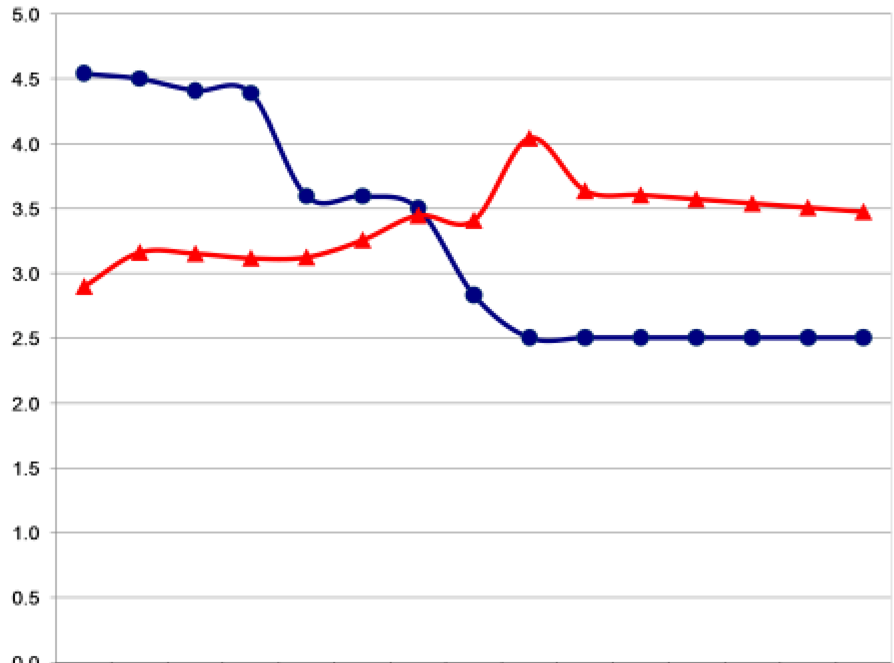
2. External Debt Management

117. 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 guaranteed debt, there is a projected decline from the current level of service of $4.5 million to $2.5 million by

Table 10 RMI government number of public servants by fund, FY2004–FY2010

Fund	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	Change[1]	% Chang
General Fund	825	861	871	865	885	920	939	938	112	13.6%
Compact II	888	933	1,171	1,130	1,134	1,107	1,123	1,135	47	5.2%
Special Revenue	69	74	76	79	85	68	46	57	-12	
Federal Grant	166	177	227	282	244	219	228	235	69	41.5%
ROC	36	34	30	27	38	28	26	26	-10	
UNDP	1	2	3	5	5	6	9	8	7	
Total	1,985	2,080	2,377	2,388	2,390	2,346	2,370	2,398	413	20.8%

Note 1: adjusted for switch in employment of 200 teachers from Head Start to the SEG in FY2006



	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 19 RMI debt and debt servicing projections, FY 2011–FY2025

FY2019, when the debt service schedule stabilizes. External debt of the SOEs is at higher interest rates and shorter terms and thus incurs a proportionately higher service commitment. Current debt service levels of the NTA, MIDB, and MEC are $2.5 million, $0.6 million, and $1.1 million, respectively. The recent ADB Public Sector Program loan enabled the MEC to refinance its costly 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 $1.1 million. There are also moves afoot to restructure the remaining finance from the Rural Utilities Service to a more favorable basis.

118. For debt to the ADB, the government will be required to set aside between $3 and $3.5 million from the general fund for the next 15 years. This represents about 10% of the $36 million of general fund revenues. In previous years, nearly all of the RMI debt was in the grace-period era, and debt service obligations were not significant. However, in the last four 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 and defaulted on several loans. In FY2007, it remained in arrears, as service obligations rose to $2.2 million. By FY2008, the government placed ADB debt service higher on its payment priority schedule. It has made good on past delinquencies and is currently up to date with payments, although the requirement for periodically large payments continues to cause cash flow problems. The

ADB debt service crisis has bought home the impact of a poorly managed external debt strategy. A well-articulated debt management strategy is needed to assist the RMI in determining the type of projects for which external loan finance is appropriate and identifying cases where there is some potential for projects to cover service costs.

3. Public Enterprise Issues

i Overview and update on SOE sector

119. The SOE sector, comprising a dozen public enterprises, continues to underperform and to impose significant risk and burdens on the fiscal system and economy. Transfers (current subsidies) to SOEs in FY2010 totaled $6.7 million, down from the FY2007 total of $7.5 million, but still significant, representing nearly 20% of General Fund revenues (see Table 9 of the Statistical Appendix). Adding capital transfers to current subsidies, FY2010 total transfers to the SOE sector were $8.1 million, the bulk of which was made up of transfers to KAJUR ($1.5 million), MEC ($1.8 million), Tobolar ($1.3 million), and NTA ($1 million).

120. The 2010 ADB *Review of Public Enterprises and Options for Reform* report for the RMI and the 2011 ADB regional *Finding Balance* report both highlight significant and sobering weaknesses in the RMI's SOE governance and policy regimes, leading to weak SOE oversight and accountability, which have allowed continued poor performance on the part of the vast majority of the enterprises. Both reports strongly emphasize the need for reform. As stated in the 2010 review, "transferring significant public resources to weakly performing public enterprises without any strong accountability requirements has sent a very clear message: performance really does not matter."

121. In FY2010, all major SOEs suffered net operating losses, with total losses in the sector reaching $7.9 million. Even NTA, which had enjoyed ten straight years of operating surpluses, saw a slight operating loss in FY2010. Fig. 20 illustrates these losses for the major SOEs in FY2010.

122. Nevertheless, reforms to MEC are continuing (see section on MEC below), and the government has pledged -- and sought development partner support for -- reforms to other SOEs. SOE reform constitutes a major component of the ongoing ADB-supported Public Sector Program (PSP). To signal its intention to strengthen governance of SOEs, the RMI Cabinet passed in 2010 a set of good practice principles which state that:

- SOEs are to prepare business plans that disclose the strategic direction and performance targets and, after Cabinet has approved them, they are to be publicly released.
- The activities undertaken by SOEs are to be categorized as either essential or nonessential; the non-essential should then be sold or wound down.

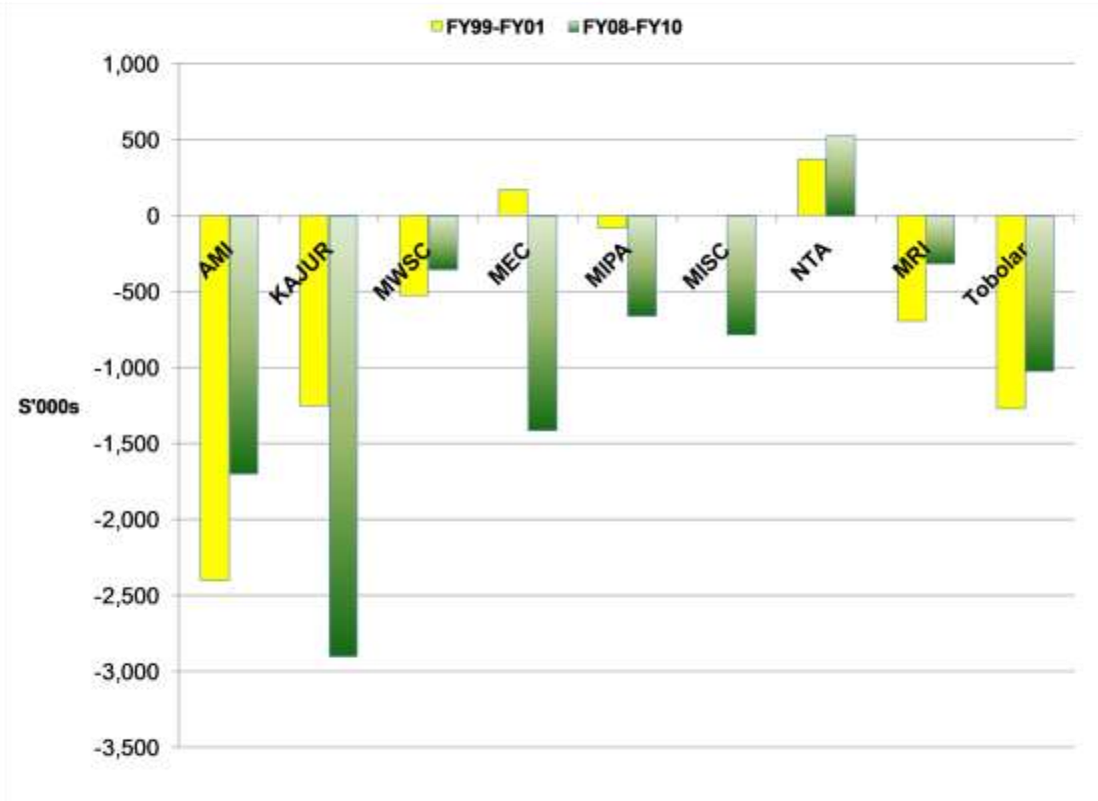


Figure 20 State Owned Enterprises, net operating profit

- The government will ensure that SOE boards are independent in operation and that they comprise members who are suitably qualified and experienced.
- The government will also ensure that the senior management within the SOEs have suitable qualifications and experience.
- SOEs will be required to align their prices and charges with the total cost of service delivery, except where they are being funded by community service obligation (CSO) arrangements.
- SOEs will be required to operate in accordance with sound financial management principles.
- The government has agreed to establish an SOE policy and SOE Act to provide mechanisms for the effective application of good practices.

123. According to the 2011 ADB Finding Balance report, “While the foregoing are 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.”

124. Moreover, it appears that despite the official adoption of these principles, not all of them have been implemented. For instance, the majority of SOEs (as of mid-2011) have yet to develop and publicize business plans. Also, alignment of prices and charges with total cost of service delivery remains an area for improvement.

125. Nonetheless, with ongoing technical support from ADB, a new SOE Policy will be drafted and adopted by Cabinet in late 2011, paving the way for the proposed new SOE Act to be introduced sometime in 2012. Furthermore, in addition to MEC, ADB will provide support to three other SOEs in 2011 and 2012, specifically for their development of medium-term, time-bound reform/strategic plans (see section below on other SOEs).

126. These efforts notwithstanding, it is clear that significant technical and financial resources, political will, and time will be necessary to see real changes in the governance and performance of SOEs in the RMI.

ii Reform update on Marshalls Energy Company (MEC)

127. MEC reforms are guided by its Comprehensive Recovery Plan (CRP), which identify major reform goals, objectives and actions for the FY2010-12 period. The CRP sets out a number of reforms covering MEC governance, policy, performance, and finances. The ADB PSP loan also includes MEC policy actions and requirements.

128. A review of progress made against the CRP since 2010 shows a number of achievements. In early 2010, MEC adopted a new tariff template that has brought closer into alignment the costs and revenues associated with its electricity business. The retirement of MEC's commercial debt with the Bank of Guam in early 2011 (facilitated by the ADB PSP loan) has freed up some cash flow to the company, part of which has been used to complete the refurbishing of one of its two large Deutz generators, thus improving MEC's generational efficiency. MEC has rolled out more than 600 prepay meters and is expecting another 1,000 to be installed by year-end 2011. After nearly two years of negotiations with the U.S. Rural Utilities Service (RUS), to which MEC held long-term debt of $6.3 million at the end of FY2010, MEC has received approval for the restructuring of its RUS debt, which will include a four-year grace period beginning in October 2011 (during this four-year span, MEC will maintain interest payments on the RUS loan). This restructuring will free up around $1 million annually to MEC. Other reforms and initiatives are in motion to help MEC improves its financial and operational viability, including technical assistance from ADB for the exploration of a coconut oil and diesel blending pilot project (which, if successful, could result in significant cost savings for the company). MEC has also retrofitted nearly all Majuro public streetlights to more efficient LED lights, which should reduce its non-revenue generation ratio.

129. As shown in Table 11, MEC continues to run major operational losses in its electricity business. In FY2010, despite its revised tariff template, MEC's utility operating expenses exceeded revenues by over $1.2 million (although the magnitude of losses has fallen over the four-year period). In its non-utility business, and in particular in its diesel

fuel sale business, MEC has seen a return of significant gross profits in both FY2009 and FY2010, with both years registering over $1 million in operating income.

130. Nevertheless, MEC remains in a precarious situation, particularly with regard to its cash flow and short-term solvency position. As shown in the table above, MEC's cash ratio (the amount of cash on hand relative to current liabilities) has deteriorated significant over the past four years, such that MEC had only 6 cents on hand for every $1 in owed in current liabilities (due within one year) at the end of FY2010. Recent indications from MEC (for FY2011) show that this situation has not improved (and may possibly have worsened), with MEC continuing to owe back payments to its fuel supplier. The utility is thus forced to continue its reliance on short-term commercial borrowing and/or government transfers (subsidies) to cover its obligations. As shown in the table above, government transfers to MEC reached $1.8 million in FY2010.

131. MEC's system losses remain too high and remain a key area for improvement. A technical survey conducted in 2010 quantified MEC's system losses (technical and non-technical) at well over 20%t, an unacceptably high and inefficient level. Moreover, recent estimates suggest that MEC's non-revenue generation ratio remains in the high 20s.

132. MEC also continues to slack on its collections; accounts receivable balances are high and rising. It ended FY2010 with nearly $5.8 million in receivables, an amount which, as of mid-FY2011, had ballooned to around $10 million -- clearly an untenable situation for a company already strapped for cash. Conversion to prepay meters will provide some relief, but more-aggressive collection practices are necessary to stem the rising tide of receivables. One of MEC's most delinquent clients is another state-owned enterprise, the Marshalls Islands Resort, whose balance owed to MEC had surpassed the $1 million mark in mid-2011.

133. In sum, while MEC has made tangible progress in several areas, it remains gener-

Table 11 Marshalls Energy Company indicators, FY1999–FY2010, US $'millions

	FY2007	FY2008	FY2009	FY2010
Utility operations indicators				
Utility operating revenues (a)	13.7	18.7	14.1	16.7
Utility operating expenses	17.5	21.7	16.3	17.9
Net operating income (loss) from utility operations	-3.7	-3.0	-2.1	-1.2
Non-utility operations indicators				
Non-utility revenues (fuel, propane, lubricants, other)	8.4	13.0	13.0	20.1
Non-utility expenses	7.5	13.0	11.9	19.1
Net operating income (loss) from non-utility operations	0.8	0.1	1.1	1.0
Total net operating income (loss)	-2.9	-2.9	-1.1	-0.2
Other indicators				
Transfers (current subsidies)	0.9	0.4	1.2	1.8
Cash ratio (cash to current liabilities)	45.0%	9.4%	9.4%	6.1%
Accounts receivable (b)	2.6	5.0	3.3	5.8

(a) net of provision for doubtful accounts
(b) net of allowance for uncollectable accounts

ally insolvent and will have to step up its efforts to realize the goals and objectives of its CRP.

iii Update on other public enterprises

134. Air Marshall Islands (AMI) continues to run major operational losses, totaling an estimated $1.8 million and $0.7 million in FY2009 and FY2010, respectively. These shortfalls have necessitated continued government capital and operating subsidies, which totaled $0.5 million and $0.9 million in FY2009 and FY2010, respectively. A 2010 review of AMI documented major shortcomings in the company's performance and presented a set of policy reform options for government consideration (see AMI Financial Review and Reform Analysis, conducted as part of ADB TA-7336). A Chamber of Commerce public forum on AMI in April 2011 was followed up by a policy advisory letter from the Chamber Executive Committee, which argued for more aggressive reforms by government. The letter stated that "in recent years [AMI] has been unacceptably unreliable. Today the public and taxpayers are not happy with the level of service that is currently provided. They deserve better. As businessmen and women we think that this means there is a need for different management. Our government is inundated with many financial challenges. If fixed, AMI can be one less problem to solve." The letter called for, among other things, a new management team, an end to interference in the day-to-day operations of the airline, and removal of all elected officials from the board.

135. The Kwajalein Atoll Joint Utility Resources (KAJUR), which provides power, water and sewer services on Ebeye, ran operating losses of $3 million and $2.5 million in FY2009 and FY2010. Capital and operating subsidies to KAJUR in these years totaled $3.5 and $1.5 million. A U.S. Army Corps of Engineers survey in 2010 documented major problems in KAJUR's core operating systems. Since 2008, KAJUR has made significant investments in new generators, which have in turn stabilized power supply on Ebeye. Nonetheless, KAJUR's system losses remain significant (at over 20%) and its water and sewer systems and services remain very poor. An Australia-funded water and sanitation engineer, in-country from mid-2011 to mid-2012, will advise KAJUR (and MWSC) on necessary water/sanitation reforms.

136. The Majuro Water and Sewer Company (MWSC) ran operational losses of $0.38 million and $0.35 million in FY2009 and FY2010, requiring subsidies of $0.35 million and $0.32 million in these years. Like KAJUR, MWSC has seen steady deterioration in its operating assets, and its tariffs fall far short of covering its operating costs. With the guidance from the Australia-funded water and sanitation engineer, and with support from the ADB, MWSC will develop a medium-term reform plan in late 2011.

137. The Marshall Islands Shipping Corporation (MISC) has significantly improved the reliability of shipping services compared to the previous service run by the Ministry of Transportation and Communication's Sea Transport Division. However, MISC operates a fleet of dilapidated vessels which are in desperate need of major overhauls. MISC's operating losses totaled $1.3 million and $1.1 million in FY2009 and FY2010, requiring

subsidies of $1 million in each of these years. An MISC landing craft sank on January 1, 2011, reducing its fleet from four to three. Japan has agreed to finance two new vessels for MISC (to be delivered in 2013), but major reforms to the company will be necessary to ensure that these vessels are properly maintained and to improve the company's financial viability. The board and management of MISC have agreed to work with ADB to develop a medium-term strategic plan in late 2011.

138. The Tobolar Copra Processing Plant ran operating losses of $2.4 million and $0.7 million in FY2009 and FY2010 and received subsidies from government in these years worth $1 million and $1.3 million, respectively. These subsidies have allowed Tobolar to continue its long-held practice of purchasing copra from outer island farmers at prices above the world market. This arrangement is considered a social assistance program, targeting low income farmers, but a number of studies have characterized it as highly inefficient and unsustainable. A 2010 evaluation of Tobolar's physical and operational capabilities documented major deterioration in the physical condition of its main plant facilities and called for major improvements in its maintenance, safety, and personnel management. Responding to this assessment, government made management changes in the company (including a new General Manager and several new board members). The new management has made clear its intentions to reform and improve Tobolar's operations, and the record sale of $3.8 million in coconut oil in mid 2011 will help finance some improvements and reforms. Support from ADB in late 2011 and early 2012 should lead to the development of medium-term reform and strategic plan for Tobolar.

139. The Marshall Islands National Telecommunications Authority (NTA) is the only SOE that has recorded consistent operating profits over the past decade, but in FY2010 NTA saw a small operating loss of $0.093 million. NTA continues to enjoy a legislated monopoly status, and its commercial prospects have improved with the completion of a submarine fiber optic cable in 2010. Nevertheless, NTA requested and received subsidies worth $1 million in both FY2009 and FY2010.

4. TRUST FUND VIABILITY -- MONITORING THE SUFFICIENCY OF THE TRUST FUND

140. The establishment of the Trust Fund for the Peoples of the RMI 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, stated that "the amended Compacts and their subsidiary agreements contain no commitments, either express or implied, regarding the level of the 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 FSM and RMI."

141. Despite the lack of a secure and sustained funding level, the Trust Fund Agreement does specify a withdrawal rule that is precisely based upon the FY2023 annual grant assistance level plus full inflation, and each year thereafter the specified withdrawal rate is increased by full inflation. In fact, the withdrawals would occur under current rules at this fully inflation-adjusted annual rate, even if it were known by all parties that the Trust Fund had not achieved a sufficient size to reliably support such withdrawals over the long term. This is a serious technical flaw if the real value of the Trust Fund is meant to be protected and if the stability of annual flows to the RMI is a shared objective. As currently structured, only the nominal value of the Trust Fund is likely to be protected, while the stability of annual distributions will be at severe risk.

142. The problem of immense and repeated fiscal shocks would arise, in the case of the Trust Fund not being sufficiently large, if the returns in any post-2024 year are insufficient (or negative) and if the "C" account, established as a buffer, is too small (or empty). In such a scenario, the RMI would suffer the consequences of having zero funds available for budgetary or infrastructure investment support in specific years. All too frequently, considering historical investment return patterns, such events could lead to two or more consecutive years with vastly diminished or zero funding. Thus, it makes sense for the RMI and the U.S. to consider modifications to the poorly specified buffer account and withdrawal rules embedded in the Trust Fund Agreement, so as to reduce the risk of repeated fiscal shocks of potentially massive proportions. At a minimum, consideration should be given to modifying the operations of the "B" account, which, as described, now provides no benefit whatsoever, and of the "C" account, which would be more reliably functional if it were created by fiat at the outset of FY2024. Subject to technical review, consideration should also be given to increasing the initial holding size of the "C" account and to providing sensible guidelines for the investment policy of the assets held in the buffer account. Consideration should also be given to the basic annual withdrawal rule, which provides no feedback mechanism to relate the annual withdrawal rate to the actual size—and therefore the sustainability—of the Trust Fund.

143. With the risk that a shortfall in the Trust Fund will not be underwritten by the U.S. government, it is imperative that the RMI government make every effort to monitor the progress of the Trust Fund and to assess performance against a sensible goal, which, we suggest, should be the sufficiency 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. By definition, and under the currently specified rules, that means the target value of the Trust Fund at the end of FY2023 must be sufficient to support annual withdrawals equal to the inflation adjusted value of the grants received in FY2023, while preserving the real value of the Trust Fund in perpetuity. A monitoring procedure is presented below that identifies the terminal condition for sufficiency of the Trust Fund at the outset of FY2024, the first year in which it must provide income to the RMI Government.

144. There is no clear documentation of the assumed growth rate of the initial RMI Trust Fund deposits augmented by the assumed annual contributions; however, there is

only one variable that affects the projected direct grant level in FY2023: the rate of inflation -- more precisely, 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 FY2012 are included, and thereafter an inflation rate of 3.0% is assumed (implying a 2.0% annual adjustment).

145. 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.

146. Using actual inflation adjustment data through FY2012 and projecting forward based on inflation at 3.0%, we project a direct grant level of $37.1 million for FY2023. Given this amount – and 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: the rate of return on investments in the combined "A" and "C" accounts (essentially the primary and buffer accounts).

147. 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: 65% of assets in equities with an assumed real rate of return of 6.5% annually and 35% in fixed income with an assumed real rate of return of 2.5% annually. The blended real rate of return for the distribution period is thus estimated at 5.1%. If inflation were to average 3.0%, a nominal rate of return of 8.1% would thus be required. All rates are assumed to be net of investment and Trust Fund management costs.

148. Taking the above projections and assumptions into account, the terminal condition for sufficiency of the Trust Fund is projected to be $748 million. If the Trust Fund had been funded in a timely manner and precisely as called for in the amended Compact (ignoring contributions from third parties), the meeting of this terminal condition value would have required an annually compounded rate of return of 7.99%. Pith annual inflation projected at 3.0% over the entire period, the implied real rate of return is 4.99%. The projected growth path from FY2004–23 is presented as the baseline growth, and actual progress is compared to this baseline (see Fig. 21, which shows the smooth line projection, from a planned deposit of $37 million in FY2004 to the target level of $748 million at the end of FY2023).

149. 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, 2011, the value should have grown to $157.3 million; however the actual value of the RMI Trust Fund at that date was $141.9 million. This shortfall of $15.4 million leaves the Trust Fund fully 10% short at this stage after 7.75 years of the

20-year accumulation period projected. Even if the returns from this date forward were to average the (initially required) trend line rate of 7.99% annually, the final value of the fund at the outset of FY2024 would be just 95% of the target level, falling short by $39 million.

150. Because of a combination of factors, the RMI Compact Trust Fund value at the end of June 2011 is below the projected path to support a smooth and sustained transition; however, following analysis of data through June 30, 2011, it cannot be said that the investment climate that prevailed for the entire period from the beginning of FY2004 through that date can be blamed for the shortfall to date. As noted below, the benchmark return from assets invested according to the prevailing Trust Fund policy would have performed slightly above the 7.99% annual compound rate of growth required to achieve the so-called "terminal" condition.

151. What can be said is that the performance of the market was favorable in the early period, during which the 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. Finally, there

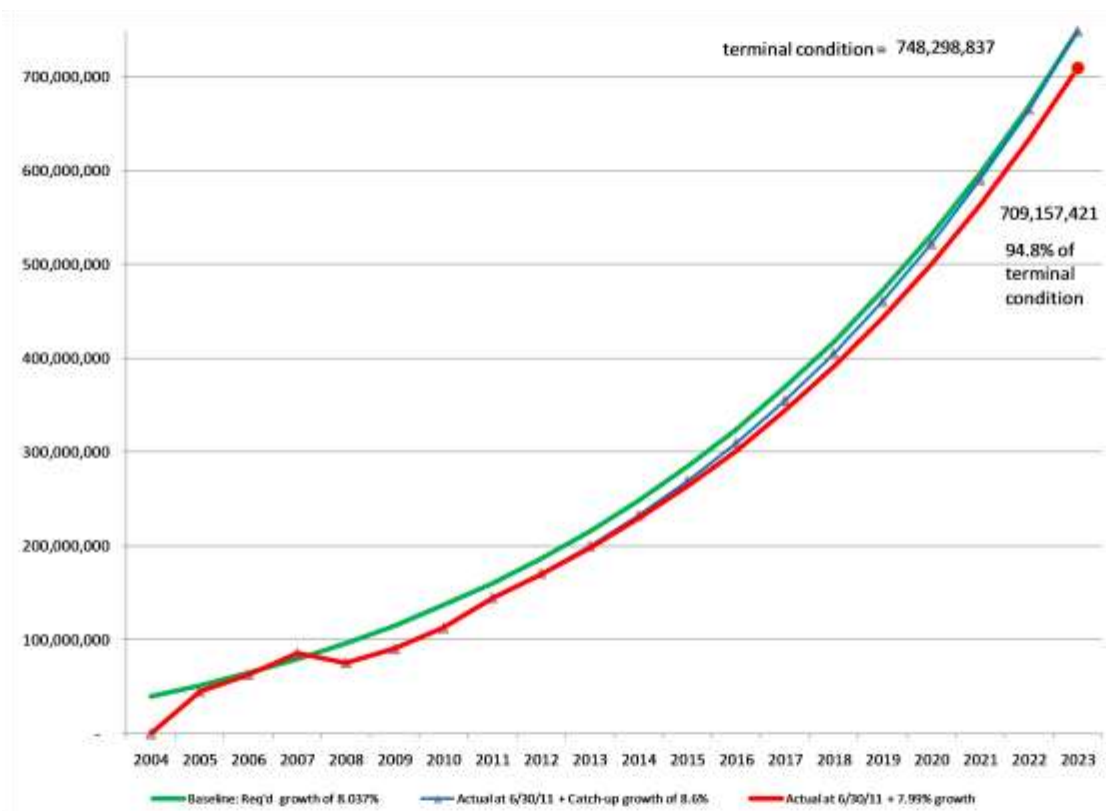


Figure 21 Compact Trust Fund Sufficiency, FY2004 – FY2024, $'millions

has been substantial recovery from March 2009 through June 30, 2011. 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 it. This type of risk is called "sequence of returns" risk, and it will persist throughout the accumulation period but will again become most prominent in the early years of the planned distribution period from FY2024 forward.

152. Several other factors that were not market-driven:

- The RMI was unable to deposit, in a timely manner, its required $30 million contribution, so the government 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). Still, there was 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, 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 Compact went into effect 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. Again, no discussions appear to have taken place to consider the impact of this and other delays relative to the originally projected 20-year accumulation period.

- While invested in the asset allocation identified in the Investment Policy adopted on August 19, 2005, and implemented on September 30, 2005, it appears that from that date through June 30, 2011, 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 benchmarks is $3.2 million, roughly 21% of the total shortfall of $15.4 million. Since the investment choices for most of the period 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.

- Finally, it is worth simply presenting the basic return performance of the RMI Trust Fund as of June 30, 2011. So far, contributions received have been $116.3 million, while the market value of the Trust Fund was $141.9 million, reflecting a total gain of $25.5 million. This computes to a compound annual growth rate of 4.4%.

153. Table 12 contains a breakdown of the negative and positive factors. As noted above, the shortfall over the initial 7.75-year period is not the result of market conditions that prevailed over the whole period. If all deposits and execution of the investment policy had been consistent with the projections at the time of the negotiations that resulted in the Compact, as amended, the expected value of the Trust Fund on June 30, 2011 would have been just slightly above the $157.3 million level projected for smooth trend-line growth.

154. Taking all factors into account, we can assess the impact of the other positive and negative factors. The market analysis utilized index comparisons against the initial investment strategy adopted by the RMI Trust Fund Committee. Specifically, 36% invested in U.S. equity (of which 14% is in large-cap growth; 14%, in large-cap value; 3%, in pharmaceuticals; and 5%, small-cap), 21% in international equity, 37% in fixed income (of which 35% is in aggregate bond and 2% in cash), and 6% in alternative (of which 6% is in real estate).

155. The initial strategy remained until replaced by action of the RMI Trust Fund Committee (Resolution RMI 2008-7, effective August 27, 2008), with the following asset

Table 12 Trust Fund Performance analyzed by Source of Variation as at end June 2010

RMI Trust Fund	Value at 6/30/2010	Difference from actual	Decomposition estimates	
If smooth trendline growth:	**157,313,504**	(15,429,582)	100%	The fund is 9.8% below target at this stage
If invested from original date:	157,701,467	387,963	3%	This is the attribution to actual market performance over the whole period from October 1, 2004 - June 30, 2011
If invested from deposit dates:	151,307,390	(6,394,077)	-41%	This is result of delayed deposits
As entered into Inv. Policy:	145,123,393	(6,183,997)	-40%	This is result of delayed investment
Actual Market Value:	**141,883,922**	(3,239,471)	-21%	This is result of fees, underperformance, and changes from benchmark inv. policy
If Taiwan deposits removed:	130,994,855	10,889,067	n.a.	The fund would be $10.9m less if Taiwan deposits (of $11.2m) had not been received

allocation targets: fixed income/cash at 25%, U.S. public equity at 40%, international equity at 30%, and alternative assets (real estate) at 5%.

156. A further modification to the approved investment strategy (Resolution RMI 2010-1, effective 12/14/2009) resulted in the following asset allocation targets: fixed income/cash at 26%, U.S. public equity at 43%, international equity at 26%, and alternative assets (real estate) at 5%.

157. Beginning with the actual investment policy in existence through three time periods, this report has created a benchmark performance index that reflects the three differing asset allocation targets over each relevant portion of the 7.75-year period. The analysis utilized actual index-based measures consistent with the target benchmarks identified by the investment advisor for the RMI Trust Fund. The analysis also took into account actual date-of-deposit data to estimate various effects (Table 12).

158. One factor that has proven positive for the RMI Trust Fund is the contributions from the Government of Taiwan, which have augmented the balance of the Trust Fund as of June 30, 2011. Taiwan has committed to a total funding level of $40 million over the twenty-year period of the amended Compact. Taiwan has deposited $11.2 million thus far— an amount exactly equal to its stated intent. Contributions planned for FY2012–23, 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 7.99% rate of return would be 101% of the target value. Clearly, the value of third-party contributions is substantial, and the allowance for third-party contributions to the Trust Fund, with mutual consent, was an enlightened feature of the amended Compact.

159. As shown in Fig. 21, the catch-up rate required for the RMI Trust Fund to achieve its planned terminal condition by the end of FY2023 in the absence of continued planned contributions from Taiwan would be an 8.6% compounded annual return for the remaining 12.25 years of the originally projected 20-year accumulation period. This return is just slightly higher than the historical returns expected from the current investment strategy. Given the historically poor initial period—and the likelihood of a sustained period of above-average performance following the downturn—it remains possible, perhaps even likely, that the RMI Trust Fund will achieve the target level. It would, however, be sensible for the RMI Trust Fund Committee to revisit its investment strategy—as it should periodically, in any event—to consider the appropriate balance of risk versus reward and the appropriate mix of asset classes and allocations to those chosen asset classes. However, it is not recommended that the RMI over-allocate to risky assets in an aggressive attempt to catch up. Rather, the most likely policy response should be to secure the planned contributions from Taiwan as well as to mobilize additional contributions—of modest proportion and from whatever domestic or external sources—to the Trust Fund to more reliably support the RMI's long-term fiscal stability and sustainability.

160. Finally, it will be important, as the 20-year planned accumulation period for the Trust Fund nears its end, that the precise role of the Trust Fund distributions—and the

direct grant flows that they are likely to be needed to replace—be clear in the minds of policy makers. Both the Asian Development Bank and the International Monetary Fund have relied upon long-term fiscal projections that assume that the RMI Trust Fund is meant to replace virtually all sources of assistance from the U.S., and not simply the Compact section 211 sector grants. To put this into perspective, the analysis in this section implies a stream of grants to be replaced by the RMI Trust Fund of $37.1 million in FY2023, while some projections provided to the RMI government assert that the Trust Fund needs to replace a stream of grants equal to $44.9 million. The latter number is 21% larger, implying that the terminal value of the Trust Fund would need to be 21% — or $905.4 million -- larger. The RMI officials with whom we consulted do not currently believe that the larger number is accurate, as it assumes the complete cessation of section 212 Kwajalein Impact payments, section 213(b) audit grants, as well as SEG education grants that were never intended to be replaced by the Trust Fund—and, in the negotiations that resulted in the amended Compact, were never included in calculations as to the desired magnitude of U.S. Trust Fund contributions. Regardless of the value of the Trust Fund, there remains a need—perhaps less dramatic than portrayed by some analysts but still substantial—for the RMI to improve both its current and long-term fiscal position so that it can, indeed, achieve the goal of fiscal stability and self-reliance.

C. Fiscal Policy and Implementation

1. FISCAL POLICY

161. Recent fiscal performance (Fig. 16 and Table 8) indicates a fiscal surplus in the years since FY2006, averaging 2% of GDP, but it does not reveal the large or growing deficits frequently associated with an unsustainable fiscal position. There is widespread understanding that the fiscal position is stressed and requires adjustment. An economy such as the RMI cannot easily run a deficit, since there is no central bank or access to external capital markets. Deficits can be supported only through such measures as aging payments to vendors, default on debt, or failure to pay monthly tax and social security allotments on behalf of employees. Thus, to accurately assess actual fiscal pressure, it is necessary to identify non-conventional signals of weakness. The following indicators have been evident during the amended Compact:

- A ruling in July 2005 by the U.S. Inspector General that Compact funds should be quarantined in special bank accounts. (This ruling curtailed the use of Compact resources to fund general operations and exposed the underlying tight fiscal position in the general fund. In FY2007, Compact funds were in fact diverted for 24 hours to fund the general account.).
- Use of the Compact Trust Fund "D" account ($3.5 million) to meet the RMI capital contributions to the "A" account in FY2005 and FY2006. Replenishment of the D account is outstanding.

- Difficulty in meeting the general fund payroll in FY2006; delays in the payment of allotments and MISSA contributions from the salaries of government employees in FY2006.
- A very finely balanced (*or:* precarious? marginally satisfactory?) fiscal outturn, existence of a priority list of recipients, and weekly cash flow management.
- Inability to service ADB debt in FY2007.
- The increasing use of the ROC project fund ($6 million in FY2009) for advances to the SOE sector and general fund purposes.
- Low unreserved working balances of the general fund and a negative unreserved fund balance ($3.0 million in FY2009, $1.6 million in FY2010).

162. There is no doubt from the above observations that the daily operation of the RMI government budget is stressed. While the situation has improved over FY2008, when debt service, payroll and allotments were in arrears, the government's cash flow position remains tenuous. Over the period of the annual cycle, the budget has been approximately in balance, but the timing of receipts and payments may be such that there is a cash shortfall during particular weeks or days. The observed day-to-day management of fiscal policy raises the question of what the major objectives of fiscal policy should be. As in last year's report, there are four key considerations:

- ***Cash flow management***: maintenance of a sufficient fiscal balance and reserves to enable smooth operations of government and payment of expenditures. In economies with a central bank or developed capital markets, the government can borrow in order to smooth out irregularities in the short term. The RMI does not have access to such funding and needs to hold sufficient cash balances to avoid payment arrears.
- ***Cyclical downturn***: The nation also needs to be prepared for cyclical developments, usually in the medium term, that arise from adverse world economic conditions, as with the current recession. These downturns may result from adverse changes in the external terms of trade, such as fuel price shocks, food price increases, or price reductions in primary commodities (e.g., coconut oil, fish). Again, suitable reserves are needed to offset cyclical movements in the world economy.
- ***Structural imbalances***: While the RMI fiscal position is tenuously in balance in the immediate short term, the medium- and longer-term outlook is less favorable, because of the decline in U.S. grants, the result of the annual decrement. Although nominal grants are likely to remain constant—because the decrement is offset by the 2/3rds inflation adjustment—the real value of the Compact grants will decline.
- ***Insufficiency of the CTF***: During a recent IMF Article IV consultation, the IMF defined the concept of "fiscal balance" in relation to the generation of sufficient savings to make up for the anticipated shortfall in the CTF in 2024. The Fund's

calculations indicate that the RMI needs to increase fiscal savings to 5% of GDP within five years -- and to maintain it at that level through 2024.

2. THE MEDIUM TERM BUDGET AND INVESTMENT FRAMEWORK

163. At the onset of the amended Compact, the RMI adopted a medium-term framework for the preparation of the annual budget and request for resources from the U.S. under the sector grants. The implementation of Public Financial Management (PFM) is typically considered under two components: the medium-term financial framework (MTFF) and the medium-term expenditure framework (MTEF). The MTFF is concerned with setting the overall fiscal envelope in which the budget is formulated, while the MTEF is concerned with the allocation of public resources (i.e., expenditures) in accordance with delivery of specified outputs. Both are set in the medium term. Reflecting a PFM approach to budgeting in the Compact, the RMI system was termed the Medium-Term Budget and Investment Framework (MTBIF).

164. The medium-term framework 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.*

165. 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. The MTBIF is supposed to be updated twice annually—in December and February—to identify budget envelopes for the following fiscal year based on past trends, expected needs, and performance. The intention is to update the MTBIF mid-year to include previous fiscal-year audit information. As part of the process, an MTBIF Policy Framework Paper is prepared to provide macroeconomic and fiscal guidance. Its input is the MTBIF, as well as other statistics and reports, including the quarterly and annual sector performance. The paper is intended to highlight major trends, such as revenue and expenditure issues, and other macroeconomic issues that the government and/or economy may be confronting in the medium term.

166. However, while the MTBIF approach was written into the amended Compact and the framework has been updated annually, the process has not been adopted as a meaningful budget planning tool or active component of fiscal and macroeconomic planning. This is the result of a series of factors. First, there has been a lack of institutional capacity to build and maintain the MTBIF within EPPSO, the Economic Policy, Planning, and Statistics Office. The MTBIF has been prepared by non-resident consultants, and there has been no local staff capable of managing, updating, or communicating the results of the process to policy makers during the budget cycle. Second, there has been a lack of up-

to-date fiscal information on which to base the framework. While audits statements are produced each year, they become available only at the end of June, when budget design is well advanced. Budgets are thus forced to be designed budget-on-budget: in the absence of last year's actual fiscal results, budgets are made in relation to last year's allocations – a process that is hardly inductive to the efficient allocation of resources.

167. Third, macroeconomic data has until lately constrained the construction of a typical macroeconomic framework, which comprises the national accounts, statement of government operations, balance of payments, and monetary survey. Only in the current process of updating the annual economic report has GDP data become available on an industrial basis. With balance of payments compilation also part of the annual statistical update, it is now possible to project all four of the major macroeconomic accounts over the medium term. The last part of this report is devoted to a preliminary attempt to develop a medium-term macro-framework, and the results are presented in Part IV (and will be refined in future reports). Ideally, such a framework would be introduced into the Ministry of Finance in its annual budget preparatory cycle. However, fiscal information needs to be available in real time to enable results-based budgeting, and local capacity needs to be enhanced to maintain and drive the process throughout the cycle.

3. Decrement Management

168. Bearing in mind the continuing structural deficit implicit in the amended Compact due to the annual decrement, the U.S. requested the RMI to prepare a decrement management plan over the medium term. At the JEMFAC in September 2009, resolution JEMFAC 2009-1 "Sustainability of Sector Budgets," was adopted:

> *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.*
>
> *JEMFAC further resolves that the RMI submit its findings and plan through the Office of Insular Affairs to JEMFAC no later than August 1, 2010, and demonstrate it has used the findings and plan as part of its internal budget development process for Fiscal Year 2012.*

169. In response to the U.S. request, the RMI issued and updated the MTBIF and in March submitted to JEMFAC a report entitled "Decrement Strategy & MTBIF Policy Framework Paper, FY11-14." The approach adopted by the MTBIF was a simple one: to implement recent reform efforts to reduce expenditures (CAP; see below), and adopt a modern tax regime (TRAM; see below). The subsequent improved fiscal position would enable education and health expenditures adopted as priorities by the RMI government to be maintained in real terms over the medium term while the rest of government would be scaled back. While the MTBIF approach represents a viable process based on previously

endorsed documents, the government has yet to demonstrate its commitment by enacting the reforms in the budget under consideration. With an election coming up in November, the situation presents a real test of the government's resolve to enact politically tough measures.

170. Recalling the above four considerations of fiscal policy, it can be seen that the MTBIF addressed only three of them. The government needs a longer-term framework (a longer-term horizon? view?) to address the annual decrement and fiscal adjustment through the end of the amended Compact, especially given the likely insufficiency of the CTF. Decrement management over the medium term will require continuing reprogramming, as the real value of Compact flows tails off. While preserving education and health may be possible (with commitment) in the medium term through compressing all other expenditures, this tactic is not viable in the longer term, as the rest of the government fails to receive the necessary operating funds. The government must thus design a Long-Term Fiscal Framework (LTFF), which would address the decrement issue (as noted above), along with the CTS concerns and the appropriate level of all government services.

171. The LTFF could be used in parallel to the medium-term MTBIF. While the MTBIF needs to be upgraded and projections made of all the four macroeconomic accounts (see Part IV of this report as an outline), the LTFF would require a different approach, which would include an economic model based on the structural characteristics of the RMI economy, with a planning horizon through 2024. The modeling framework would enable simulation of the main policy instruments available to government: expenditures and revenues by economic and function category, including sector grants, public servant employment, wage rates, and taxes. The LTFF would allow simulation of alternative assumptions of the exogenous variables such as exports, worker's remittances, landowner rents, interest earnings, grants, and transfers. A policy package could then be developed to meet the long-term objectives of the RMI government and address sector grant concerns and the CTF issue. However, as with the MTBIF, the process must be embedded in the institutional structure of the RMI, with continuing update and dialogue with the policy makers, if it is to be an effective tool for fiscal and economic planning.

D. Public Sector Reform

172. In response to the emerging world economic crisis in 2008, as well as rising fuel and food prices, the 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 CAP Advisory Group was created to develop an internally conceived and designed Comprehensive Adjustment Program. The program would promote the immediate interests of fiscal responsibility and stability, while also enhancing medium-term prospects for private-sector-led economic growth. The second group ,created by the Cabinet, was the Revenue and Tax Reform and Modernization Commission (TRAM), which was to develop a proposal to reform the existing revenue system and strengthen compliance and collections. Arising out of these internally

generated reform initiatives, the ADB was requested to provide support through a Public Sector Program (PSP) aimed at consolidating the reform process and in particular providing resources to refinance MEC debt on concessional terms. The following sections describe each of these initiatives and the progress towards its implementation.

1. THE COMPREHENSIVE ADJUSTMENT PROGRAM (CAP)

173. The CAP was formed by the Minister of Finance and the Cabinet on April 22, 2009; the report submitted by the Advisory Group to the Cabinet in September 2009 identified two broad goals:

- *The first goal is to provide the Government with a well-defined series of actionable measures to recover from the recent (and continuing) deterioration in the fiscal position of the RMI Government and, following a period of fiscal restraint, to put the Government on a path toward long-term fiscal sustainability, while also placing the RMI economy on a similar path toward sustained growth.*
- *The second goal is to provide the Government with an internally designed program that can better guide its relations with the external donor community. Here the measurable objectives will be (a) to mobilize increased and better-targeted donor resources to support the implementation of the CAP, (b) to reduce the RMI's net external debt, and (c) to direct those resources towards the best uses for the RMI's long-term development.*

174. The CAP Advisory Group then goes on to make clear that the adjustment program will require significant political will on the part of the nation's leadership. Sacrifices will inevitably be required in the near- to medium-term. The reform program should possess the following characteristics:

- *The larger share of the fiscal adjustment should be devoted to expenditure reductions, with significant, but lesser, reliance upon revenue increases.*
- *The fiscal adjustments approved for implementation by the Cabinet should be undertaken in two phases, with the items delivering the greatest fiscal savings/earnings prioritized for Phase I. This front-loading will enable the benefits of adjustment to be realized earlier.*
- *All of the RMI's commitments for implementing its own internally-designed CAP should be shared with its major donor partners, so that the RMI can benefit from coordinated and enhanced donor assistance.*
- *Finally, all of the elements of the CAP, and all of the RMI's future fiscal operations should be consistent with:*
    - *the "Decrement Management Plan" to be developed pursuant to JEMFAC Resolution No. 2009-1; and*

- *an "External Debt Management Strategy." The goal will be to reduce the RMI's net-indebtedness over the period of CAP implementation and to ensure that the RMI never again subjects itself to unsustainable levels of external debt.*

175. Although the CAP Advisory Group outlined the general principals of reform, the specific measures were almost entirely related to expenditure reduction and followed a detailed examination of the major areas of expense. Table 13, reproduced from the CAP report, indicates a lower and upper range of potential savings by expense category. We will not go through the list in detail, with the exception of two major categories relating to the civil service and SOE subsidization. In the RMI, the civil service represents nearly 50% of the cost of current operations. The Advisory group recommends the implementation of a RIF ranging from 50-400 civil servants, with cost savings of $0.7-$5.6 million. It is clear that any reduction in force must be effected from the general fund, as other categories are protected by dedicated funding sources. At the time of the PSRP, the general fund supported about 600 staff outside of education and health (now funded through Compact sector grants). Since that time, employment financed by the general fund has grown by about 300. The reduction in cost savings represented by the upper bound of the CAP in Table 13 corresponds to approximately this level, i.e., about 300 civil servants. The target is thus at the upper end of feasibility and would come at a hefty political cost.

176. The CAP study 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 noted above, the CAP did recommend a review of the SOE sector; this review, now completed, recommends development of a comprehensive approach. Clearly, "stroke of the pen" savings are not easily achieved without disrupting delivery of existing government services, many of which support disadvantaged groups in the outer

Table 13 CAP Advisory Group Proposed Savings by Expense Category

REFORM AREAS	**MINIMUM SAVINGS ($m)**	**MAXIMUM SAVINGS ($m)**
The Civil Service	1.7	4.9
Nitijela Member Compensation	.14	.17
Housing Allowances	.25	.27
Electricity Allowances	.5	1.52
Leased and Rental Housing	.07	.15
Utility Bills	.25	.75
Communications	.05	.1
Vehicles	.05	.1
Fuel	.07	.1
Travel and Per Diem	.1	.2
Professional Services	.03	.06
Grants and Subsidies	.6	1.8
Organization/Facilities Consolidation	.15	.3
TOTAL	**3.96**	**10.42**

atolls. Reduction of these services would again come at a high political cost. However, the SOE sector is clearly an area where costs have risen very significantly, and long-run cost savings should be an essential element of reform.

177. Overall the CAP group recommended expenditure reduction of $7 to $8 million over a one-to-three-year period to address the structural deficit position. This reduction is similar to the level recommended in a recent IMF Article IV consultation. However, since the time of the CAP recommendations, none have yet been implemented. The FY2010 makes an across-the-budget cut of 5%, which was not a CAP recommendation and clearly not an efficient means of expenditure reduction. In FY2011, a further 5.5% cut was imposed to allow for increased allocations to investments, which does not indicate any reduction in total outlays. During March of 2011, a resolution was introduced to reduce the working day by one hour per day -- or one day in the biweekly pay period. A public meeting to discuss the proposed cuts attracted a large turnout, and the proposal was shelved. At the time of the preparation of the current FY2012 budget, it is understood that although Ministries are running "low on gas," that there will nevertheless be a further 5.5% across-the-board cut. The non-specific reductions that have prevailed in the last three budgets are 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 or elimination of non-essential services. The current approach to budget management, which may be perceived as sharing the burden across service providers, totally fails in this regard.

2. The Tax Revenue Reform and Modernization Commission

178. Complementing the creation of the CAP Advisory Committee, the Cabinet created the Tax and Revenue Reform **a**nd Modernization Commission (TRAM) on July 11, 2008. While the CAP was created to investigate ways to save cost in the operations of government, the TRAM was created to:

- *deliver to the Government for its consideration a* ***proposal to reform current tax system and structure*** *to meet the current and future financial needs of the Republic of the Marshall Islands and a tax and revenue design conducive to current realities and circumstances;*
- *deliver to the Government a proposal to* ***strengthen the capabilities and effectiveness of the revenue collecting administration****, sufficient to implement the revenue and tax reforms and improve the level of (voluntary) compliance of RMI taxpayers.*
- *take responsibility for governing and oversight of the design* ***to ensure effective implementation*** *of the changes needed to enhance a sustainable revenue stream to the Government*

179. In its proposal, the TRAM adopted the following guiding principles for tax reform:

- transparent and certain
- effective and efficient to administer
- simple and broad-based
- fair and equitable
- financially neutral
- low tax burden
- promote private sector development
- attractive to foreign investment.

180. In order to support the recommendations of the TRAM, a request was made to PFTAC for technical assistance in the development and design of the tax reform package. The essence of the tax reform proposed by PFTAC was the introduction of a modern tax system which is 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 (except as a presumptive tax for small businesses), 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 (that is, businesses with annual turnover greater than $100,000);*
- *retaining the GRT for businesses with turnover less than $100,000 but increasing the rates in certain cases; and*
- *modifying the wages and salaries tax by broadening the tax base to include items which are currently exempt, modifying and expanding the current tax-free threshold so that it is available to all taxpayers, and introducing a higher tax rate for high-income earners.*

181. While the PFTAC proposal outlines a set of reforms, it also stresses the need for strengthening of tax administration. In particular, the introduction of the consumption tax (VAT) would be key to a modern tax system and would contribute to better levels of compliance. PFTAC also proposed the creation of an independent tax authority, which would incorporate an efficient and incentivized administration not subject to public service regulation. The tax reform strategy and administrative reforms would provide RMI with an internationally recognized tax system that is conducive to business and foreign investment and is more equitable for taxpayers. The proposed reforms would also increase the revenue yield.

182. The PFTAC tax reform proposal was well received by the TRAM Commission and, barring one major exception, was recommended to the Government, largely without modification. The major exception was the introduction of the VAT, which in effect was the centerpiece of the PFTAC tax reform initiative. The adverse reaction to the implementation of a VAT has been long-standing in the RMI, going back to the time of the PSRP, when it was initially proposed and rejected. However, after a set of public awareness meetings, these objections have been overcome, and the Minister of Finance has agreed to include the VAT in the tax reform initiative. Laws have now been drafted for an Income Tax Act, A Marshall Islands Consumption Tax, and a Revenue Administration Act. The intention is to submit the bills to the August session of the Nitijela, before the next election, but to implement in phases over a two-year program. Support is being sought from AUSAID for a tax advisor (for two years), from the ADB for a legal advisor on enforcement and compliance issues (six months, intermittent), and from PFTAC for an IT specialist.

3. ADB Public Sector Program

183. Based on the recent internally designed reform initiatives developed by the CAP Advisory Group, the TRAM Commission and SOE report endorsed by the Cabinet, the ADB engaged in negotiations with the government to develop a Public Sector Program (PSP) loan, which became effective in September 2010. The first tranche of the loan was $9.5 million, of which $8.4 was devoted to refinancing of the existing MEC debt with the Bank of Guam. The balance of the loan, just over $1 million, was initially held by the government, but after some negotiations was transferred to MEC in early FY2011 for additional support. The PSP is designed to support the government in the achievement of its reform initiatives through the delivery of five outputs:

- improved medium-term fiscal outlook,
- restraint of recurrent expenditure,
- increased tax revenue,
- improved SOE performance, and
- increased stakeholder participation.

184. The conditions of the policy matrix of the program were intended to be achieved over a two-year span, FY2011-12. While FY2011 has yet to close out, it is still possible to briefly review progress towards implementation of the policy matrix and to estimate the likelihood of success in the achievement of the loan covenants.

i Improved medium-term fiscal outlook

185. Improvements in medium-term fiscal prospects were defined in two parts: general budget policies, and public-sector debt management.

A. Budget policies

i. *An average annual budget surplus over FY2011 and FY2012 of approximately 3.0% of GDP.* The inclusion of this output is based on the IMF definition of "fiscal sustainability" as a CTF asset level that would create an income stream sufficient to replace the Compact grants without eroding the real level of the assets. In FY2010, the government ran a fiscal surplus of 4.6% of GDP, but this was due to restricted savings on several funds, unlikely to be repeated. In all probability, the large surplus achieved in FY2010 will be run off in FY2011, as the accumulated savings are spent on the intended purposes, and a large deficit will result. The PSP definition of fiscal surplus was ill-defined; a better measure would have been fiscal surplus on the general fund, the discretionary part of government spending. In FY2010, a general fund surplus of 1% of GDP was attained. In essence this implies running a zero balance on the general fund after principal debt repayment. Given past performance and the impending elections in November, it is very difficult to imagine how this key objective will be achieved.

ii. *An average annual contribution from the General Fund to the Compact Trust Fund over FY2011 and FY2012 of at least 1.5% of GDP (approx $2.5 million).* In the FY2011, budget there was a programmed contribution of $1.1 million, as well as $0.4 million under the ROC project budget. As mentioned above, there are many considerations in the design of fiscal policy. While viability of the CTF is clearly a key objective, and RMI efforts in this regard would be well received, it is a shared responsibility between the parties of the Compact and their mutually-agreed goals. It is not clear that it should be the sole responsibility of the RMI.

iii. *A reduction in the ratio of wages and salaries to GDP to 21.0% by FY2012 (preliminary estimate of 22.3% for FY2010).* Wages were 21.5% of GDP in FY2010. As noted earlier, a resolution to reduce the level of compensation in March was shelved after public outcry. The current budget for FY2012 does not contain any specific policies to meet this objective.

iv. *A reduction in the ratio of 'subsidies and transfers' to GDP to 9.0% by FY2012 (preliminary estimate of 10.1% for FY2010).* The level of subsidies and transfers as defined in the GFS was 9.2% in FY2010, but FY2010 was an unusually good year for SOE subsidies, with transfers to AMI and KAJUR lower than normal. The high copra prices in FY2011 will obviate the need for any transfer to Tobolor, and this fourth objective may be achieved.

v. *A ratio of capital expenditure to GDP of at least 13.0% in FY2011 and FY2012 (preliminary estimate of 13.7% for FY2010).* According to the GFS statistics in this report, capital outlays were 10.7% of GDP in FY2010. The RMI is required under the Compact to devote between 30% and 50% of its Compact sector grants to infrastructure. It is understood that at present this target is presenting difficulties, as the government attempts to maintain priority services in health and education, even as the decrement erodes the real level of the sector grants.

vi. *An increase in the ratio of 'tax revenue' to GDP to 16.5% by FY2012 (preliminary estimate of 16.2% for FY2010).* Tax revenue was 15.5% of GDP in FY2010; taxes fell back from the FY2009 level. Implementation of the TRAM tax reforms will no doubt the increase tax effort (although revenue neutrality is the stated objective). However, implementation of the new tax regime will not become effective until FY2014, two years after the intended completion date specified in the program.

B. Public Sector Debt Management

i. *A freeze on new borrowing to fund expenditure of the general government sector of government ministries.* There has been no new or intended borrowing in FY2011 or FY2012.

ii. *A freeze on the level of non-concessional borrowing by 11 SOEs.* MEC drew down a commercial loan of $4 million from the Bank of Marshall Islands to fund a cash flow crisis in March and August of 2011, although the terms of this borrowing are unknown.

iii. *No government lending or loan guarantees to parties outside the public sector.* The government is in compliance with this provision.

iv. *Concessional borrowing by SOEs to require prior approval of Cabinet.* The government is in compliance with this provision.

ii Restraint of recurrent expenditure

186. The second output is to be achieved through the implementation of key recommendations of the CAP and the conduct of work force audits.

A. Implementation of key recommendations of the CAP

i. *Reduction in over-budgeting of the wage and salary bill by eliminating 50 vacant positions (equivalent in value to 5% of the FY2010 budget allocation for wages and salaries).* Not indicated in the FY2011 or FY2012 budgets.

ii. *A one-time cut and then a freeze in grants and subsidies to 11 SOEs; electricity concessions provided to land owners affected by MEC operations; travel and per diem expenses; and government operating expenditure on housing leases and rental, electricity, water, communications, vehicles, fuel and professional services.* Not indicated in the FY2011 or FY2012 budgets.

iii. *A freeze on the wage and salary bill of the civil service, Nitijela members' compensation and housing allowances for public officials*. In effect, with the general cut in the FY2011 and FY2012 budgets, this condition could be met. However, it is likely, as in the case of the FY2010 outcome, that the wage bill will increase in both FY2011 and FY2012 and that offsets would be achieved in the general use of goods and services to meet the 5% reduction targets.

B. Conduct of work force audits.

i. Conduct of work force audits performed by independent consultants for three major Ministries (Education, Health, and Public Works). Work force audits are yet to be commissioned, but ADB technical assistance to conduct audits is available and is planned for late 2011.

ii. Review and endorsement by the Cabinet of key recommendations in the work force audits, relating to reducing budget allocations to civil servant salaries and wages. Work force audits are yet to be commissioned, but if these are conducted in late 2011, then presumably this review and endorsement of recommendations will be executed by the Cabinet.

iii Increased tax revenue

187. The third output is to be achieved in two parts: (i) an independent assessment of the tax system by the TRAM commission and endorsement by the Cabinet, and (ii) a set of time-bound actions to improve the efficiency and equity of the tax system, with implementation beginning in FY2011. PFTAC was requested to provide an outline of a tax reform initiative and, as discussed in the section on the TRAM, this outline has now been endorsed by the Committee and Cabinet. The second part of the tax component of the PSP is essentially implementation of the PFTAC proposal and was specified as follows:

i. Adoption of a broad-based consumption tax as a replacement of existing distortionary taxes.

ii. Adoption of excises on alcohol, tobacco, motor vehicles and fuels as a replacement of existing distortionary taxes.

iii. Adoption of new income tax rates and a reduction in exemptions to reduce the overall regressivity of the tax system.

iv. Improvement in compliance by streamlining and consolidating the multiple tax monitoring and collection systems.

188. The first three requirements are part of the PFTAC reform proposal, which has been adopted. New laws have been drafted, and these will be presented to the Nitijela in the August session for passage before the November election. Regarding condition iv, AUSAID, the ADB and PFTAC will support the RMI in its efforts, by providing technical assistance to improve compliance and introduce modern IT systems. It is important to note that the overall section calls for increased tax revenue, although the TRAM recommendation called for revenue neutrality. Clearly revenue neutrality is politically more saleable, but in reality, the introduction of a modern tax regime is likely to entail increased revenues.

iv Improved SOE performance

189. The fourth output of the program is the improved performance of the RMI's state-owned enterprise (SOE) portfolio; it includes six major policy actions.

A. Endorsement by Cabinet of recommendations for improving SOE performance

i. Conduct by independent consultants of an assessment of the commercial performance of 11 major SOEs and identification of options to improve performance. With ADB assistance, an initial SOE-sector assessment was completed in late 2009, and subsequent SOE-specific assessments have been conducted through mid-2011.

ii. *Review and endorsement by Cabinet of the key recommendations of such assessment relating to improving SOE performance.* An initial set of SOE "Good Practice Principles" was endorsed by Cabinet resolution in mid-2010. Moreover, a draft SOE Policy is currently being developed for consideration and adoption by the Cabinet in late 2011, and a proposed SOE Act will be drafted and introduced into Nitijela in 2012.

B. Cabinet endorsement of good practice principles for 11 SOEs

i. Establishment and public release of plans approved by the Cabinet and SOE Boards that set out the SOEs' strategic direction and performance targets. Work is underway to develop reform/strategic plans for three SOEs, to be reviewed and accepted by the Cabinet in late 2012.

ii. Identification of essential activities and the sale or winding down of non-essential activities. This has yet to be completed, as SOE reform plans are still being developed (for three SOEs).

iii. Ensuring SOE boards have independence in operation and are staffed by suitably qualified and experienced members. No formal effort has been undertaken in this regard.

iv. Ensuring senior managers of SOEs have suitable qualifications and experience. No formal effort has been undertaken in this regard.

v. Alignment of prices and charges with the total cost of service delivery, except where funded by community service obligations. This has yet to take place.

vi. Sound financial management of SOEs, including the timely production of audited accounts. Thus far, all SOEs, except for MIDB, have had timely audits.

vii. Authorization of the MOF to establish an SOE policy and SOE act to provide mechanisms for the sound application of good practice principles. These are currently under development, for introduction and endorsement in late 2011 (policy) and 2012 (act).

viii. Confirmation by the MOF of beginning preparation of an SOE act to provide mechanisms for the sound application of good practice principles, to be submitted to the Parliament within calendar year 2010. This is under development for submission to Nitijela in 2012.

C. MEC comprehensive recovery plan prepared and endorsed by the MEC board

This was completed in 2010.

D. Implementation of MEC comprehensive recovery plan commenced

i. Reduction of MEC board membership from ten to seven members and inclusion of members who have private sector/commercial experience and represent customer interests (action 1.1.1 of the Plan). This was completed in 2010.

ii. Adoption of a new procurement policy (action 24.1.1 of the plan), new financial management and reporting policies (action 24.1.3 of the Plan), and a new vehicle policy (action 24.1.4 of the plan). These were adopted in 2010.

iii. Adoption of a revised tariff template to reflect increased costs since the inception of the tariff in 2007; the revised template will be applied quarterly to ensure electricity tariffs cover at least 75% of the operating cost plus interest cost of the electricity business (action 3.1.1 of the Plan). This was adopted in 2010.

iv. Strengthening of procurement procedures, including requiring that all tenders must be competitively bid, with a minimum of three eligible bidders (action 3.24.6 of the Plan). This was completed in 2010.

E. Cabinet and MEC board endorsement of actions to restructure MEC debt

i. Establishment of a financing agreement between the MOF and MEC that will be used to reform and stabilize the MEC. No formal agreement has been put into place, aside from the subsidiary loan agreement between RMI and MEC.

ii. Deferral of principal repayments for three to five years of the existing loan with the Rural Utility Services of the U.S. Department of Agriculture. Since 2010 MEC has been seeking restructuring of the RUS loan. In August 2011, MEC was granted the restructuring, to consist of a four-year deferment on principal repayments (interest payments will continue over the four-year period). The deferment period will commence in October of 2011.

iii. Establishment by the MOF and MEC of a debt-servicing sinking fund for the financing agreement between the MOF and MEC. The fund is established, but its balance is unknown.

F. MEC Board endorsement of a maintenance & repair account to set aside sufficient funds to meet all MEC maintenance & repair needs.

The maintenance and repair account is established; as of August 2011, its balance was $161,000.

v Effective stakeholder participation

190. The last output of the program has two conditions:

i. *Implementation of a public consultation program through stakeholder forum.* The Development Partner Meeting discussed in the next section afforded a high level opportunity to present reform initiatives to the donor community and RMI stakeholders. However, the PSP is not as generally well known to the public as the original PSRP in the late 1990s, when the need for reform was urgent and unavoidable. A lesson learned from the original PSRP was the consequences of attempting reform without sufficient public involvement. It is clear that the current program starts out with a disadvantage, inasmuch as there is no urgent need of immediate reform. Under a technical assistance project in 2009, leading up to the development of the PSP, a public consultation program was held to discuss SOE reforms specifically and fiscal and public sector reforms more generally. Under the TA accompanying the PSP (TA-7578: Supporting the Public Sector Program), a new round of public consultation activities is now underway, focusing again on SOE, fiscal, and public sector reforms. Every effort will be needed subsequent to the November elections if the targets set in the PSP and proposals of the CAP, TRAM and SOE reports are to be effectively implemented.

ii. *SOE, TRAM Commission, and CAP Advisory Group reports publicly available.* The preparation of the SOE, TRAM and CAP reports involved a significant degree of high-level participation, and the reports have been made public through the Internet, including through the RMI Development Partner Meeting website: www.rmidpm.info.

4. Development Partner Meeting (DPM)

191. The Republic of the Marshalls hosted a Development Partner Meeting in Majuro in early December, 2010. The meeting engaged governmental participants from within the Marshall Islands, as well as the RMI's primary international development partners. In attendance were high-level representatives from the Asian Development Bank, Australia, the European Union, International Monetary Fund, Japan, Republic of China (Taiwan), Secretariat of the Pacific Community, United Nations, United States, and the World Bank, among others.

192. The primary purpose of the DPM was to allow representatives of the Marshall Islands government to present an overview of the nation's fiscal and economic adjustment programs, including the RMI's Comprehensive Adjustment Program (CAP), the Tax and Revenue Reform and Modernization (TRAM) program, and reform plans for the energy sector and state-owned enterprises. Following the presentations, the Development Partners provided program overviews, which they attempted to align with the national priorities of the RMI government. Discussion was facilitated by the RMI Ministers of Finance and Foreign Affairs, who co-chaired the meeting.

193. In general, the Development Partners noted the comprehensive nature of the RMI's reform efforts, and commended the government for its commitment to reform. However, the Development Partners also noted the need for discipline in following through on these commitments. Clearly, the DPM was an important opportunity for the

RMI Government to publicly present its plans for reform to its Development Partners. The DPM also helped secure a Public Sector Reform Program loan from the Asian Development Bank, which is now the primary driver of the implementation of these reforms.

E. Private-Sector Development (PSD)

194. The RMI has long recognized PSD as one of the pillars of long-term economic growth. The government's early five-year National Development Plans (covering the years 1986-91 and 1992-97) gave particular policy attention to facilitating development in fisheries, tourism, agriculture, and other sectors.

195. Since the 1980s, government has manifested this policy commitment by channeling millions of dollars into various projects that attempted to jump-start the private sector. Several examples deserve mention. In 1992, through its first loan from the ADB, government financed the startup of a domestic commercial fishing industry. At around the same time, government established a new international airline service in an attempt to develop both a tuna export industry and tourism. In 1996, it spent $12 million on a new 150-room resort (MIR) that would allow it to host regional and international conferences and further facilitate tourism development. Government has also provided millions of dollars to subsidize investments and operations in its many SOEs, in the hope that these sizeable public investments would improve growth prospects.

196. In recent years, RMI has made new (and renewed) commitments to improving the policy environment for business and investment. These commitments have included efforts to attract foreign investment, a redesign of its tax policy, establishment of a new land registry to improve secure access to land, adoption of a new, secure transactions system, and support of small-business development. The amended Compact, which identifies PSD as one of the priority sectors for use of grants, also reflects and supports this commitment.

197. Despite these many efforts over many years and many millions of dollars spent on PSD-related investments and initiatives, and notwithstanding some signs of growth in a limited number of areas (most notably fisheries), the RMI has not realized its long-held aspiration of developing a thriving, private-sector-driven economy.

198. Fundamentally, private initiative in the RMI is generally constrained by the natural limitations of a remote location, a small and fragmented domestic market, a limited natural resource base, and weakness in the policy environment. Recent assessments of the RMI private sector, including the World Bank—Doing Business survey, pinpoint some specific comparative disadvantages, such as difficulties in registering property, limited access to credit, a shortage of skilled domestic labor, and high costs of doing business. The RMI ranks 8th out of 11 Pacific Island economies and near the 60th percentile (108th out of 183 economies) in the global rankings of the 2011 Doing Business survey. Clearly

there is room for improvement in reducing the barriers to and costs of starting and running businesses in the RMI.

199. As highlighted in previous sections of this report, private sector indicators showed some signs of growth in FY2010, but overall the private sector remains reliant on government consumption. As illustrated in Fig. 4 (Part II, Review of Economic Developments), the private sector‘s share of GDP in FY2010 was 29.6%, up slightly from 27.6% in FY2009. In FY2010 private sector GDP recorded growth of 11%, fueled mostly by very strong growth in the fisheries sector.

200. Formal private sector employment has grown strongly in recent years. From FY2007 to FY2011, businesses added more than 500 new employees, with private sector employment as of FY2011 totaling 4,440 (Fig. 7). This represents 41% of total formal employment. Private sector employment on Kwajalein, which totaled 978 in FY2010, fell to 924 in FY2011 and has fallen significantly from its peak of 1,453 in FY2003. Nonetheless, the magnitude of retrenchment on Kwajalein in FY2008- 10 has been less severe than initially expected.

201. Banking sector data show significant unutilized foreign reserves, and commercial credit has grown only slightly in recent years. Foreign direct investment flows were high in FY2009 and FY2010, at $14.6 and $37.1 million respectively, reflecting the expansion in commercial fisheries, which has been the only productive sector that has grown in recent years.

202. In summary, many diagnostic analyses have identified key impediments to PSD. The binding constraints to investment and growth are fairly well identified and articulated. But what remains missing is a clear, comprehensive, and credible strategy for addressing these constraints. The lack of any sort of economic development plan remains a critical policy challenge in the RMI. Such a strategy could articulate how the country intends to address its business constraints and weaknesses and capitalize on its comparative strengths.

F. Conclusion

203. Earlier economic reports had indicated that the initial period of the amended Compact FY2003-07 had been a period of sustained fiscal expansion and public-sector-led growth, with overall GDP growing by an annual average of 2.6%. However, revisions to the national accounts and derivation of GDP by industry now show that growth faltered in the early part of the Compact and averaged only 1.9% during the period. In FY2008-09 growth turned negative, as it did in many countries, with the onset of the international recession. However, FY2010 has turned out to be a particularly favorable year with strong growth of 5.2% resulting from low inflation and from expansion in the fisheries sector. Furthermore, this trend is set to continue in the next three years, as investment in fisheries enterprise and airport improvements continues.

204. Employment data indicates that the economy has managed to generate a number of additional jobs over the period, amounting to 0.9% annual growth(?) in the amended Compact period. Both the private and public sectors have grown, despite the 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.

205. This review has indicated that while the economy may continue to grow in the near term due to fisheries expansion and construction projects, the long-term prospects are less favorable, and the economy is projected to decline. The fiscal situation is very finely balanced and fragile. A costly public service, external debt service, and the financial situation of the state-owned enterprises threaten the nation's financial viability. The financial conditions of the amended Compact—decrement and lack of full indexation—will involve declining real resource inflows. Unless the private sector is able to find new rewarding activities and become the engine of growth, sustained economic growth is unlikely.

206. Realizing the economic and financial circumstances facing the nation, the RMI leadership initiated a series of reforms. The Comprehensive Adjustment Program (CAP) Advisory Group and 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 the Public Sector Program, including loan assistance in refinancing the external debt of the MEC. However, as the review of the current status of the PSP indicated, while some reforms, such as the energy sector and taxes, are on-track, others, such as the generation of a sustained fiscal surplus and expenditure compression, are not. While there is an election looming in November and some leeway may be granted, the question arises as to whether the RMI has the resolve necessary to implement the commitments already made. The donors indicated their support at the recent Development Partners Meeting, but credibility will undoubtedly be lost if no further progress is made once a new government is formed after the elections.

IV. THE MEDIUM TERM ECONOMIC FRAMEWORK

207. As part of the FY2010 review, a medium term economic framework has been prepared based on standard macroeconomic accounts: GDP by industry, the fiscal account, balance of payments and the banking survey. The framework is interconnected; variables in one part of the system are interrelated to variables in another. The goal of the framework is to provide projections for the year in progress (in this case, FY2011) as well as three additional years (FY2012 through FY2014). Two different projections are made. The first is a baseline projection, which assumes no change in economic policies. The second projects a reform scenario, which essentially examines the medium-term impact of selected CAP reforms, if they were to be implemented. Since the framework is "under development" the results must be considered preliminary. The detailed results of the baseline projection are provided in the Appendix 1.

A. Baseline Projection

1. ECONOMIC ACTIVITY

208. The baseline projection is shown in Fig. 22. Without changes to policy, GDP is set to grow strongly in FY2011 and FY2012 by 9.0% and 8.4%, respectively, and then to drop back to 3% in FY2013 and to decline by -2.8% in FY2014. The high and unexpected rates of growth in the initial years are due to two factors: (i) growth in the fisheries sector in commissioning additional purse seiners and (ii) the impact of the $18 million FAA road realignment project at the airport.

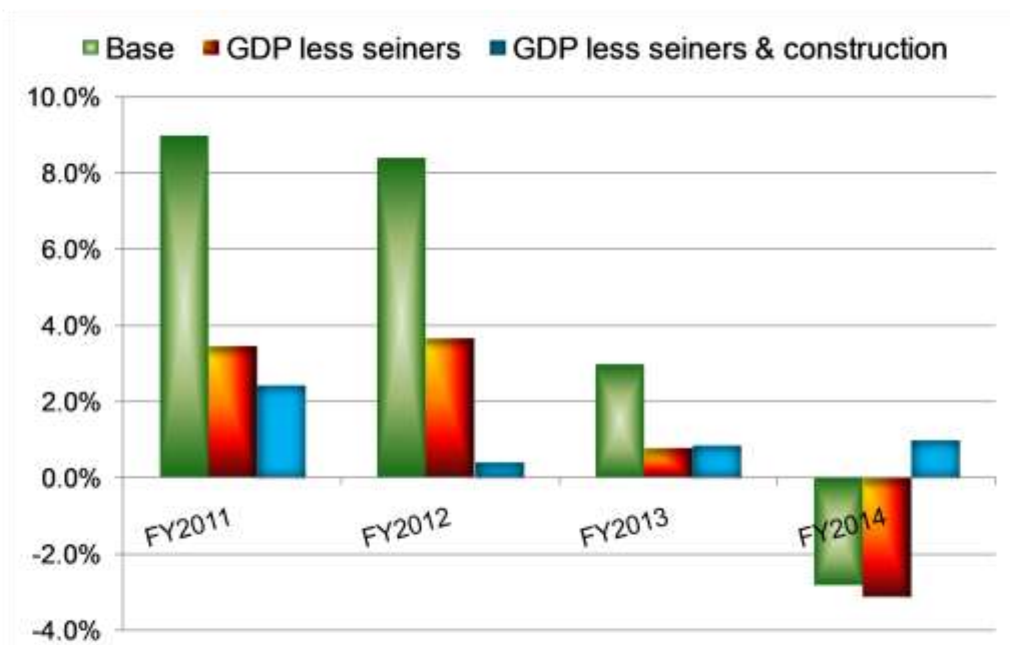


Figure 22 Baseline projections with impact of fishing and construction

209. Two additional purse seiners were commissioned in August 2010, which will record a full year of operations in FY2011 resulting in significant GDP growth in that year. An additional two boats are anticipated in FY2012, and a third in FY2013. In addition, implementation of the FAA road project is scheduled to begin in FY2011 with a modest expenditure of $2 million, with expenditures increasing to $8 million in each of the following two years. The combined impact of these large new activities is significant. Without them, economic growth would be much more modest, averaging 0.7% during the FY2012-FY2014 period. In the case of fisheries, the new seiners will generate strong economic growth in the years that the new boats come into service, and GDP will then stabilize at the higher level. For the FAA project the increased construction activity will generate growth during implementation, but economic activity will fall back once the project is complete. While these additional investments are obviously welcome, the impact on economic growth is unlikely to be sustained and the prospects for economic growth in the longer-term remain modest. For the RMI economy to experience sustained growth, additional private sector investment in new activities will need to be generated.

210. The remainder of this section describes the likely evolution of the major industrial activities in the RMI economy (see Table A1 of Appendix 1). Projections have been made for current and constant price GDP by industry and compensation of employees by industry. Five main methods of forecasting have been used, including:

- Trend either linear, exponential or growth factor,
- Moving average,
- Prior knowledge based on intended investment intentions,
- Linkages to other economic variables in the system, and
- Held constant.

211. Agriculture is comprised of two main activities: subsistence (non-marketed), and mixed income (primarily copra production.) Subsistence production has been forecast to grow in line with population change (0.7%), while copra production has grown by 3% per annum in recent years. Fishing is comprised of both formal and informal activities. Discussion with Pan Pacific Foods indicated planned expansion of their purse seine and loining plant operations. As discussed above a significant expansion in fishing operations is anticipated while loining plant operations will be curtailed by labor availability. The Marshall Island Fishing Venture (MIFV) is forecast to grow on trend as is MIMRA the Marshall Island Marine Resource Authority. The Marshal Island Fishing Company (MIFCO) is projected as a moving average of prior years, reflecting no anticipated expansion in shore-based operations. Household fishing activity is projected as per population growth.

212. Manufacturing is comprised of coconut oil production and general manufacturing for the local market. The former is projected on trend and the latter according to the over-

all level of economic activity. Electricity and water production is projected in line with the general rate of economic activity, while commercial construction is forecast on trend along with the impact of the airport road re-alignment project. The government (PWD) also engages in construction and is forecast as a moving average, while household ownership of dwellings is forecast in line with population growth.

213. Wholesaling and retailing is projected on the overall rate of demand in the economy (GDP), while the demand for tourism is not anticipated to change and is forecast as a moving average. The transport and communications sector is comprised of a variety of different activities: general private sector transport services, the ports authority (MIPA), the state owned shipping company (MISC), the local airline (AMI), and the national telecoms authority (NTA). Private sector transport plus MIPA are forecast to grow in line with economic activity, while the rest are forecast as moving averages reflecting public sector ownership. Financial intermediation has grown rapidly in recent years and is projected on trend, but at a declining rate reflecting market saturation. Imputed rent (home ownership) is projected according to the rate of population growth, while business and personal services are driven by domestic demand.

214. Government administration is comprised of a set of activities: national government, local government, and extra budgetary units. The national government is projected on trend at 3.5%. This rate is not sustainable and in the reform scenario the impact of a reduction in public administration is investigated. The two local governments MALGOV and KALGOV are assumed to remain constant, while extra budgetary units are projected as moving averages. Education and health are assumed to remain constant in real terms reflecting the impact of the annual decrement and tight fiscal situation. The College of the Marshall Islands (CMI) is projected to grow on trend now that accreditation problems have been resolved.

215. There are four major categories of net indirect taxes: The gross receipts tax (GRT), import taxes, local government sales taxes and SOE subsidies. Import taxes are projected in line with economic demand (GDP), while the GRT is linked to those activities that generated the tax. Local government sales taxes are linked to the rate of growth of wholesaling and retailing, while finally subsidies are projected as a moving average.

216. The overall rate of economic growth clearly reflects the assumptions behind the individual activities. While the GDP projections for the economy are buoyant in the period under discussion, these reflect new activity in fishing and construction. Without these activities, economic performance is constrained by the level of public sector demand, an inefficient and large state owned enterprise sector, a stagnant tourism industry, and the overall rate of population growth, which is low due to outmigration.

2. Fiscal Projections

217. The baseline fiscal projections are based on a series of assumptions. Receipt of Compact funds is based on the Compact agreement and World Bank projections of the

US GDP deflator. Indirect taxes are linked to current price economic growth for import taxes, and private sector GDP growth for the GRT receipts. Wage tax and social security collections are based on projections of compensation of employees. Other non-tax revenues are forecast on the basis of expected flows (ship registry fees and fishing royalties) where these are known with a degree of accuracy, or on past performance for other non-tax revenues.

218. On the expenditure side it is assumed that payroll numbers remain constant in education and health and that public administration grows on trend. Wage rates are forecast to grow on trend at approximately 1% per annum. For goods and services it has been assumed that general fund expenses grow in line with past performance, but that all other funds are held in check in nominal terms reflecting funding constraints. It is thus implicitly assumed that additional wage payments must be paid out of general fund revenues. Interest payments are based on repayment schedules, SOE subsidies on needs and past trends but no policy changes, and transfers to other entities remain flat in nominal terms. Capital expenditures are linked to capital grant levels.

219. The fiscal deficit is the sum of revenues less expense and acquisition of nonfinancial assets. It does not include repayment of principal on government debt. In the RMI case the cash position of government is the sum of the fiscal deficit less debt repayments plus incurrence of new debt. The cash position is equivalent to the change in Fund balances recorded in the annual audits. Table A3 and Fig. 14 indicate a fiscal surplus during

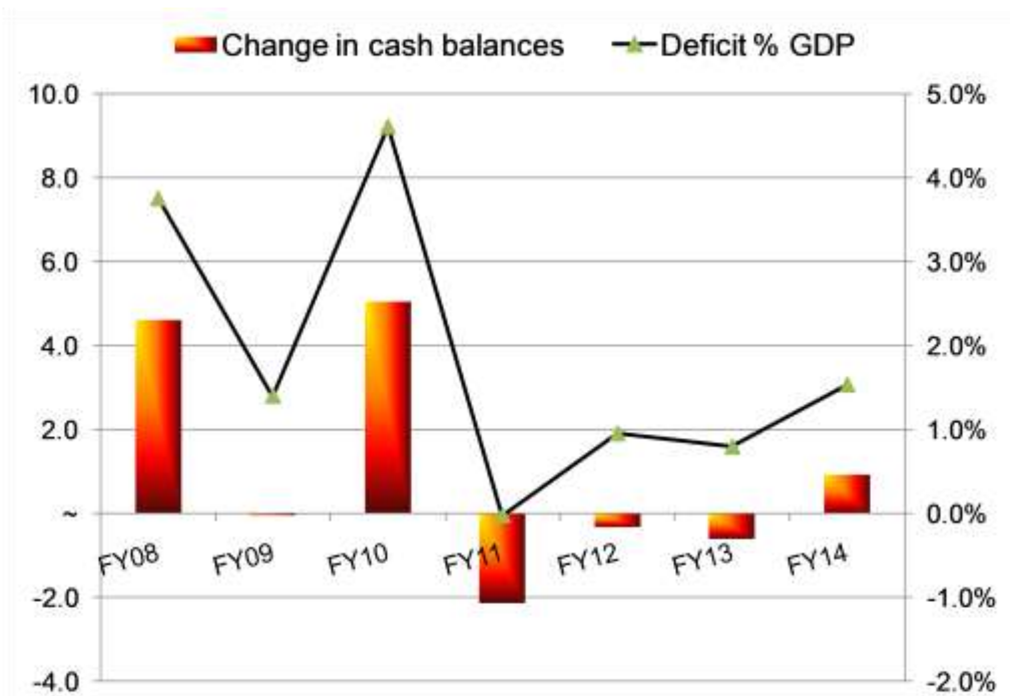


Figure 23 Fiscal position, $M's and deficit percent of GDP, FY2008 – FY2014.

FY2008 through FY2010, on average, 3% of GDP. This is a favorable result and reflects accumulation of unspent resources in activities falling outside the general fund. The general fund itself, however, was depleted during this period. In FY2011 it has been assumed that both the fiscal surplus and cash position will deteriorate as use is made of the unspent resources left over from the prior year. In the projection period the fiscal outturn is forecast to run small surpluses averaging 2.3% of GDP, while the cash position averages zero. Government will have sufficient resources to meet its debt obligations but its cash flow position will remain tight.

3. Balance of Payments

220. The external account projections are provided in Table A6 and the forecasting methodology follows the same general principals outlined above. Projections of exports are linked to the relevant current price projections for loined fish and coconut oil. Likewise imports of goods are linked to the level of current price GDP plus allowance for new purse seiners. The major items of service exports include home base services provided to fishing operators, and expenditures of visitors and tourists, which have been linked to the relevant current price GDP projections. Imports of services are linked to imports of goods in the case of freight and insurance, and current price GDP for other items such as business services and travel.

221. The major items of primary income receipts are compensation of employees of Marshallese workers at the U.S. base, Kwajalein landowners receipts, and receipt of interest and dividends on investments. Projections of Kwajalein workers assume a reduction in numbers, but that wage rates rise on trend. Landowner receipts are specified according to the Compact agreement. The main item of primary income payments is dividends of Pan Pacific Foods, which grows rapidly reflecting the increasing operations of the purse seine fleet. Secondary income flows are dominated by grants and receipt of Compact flows, which are consistent with the fiscal account. The College of the Marshall Islands receives Pell grants and U.S. military personal pay the local wage tax. The former is assumed to grow in line with inflation and the latter in accord with forecast of compensation of employees at the base. Household remittances both inwards and outwards are not known with any degree of accuracy and have been projected in line with U.S. GDP and local GDP forecasts, respectively.

222. The capital account is dominated by Compact flows, contributions to the CTF, and FAA airport improvement grants all of which are known with a high degree of certainty. Turning to the finance account, FDI is dominated by investment in enlargement of the Pan Pacific Foods purse seiner fleet. Changes in portfolio investment reflect increases in CTF assets, draw down of the various nuclear claims funds and increases in Social Security funds. Draw down of nuclear claims funds have been forecast on trend as are the Social Security funds. Changes in commercial banks foreign assets are consistent with the banking survey forecasts and draw downs and repayments of the external debt are consistent with the external debt forecasts.

223. Overall the balance of payments projections indicate significant variation in errors and omissions from year to year. A negative forecast of -$29 million in FY2011 swings to $36 million in FY2012, and although balance is projected in FY2013 this swings back to -$42 million in FY2014. While the projected BoP variation is in fact not dissimilar to historical series, it indicates the preliminary nature of the forecasts. However, it is felt worthwhile to report on the initial attempt to forecast the external account as part of the overall macroeconomic forecasting framework.

4. The Banking Survey

224. Table A5 provides the banking survey forecasts. Starting with the liability side, demand deposits are forecasts as a moving average, while both savings and time deposits are projected on recent trends. Government deposits are assumed to remain constant while the capital accounts have been projected as a linear trend reflecting recent additions to BOMI retained earnings/equity. On the liability side commercial lending is assume to grow in line with growth in compensation of employees of government employees, while commercial credit is projected in line with nominal GDP. Foreign assets are treated as a residual, and the resulting time series provides a plausible trend. Further work on forecasting the banking survey will explore fitting a demand for money function, and checking the forecasts to ensure consistency with the structure of the banks operating in the Marshall Islands.

B. The Reform Scenario

225. In this section the impact of a possible reform scenario is discussed. It is assumed that some of the CAP recommendations are implemented. In particular, it is assumed that the level of administrative services is cut by 10% in both FY2012 and FY2013, which is equivalent to a loss of 150 jobs. This amounts to a cost savings of $1.1 million in FY2012 and $2.5 million in FY2013. It is also assumed that savings of $1.5 and $3.0 million are realized through a reduction in the use of goods and services, such as electricity allowances, utility bills, transfers, etc.

226. The results of these savings on government's cash flow position are indicated in Fig. 24. The Reform Scenario projects a savings of nearly $2 million in FY2012, and $4.0 million in FY2013. There is a compensating lose in tax revenues resulting from the reductions in wage payments and demand for local services. The macroeconomic framework indicates that about 30% of the total original cost savings are likely to be lost due to reductions in taxes and social security receipts. Although the compensating loss in tax revenues may appear high, this reflects the interlinkages in the system, and indicates the benefits of using a consistent macroeconomic framework.

227. While the argument for reform is made in many parts of this report, the impact of the reforms is a significant loss in GDP and welfare. Fig. 25 indicates a comparison of the impact of the baseline status quo and the Reform Scenario on GDP. In FY2012, imple-

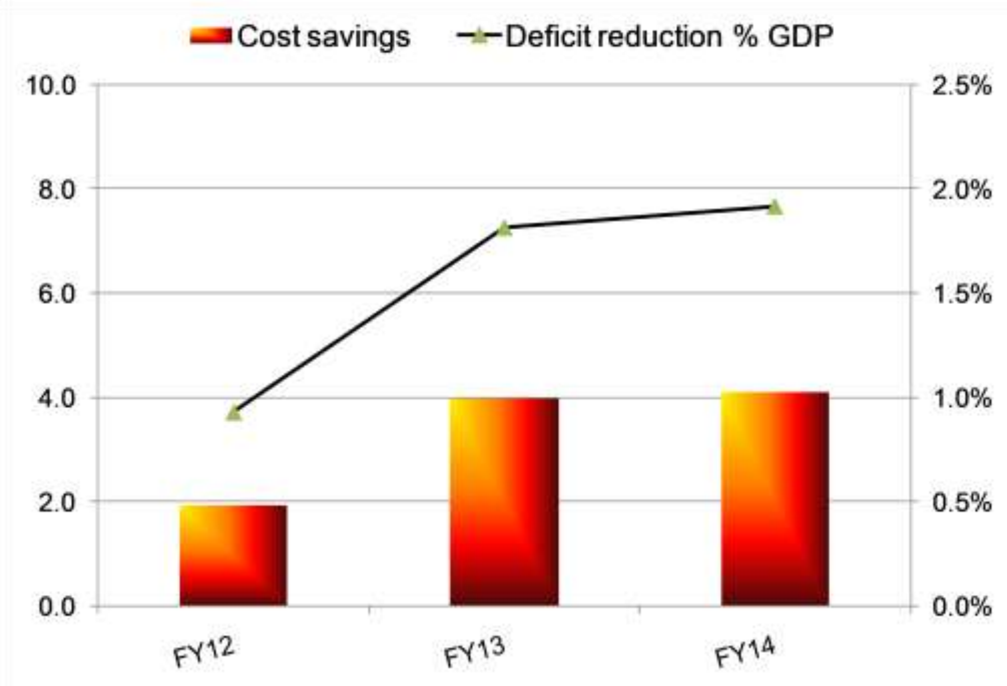


Figure 24 Change in fiscal position: base and reform scenario.

mentation of the Reform Scenario would result in a loss of 1.2% of GDP in comparison to the baseline, and in FY2013 the loss amounts to 1.4% of GDP.

1. Policy Implications

228. As figure 25 indicates, implementing the Reform Scenario will have a negative impact on GDP. So, why reform? In its report to Cabinet, the members of the Comprehensive Adjustment Program stated that the RMI government needed to "restore fiscal flexibility and to enable the Government to respond to emerging needs without being forced to operate in a persistent state of crisis management and cash-flow shortages." In the absence of reform, the framework projects a baseline of exactly this scenario: the RMI government will be able to pay its debts, but will not have achieved any fiscal flexibility, and will not be able to respond to any external shocks.

229. Moreover, even the most optimistic market scenarios project a shortfall in the Compact Trust Fund's ability to replace operational expenses in 2023. The sooner the RMI government begins working proactively to generate savings that can be used to augment the CTF, the easier their adjustment will be in 2023.

230. Attaining fiscal surplus and making additional contributions to the CTF have been repeated findings of the IMF. The ADB has also supported such reforms, requiring the RMI government to deposit 1.5% of GDP into the Compact Trust Fund in FY2011 and FY2012, in order to access the second tranche of funding for the PSP. Whether through the CAP, the DPM, or ADB loan covenants, the RMI government has committed to a reform path, even as

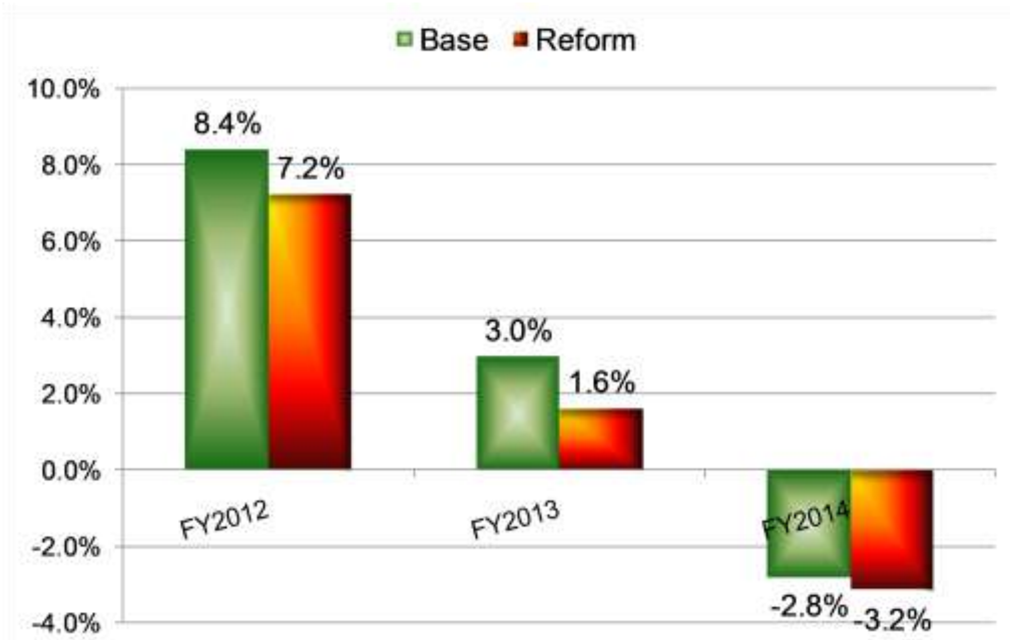


Figure 25 GDP growth with and without reform

elections loom in late 2011. Without significant progress in implementing reforms, the government will not only face mounting fiscal challenges, but will also face credibility problems across the Development Partner community.

V. APPENDIX 1 STATISTICAL PROJECTIONS

Table A1 GDP in constant prices FY2004, $M's (FY2008-FY2014)

	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Agriculture, Hunting and Forestry	4.6	4.4	4.2	4.2	4.3	4.4	4.4
Fisheries	7.2	9.0	12.5	20.6	28.3	32.2	32.4
Mining and Quarrying	~	~	~	~	~	~	~
Manufacturing	4.6	4.1	3.7	3.8	3.9	4.0	4.0
Electricity, Gas and Water Supply	2.4	2.3	2.3	2.4	2.5	2.5	2.4
Construction	9.3	8.6	8.2	8.9	12.0	12.0	8.1
Wholesale and Retail Trade and Repairs	18.1	17.5	18.5	19.3	20.0	20.1	19.4
Hotels and Restaurants	3.8	3.8	3.4	3.8	3.7	3.7	3.6
Transport, Storage and Communications	10.3	10.7	11.2	12.9	13.4	13.3	13.1
Financial Intermediation	7.3	7.6	7.9	8.2	8.4	8.6	8.7
Real Estate, Renting, Business Activities	10.1	10.4	10.5	10.7	10.9	11.0	10.9
Public Administration	22.7	21.7	21.5	21.6	21.5	21.8	22.2
Education	19.5	20.0	21.1	21.2	21.4	21.5	21.7
Health and Social Work	9.3	8.9	9.5	9.5	9.5	9.5	9.5
Other Community, Social, Personal Servi	1.0	1.1	1.2	1.3	1.3	1.3	1.3
less intermediate FISIM	-3.3	-3.6	-3.7	-3.8	-4.0	-4.0	-3.9
GDP at basic prices	127.0	126.5	132.1	144.6	157.1	161.9	157.9
Indirect Taxes	11.6	10.1	11.7	12.1	12.8	13.0	12.1
GDP at market prices	138.5	136.7	143.8	156.7	169.9	174.9	170.0
Growth	-1.9%	-1.3%	5.2%	9.0%	8.4%	3.0%	-2.8%

Table A2 GDP in constant prices FY2004, % growth on previous year (FY2008-FY2014)

	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Agriculture, Hunting and Forestry	7.0%	-3.5%	-5.8%	1.4%	1.4%	1.4%	1.5%
Fisheries	-7.0%	24.0%	40.0%	64.2%	37.2%	14.0%	0.7%
Mining and Quarrying							
Manufacturing	7.7%	-10.4%	-11.4%	3.5%	3.5%	1.9%	-0.1%
Electricity, Gas and Water Supply	7.5%	-0.5%	-1.1%	4.0%	4.0%	0.6%	-3.8%
Construction	0.2%	-7.5%	-4.8%	8.9%	34.7%	0.0%	-32.3%
Wholesale and Retail Trade and Repairs	-0.9%	-3.3%	5.5%	4.1%	3.7%	0.6%	-3.5%
Hotels and Restaurants	-7.8%	-2.2%	-8.9%	10.4%	-0.7%	-1.6%	-1.0%
Transport, Storage and Communications	-22.8%	4.8%	4.6%	14.9%	3.5%	-0.1%	-1.6%
Financial Intermediation	6.6%	3.1%	5.1%	3.1%	2.6%	2.1%	1.6%
Real Estate, Renting, Business Activities	1.3%	3.2%	1.0%	1.7%	1.7%	0.7%	-0.7%
Public Administration	3.0%	-4.5%	-0.9%	0.7%	-0.6%	1.5%	1.5%
Education	-1.2%	2.2%	5.7%	0.6%	0.6%	0.7%	0.7%
Health and Social Work	-3.1%	-4.7%	6.4%	0.0%	0.0%	0.0%	0.0%
Other Community, Social, Personal Servi	40.2%	9.6%	14.5%	4.0%	4.0%	0.6%	-3.8%
less intermediate FISIM	10.7%	7.1%	3.1%	4.0%	4.0%	0.6%	-3.8%
GDP at basic prices	-2.0%	-0.3%	4.4%	9.4%	8.6%	3.1%	-2.5%
Indirect Taxes	-1.4%	-12.2%	15.0%	3.9%	5.7%	1.7%	-6.9%
GDP at market prices	-1.9%	-1.3%	5.2%	9.0%	8.4%	3.0%	-2.8%

Table A3 Statement of Government Operations, $M's (FY2008- FY2014)

	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Total revenue and grants	107.1	104.9	109.2	108.8	110.9	112.0	115.2
Total domestic revenue	39.1	37.8	40.3	42.3	44.7	45.9	46.0
Taxes	26.2	24.3	25.2	26.7	28.3	29.0	28.1
Income	11.0	11.2	10.8	11.2	11.5	11.8	11.9
Gross revenue	5.8	5.4	6.2	6.7	7.4	7.6	7.0
Imports	8.7	7.1	7.7	8.3	8.8	9.0	8.7
Other	0.7	0.6	0.5	0.5	0.6	0.6	0.6
Nontax	12.9	13.5	15.1	15.7	16.3	16.8	17.8
Fishing rights	1.5	1.5	2.0	2.2	2.4	2.6	2.8
Social contributions	6.9	6.7	7.2	7.4	7.6	7.9	7.9
Fees and charges	1.5	1.4	1.5	1.4	1.4	1.4	1.4
Investment income	0.4	0.1	0.1	0.1	0.1	0.1	0.1
Ship registry	2.0	3.3	3.0	3.8	4.0	4.0	4.8
Other	0.7	0.5	1.3	0.8	0.8	0.8	0.8
Grants	68.0	67.1	68.9	66.4	66.3	66.2	69.3
Current	44.3	47.8	47.7	46.7	46.6	46.5	48.8
Compact	30.0	33.8	31.9	31.8	31.7	31.7	33.7
Federal programs	8.3	8.2	9.4	8.9	8.7	8.8	8.9
ROC	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Other	2.0	1.8	2.3	2.1	2.2	2.1	2.1
Capital	23.6	19.3	21.2	19.7	19.7	19.7	20.5
Compact	11.3	13.2	13.3	12.5	12.5	12.5	13.3
ROC	12.3	6.1	7.9	7.2	7.2	7.2	7.2
Total expenditure	101.3	102.8	101.7	108.8	108.9	110.3	111.9
Current expenditure	82.9	85.9	84.3	89.1	89.3	90.6	91.4
Wages and salaries	34.2	34.3	35.0	36.4	36.6	37.3	37.9
Goods and services	34.9	37.5	33.3	37.6	37.8	38.1	38.3
Interest payments	1.3	0.9	0.9	0.8	0.9	0.8	0.8
Subsidies to public enterpris	6.9	7.5	5.8	6.4	6.4	7.4	7.4
Other subsidies and transfer	5.6	5.7	9.3	7.9	7.5	7.0	7.0
RIF payment	~	~	~				
Capital expenditure	18.5	16.9	17.5	19.7	19.7	19.7	20.5
Current balance	12.9	5.8	11.7	-0.0	2.0	1.7	3.3
Overall balance	5.7	2.1	7.5	-0.0	2.0	1.7	3.3
Financing	-5.7	-2.1	-7.5	0.0	-2.0	-1.7	-3.3
Net government debt repayment	-1.1	-2.2	-2.4	-2.1	-2.3	-2.3	-2.3
Principal repayment	-1.1	-2.2	-2.4	-2.1	-2.3	-2.3	-2.3
Gross borrowing	~	~	~				
Change in government financial a	-4.6	0.0	-5.1	2.1	0.3	0.6	-0.9

Table A4 Statement of Government Operations, % GDP (FY2008- FY2014)

	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Revenue and grants	70.2%	69.2%	67.0%	58.6%	53.1%	50.9%	53.7%
Revenue	25.6%	25.0%	24.7%	22.8%	21.4%	20.8%	21.4%
Taxes	17.1%	16.1%	15.5%	14.4%	13.6%	13.2%	13.1%
Grants	44.5%	44.3%	42.3%	35.8%	31.7%	30.1%	32.3%
Expenditure	66.4%	67.8%	62.4%	58.6%	52.1%	50.1%	52.1%
Current	54.3%	56.7%	51.7%	48.0%	42.7%	41.2%	42.6%
Wages and salaries	22.4%	22.6%	21.5%	19.6%	17.5%	16.9%	17.7%
Goods and services	22.8%	24.8%	20.5%	20.2%	18.1%	17.3%	17.8%
Capital	12.1%	11.2%	10.7%	10.6%	9.4%	8.9%	9.5%
Current balance	8.5%	3.8%	7.2%	0.0%	0.9%	0.8%	1.5%
Overall balance	3.7%	1.4%	4.6%	0.0%	0.9%	0.8%	1.5%

Table A5 Banking Survey, $M's, (FY2008-FY2014)

	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Assets	113.9	122.0	133.6	140.8	148.5	156.9	165.9
Foreign assets	57.1	63.6	71.8	77.4	82.7	88.9	97.6
Claims on central and local governments	2.9	1.7	3.7	1.8	2.1	2.4	2.4
Claims on public enterprises	~	~	~				
Claims on private sector	58.2	62.0	63.3	67.7	70.5	73.0	74.2
Consumer	43.9	46.1	48.6	51.0	51.6	53.2	54.8
Commercial	14.3	15.9	14.7	16.7	18.9	19.9	19.4
Unclassified assets	-4.3	-5.3	-5.2	-6.2	-6.8	-7.5	-8.2
Liabilities	113.9	122.0	133.6	140.8	148.5	156.9	165.9
Deposits	89.0	93.3	102.1	108.2	114.1	120.3	127.1
Demand deposits	24.7	24.2	23.5	24.7	24.5	24.3	24.3
Time deposits	20.6	19.0	22.2	23.3	24.5	25.7	26.9
Savings deposits	35.7	41.3	47.9	52.2	56.9	62.0	67.6
Central government deposits	8.0	8.8	8.5	8.0	8.2	8.3	8.4
Foreign liabilities	1.6	2.4	2.8	2.5	2.3	2.3	2.5
Capital accounts	22.5	25.6	27.4	29.2	31.3	33.3	35.4
Unclassified liabilities	0.8	0.7	1.3	0.8	0.9	0.9	0.9

Table A6 Balance of Payments, $M's (FY2008-FY2014)

	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Current Account Balance	-3.9	-26.4	-40.7	-13.0	-53.8	-36.1	-7.8
Goods balance	-69.8	-73.3	-93.3	-74.7	-73.4	-50.0	-28.8
Exports, f.o.b.	20.2	20.8	32.3	51.1	66.9	75.9	76.6
Imports, f.o.b.	90.0	94.1	125.5	125.7	140.2	125.9	105.3
Services account	-39.5	-54.0	-42.8	-46.9	-47.2	-46.9	-44.4
Receipts	10.2	10.5	11.3	12.6	12.8	12.9	13.2
Payments	49.8	64.6	54.1	59.5	60.0	59.9	57.6
Freight and insurance	15.1	13.7	14.6	18.2	15.6	15.9	15.3
Passenger services, airlines	12.9	12.2	10.9	12.2	12.2	12.1	12.0
Travel	8.9	9.8	10.4	11.1	12.4	12.8	11.7
Other	12.8	28.9	18.1	17.9	19.7	19.1	18.7
Primary income balance	43.2	40.8	34.5	50.3	8.9	2.8	4.7
Receipts	56.1	52.9	51.2	86.1	54.6	56.3	58.7
Compensation of employees	19.9	20.1	19.0	18.7	18.1	18.7	19.2
Rent (Kwajalein land)	16.2	17.1	16.7	49.1	17.3	17.7	18.1
Other	20.0	15.7	15.5	18.2	19.2	19.9	21.4
Payments	12.9	12.1	16.6	35.8	45.7	53.5	54.0
Secondary income balance	62.2	60.2	60.9	58.3	57.9	58.0	60.7
Receipts	66.3	64.6	66.2	64.0	63.9	64.1	66.6
Budget grants	57.2	54.4	56.2	53.9	53.8	53.7	55.9
Compact current grants	39.7	43.1	42.5	40.6	40.3	40.4	42.7
Other budget grants	17.5	11.3	13.7	13.3	13.4	13.3	13.3
Other	9.1	10.2	10.0	10.1	10.2	10.4	10.7
Payments (mainly households)	4.1	4.4	5.3	5.7	6.0	6.1	5.9
Capital account balance	30.1	36.2	31.6	28.4	35.5	36.3	29.4
Compact capital grants	11.3	13.2	13.3	12.5	12.5	12.5	13.3
Trust Fund Compact	10.5	14.9	13.5	13.8	14.5	15.3	16.0
Other	8.4	8.0	4.8	2.0	8.5	8.5	0.0
Net lending/Borrowing (Curr + Cap)	26.2	9.8	-9.1	15.4	-18.3	0.1	21.6
Financial account balance	8.8	14.4	19.7	-13.6	17.3	0.1	-19.9
Direct investment	5.7	14.6	37.1	3.0	36.0	19.6	3.1
Portfolio investment	4.1	-4.9	-5.3	-6.2	-7.1	-7.0	-7.8
Assets	4.7	-5.7	-5.7	-6.1	-7.1	-7.2	-8.0
Trust Fund, Government	-10.5	-14.9	-13.5	-13.8	-14.5	-15.3	-16.0
Trust Fund, Nuclear	7.2	11.9	11.6	11.8	11.7	11.8	11.7
Other mainly Social Security	8.0	-2.7	-3.8	-4.1	-4.3	-3.7	-3.7
Liabilities	-0.6	0.8	0.4	-0.1	-0.1	0.3	0.3
Other Investment	-1.1	4.7	-12.2	-10.3	-11.5	-12.5	-15.2
Assets (Deposits of Com. Banks)	3.6	-6.5	-8.2	-5.6	-5.3	-6.1	-8.7
Liabilities (External Debt)	-4.7	11.2	-4.0	-4.8	-6.2	-6.3	-6.5
Errors and Omissions	35.0	24.2	10.6	-28.9	35.6	0.0	-41.5