Republic of the Marshall Islands

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ECONOMIC BRIEF

RMI FY 2021

Graduate School USA

EconMAP
ECONOMIC MONITORING & ANALYSIS PROGRAM

The FY21 RMI Economic Brief

The Marshall Islands took strong proactive measures in March 2020 to protect the health of the nation from COVID-19 by effectively closing its borders, which resulted in an economic contraction. Following five years of pre-COVID economic growth, RMI Gross Domestic Product (GDP) is projected to fall by 5.5 percent in FY2021 compared with FY2019 and employment to have contracted. Reductions in the fisheries and the small hotel and restaurant sectors represent most of the decline. The RMI benefitted from a $61-million donor response to COVID, primarily from the Asian Development Bank and the United States. U.S. CARES Act unemployment benefits supported affected RMI workers. Household incomes in FY2021 are projected to be 8.7 percent higher than they would otherwise have been without the mitigation programs and unemployment benefits. However, the end of mitigation programs will lead to a projected 4.2 percent reduction of household incomes in FY2022.

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

Fiscal policy in the RMI has been driven by available revenue, with expenditures rising when revenue increases, and without the creation of fiscal reserves. With the boom in revenues from fishing fees, the government has doubled its expenses on subsidies and transfers. As fishing fees jumped from $3.5 million in FY2010 to 33.5 million in FY 2017, subsidies to large State-Owned-Enterprises (SOE) and transfers to NGOs and households doubled from 12 percent to 24 percent of GDP. But the fees boom has plateaued—they fell to$30.3 million in FY2020-- and the RMI is entering a new Compact era with possibly less economic assistance. The RMI needs to modernize its tax regime, as current efforts to improve tax collections will not keep up with economic growth. Furthermore, progress with fiscal reforms has been weak despite numerous government commitments, and the RMI needs to establish counter-cyclical fiscal reserves. Establishing a climate resilience fund is also increasingly necessary to help mitigate adverse climate events and natural disasters.

The RMI should take steps to address its current structural fiscal deficit. Since its appearance in FY2019, the RMI's structural fiscal deficit has been disguised by the inflow of donor grants during the COVID-19 pandemic. With increased fishing fees, the RMI expanded its budgets in FY2015 through FY2019, but expenses grew faster than revenue. By FY2019, expenditures outstripped revenues and the RMI recorded a fiscal deficit that was 1.8 percent of GDP. In FY2020, COVID grants created a fiscal surplus of 5 percent of GDP, with a smaller surplus for FY2021. Without additional donor funds, deficits of 3.3 percent and 2.7 percent of GDP are projected for FY2022 and FY2023, respectively.

While the outcome of the Compact renewal process looks encouraging, the RMI should prepare for the possibility of a less favorable Compact renewal result. While it is likely the current package of Compact economic assistance will continue, a less favorable outcome is possible. In the latter scenario, the RMI would rely on drawdowns from the existing Compact Trust Fund (CTF). GSUSA's CTF analysis projects that the CTF cannot always sustain a perpetual annual drawdown equivalent to the FY2023 inflation-adjusted level of expiring Compact grants into the future. In addition, current CTF rules will result in numerous years where zero funds will be available for distribution. Further, it is unclear whether all U.S. programs and services currently provided to the RMI will be extended. A severe reduction in grants will result in job losses with a proportionate increase in projected migration.

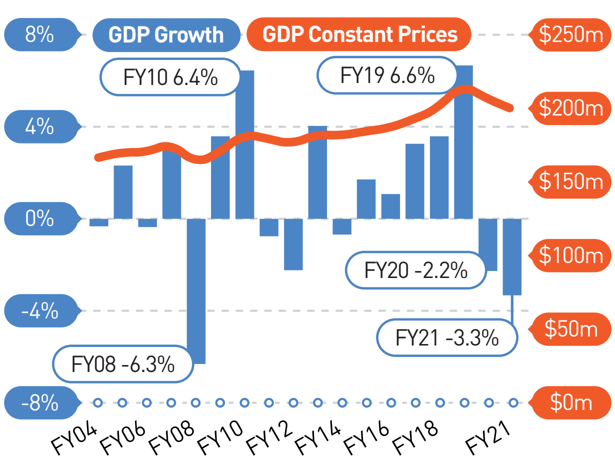
The RMI financial sector faces a series of challenges, instituting sufficient anti-money laundering and anti-terrorism financing procedures so that its bank can maintain U.S. banks relations, addressing the high debt stress of RMI households, and careful monitoring the fragile financial position of the RMI Social Security Administration. The RMI law establishing a digital cryptocurrency, the SOV, which will act as legal currency raises money laundering and terrorism finance concerns that may jeopardize relations with U.S. banks. In addition, the high price to value volatility of cryptos could destabilize the economy. The proposal to create a tax-free Digital Economic Zone in Rongelap Atoll carries similar risk.

1. Recent Economic Performance

Performance

Economic growth in the RMI has been modest during the amended Compact, averaging 1.3 percent annually with high volatility. The RMI's economic performance from FY2004 to FY2019 and just prior to the onset of COVID-19 in FY2020 has been modest, with economic growth averaging 1.3 percent during the period, see Figure 1. This is comparable to the RMI's sister FAS, Palau, which had an average 0.9 percent growth, but considerably more than the FSM, which grew at an annual average of 0.1 percent over the same period. The RMI's low average growth during the period reflects high fluctuation between periods

Figure 1: Economic groath has been volatile but displayed signs of sustained growth before COVID-19
Real GDP annual growth, FY2015 prices, (%)



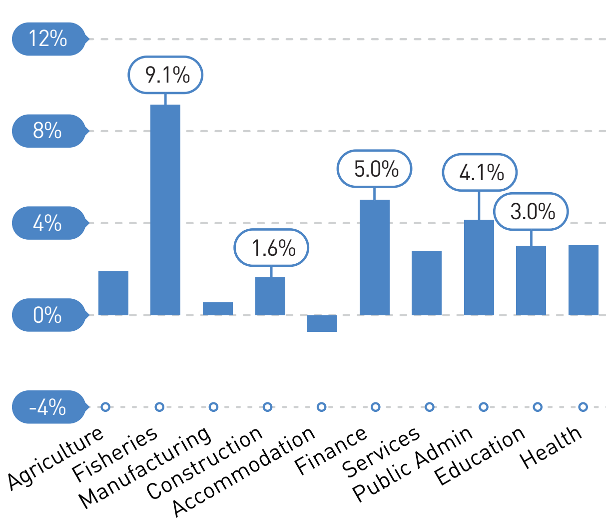
> The economy is projected to fall by 5.5 percent in FY2021 compared with the pre-COVID economy in FY2019.

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

During FY2015-FY2019 economic growth picked up to an average of 3.2 percent before COVID-19 struck. During the first half of the amended Compact, through FY2014, economic growth was weak, averaging 0.7 percent per annum. However, during FY2015-FY2019 the economy grew more rapidly with an average rate

Figure 2: Fisheries has been the main contributor to economic growth

Total GDP growth of 27% or 1.5% per annum between FY04-FY19



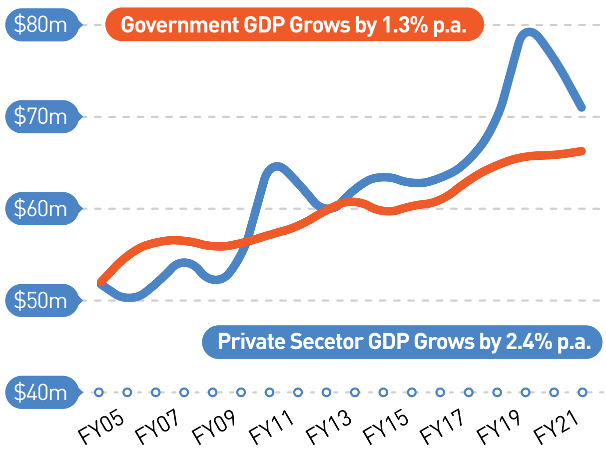
of growth of 3.2 percent. This change reflected growth in fisheries, construction, shore-based services to fishing fleets, and financial services. It was further boosted by the general boom in sovereign rents (fishing royalties and fees from the shipping registry), which increased the fiscal envelope and allowed growth in public expenditures.

The overall economic impact of COVID-19 is projected to be a 5.5 percent reduction in GDP over a two-year period. The economy is estimated to have declined by 2.2 percent in FY2020 and projected to decline by a further 3.3 percent in FY2021 as the full impact of the pandemic was incurred, bringing the total impact of COVID-19 to a 5.5 percent decline over the two years[1]. The major contributing sector to this reduction is shore-based activities supporting fishing-fleet provisioning in Majuro port, which is responsible for 2.2 percent of the overall decline. The small hotel and restaurant sector, reflecting travel restrictions, is projected to be responsible for a further 1.8 percent of the impact. The construction sector is responsible for 0.7 percent of the decline, but, despite the negative impact of travel restrictions on key skilled personnel, has avoided any large cutbacks. Finally, the fishing sector is projected to be responsible for a further 0.7 percent of the decline. While there are other offsetting impacts, the government is projected to have supported the economy by contributing a positive 0.6 percent to GDP growth.

Impact of the crisis has been uneven: the public sector is projected to expand modestly while the private sector has experienced a large contraction. Figure 3 indicates the growth in the private and government sectors during the FY2004-

[1] The data presented in this report through FY2020 is based on provisional economic statistics, while the data for FY2021 is based on projections.

Figure 3: Public sector value added grows consistently with signficant volilaity in the private sector
RMI constant price GDP by private and public sector, FY2015 prices



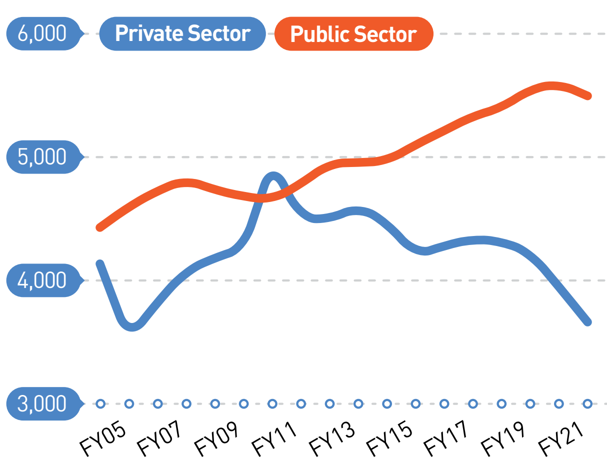
FY2021 period. The provision of government services grew modestly at 1.3 percent per annum with little variation. The private sector, however, performed far better (averaging 2.4 percent growth) but had greater volatility. The large swings in the rate of growth for the overall economy thus reflect the even greater volatility in the private sector. However, the impact of COVID-19 on the two sectors is quite different. While the public sector is projected to grow by 0.7 percent per year during FY2019-FY2021, the brunt of the impact has been felt in the private sector. Overall a very sizeable loss in output of 10.9 percent is estimated for the private sector. While the overall impact of the pandemic on the economy may appear "conservative," when the structure of the economy is taken into full account it is clear that the economic impact is highly uneven. During the crisis, the public sector remains largely unaffected, while the impact on the private sector has been painful.

Employment of full-time equivalents is projected to have contracted by 585 due to COVID-19.

Employment

Before COVID-19, public sector jobs grew steadily, but private sector employment was volatile with little change. Figure 4 indicates the growth in employment in the private and public sectors since the start of the amended Compact. The pattern in the public sector during FY2004-FY2019 mirrors that sector's contribution to GDP, which rose steadily with little volatility and averaged 1.7 percent growth per annum. With the increase in sovereign rents since FY2014, the RMI's fiscal envelope grew significantly, which enabled expansion of the civil service. Private sector employment, although displaying a similar volatility to its contribution to GDP, grew by an average of just 0.4 percent during the amended (pre-COVID, FY2004-FY2019) period.

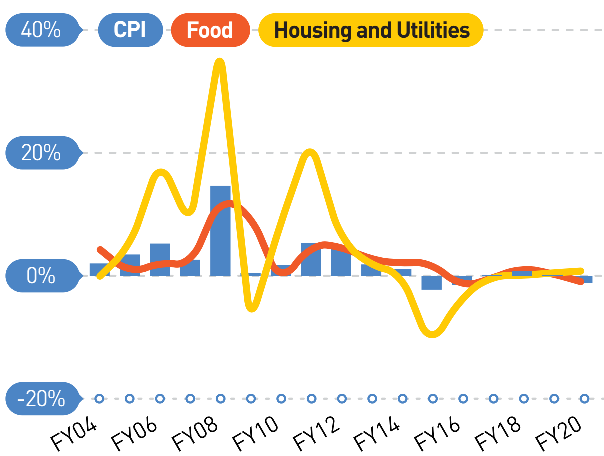
Figure 4: Public sector employment has been the main generator of jobs with private sector jobs declining rapidly with COVID
Employment in the private and public sectors



A loss of 670 full-time equivalent jobs is projected for FY2020-FY2021. This loss in jobs should be understood as a reduction to full-time-equivalent (FTE) positions rather than a specific loss in employed persons. Firms are likely to institute reduced hours for employees before terminating their jobs. Employment data for FY2020 indicates 257 jobs were lost on average during the year and in FY2021 a further loss of 413 FTEs is projected. It is estimated that out of the 670 jobs lost there was a reduction of 135 jobs at the loining plant, 83 in construction, 134 in the transportation sector, and 275 in hotels and restaurants. Offsetting this decline, the recent trend of a growing public sector helped compensate for the private sector loss with the creation of 114 jobs in administration, education, and health. Overall there was a further loss of 157 jobs across a variety of industries.

Figure 5: Inflation remains modest falling to -1.2% during FY20 reflecting lower fuel prices

Change in CPI by selected major commodity groups



imported goods, and a high demand for products (due to the impact of various mitigation programs on demand).

Inflation

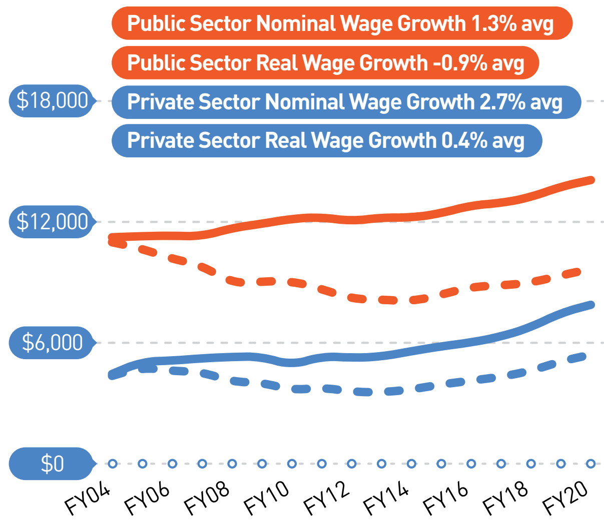
The general level of prices has fallen since FY2013 but is expected to accelerate in FY2021. After the initial part of the amended Compact and the rapid price increases of the global financial crisis, inflation has moderated and the overall price level in FY2020 is below that of FY2013, see Figure 5. This reflects very modest changes in food, fuel, and most other sections of the Consumer Price Index (CPI). Inflation continued to be modest during the pandemic and fell from the FY2019 rate of 0.1 percent to -1.2 percent in FY2020. The rate of inflation in housing and utilities, including fuel prices, fell from -0.1 percent to -1.6 percent in FY2020, which reflected lower international fuel prices, during the initial periods of the pandemic. Inflation in food prices also fell by -0.9 percent in FY2020. In FY2021 it is expected that prices will rise, which reflects rising fuel prices, reported supply shortages of

Wages

Since FY2013 real wages have grown as financial conditions have improved and

Figure 6: Real wages decline but recent improvment with low or negative inflation; wages differential remains large

Nominal and real wage rates by major institutional sector



prices have stagnated. Wages have grown modestly in the RMI by 2.7 percent and 1.3 percent per annum in the private and public sectors, respectively, during the amended Compact period, see Figure 6. However, once inflation has been taken into account, real wages grew modestly by 0.4 percent in the private sector and fell by 0.9 percent in the public sector per annum. These long-term trends mask two distinct phases: first, there was an early phase (FY2004-FY2013) when financial conditions were adverse and nominal wages struggled to remain positive and real wages declined; second, (after FY2013) as financial conditions in the economy eased and prices fell, both nominal and real wages rose in both the private and public sectors. Since FY2013 real private sector wages have risen by 6.3 percent and real public sector wages by 2.5 percent. Thus, the wage differential between the private and public sectors remains large.

2. COVID-19 Mitigation Programs and Donor Assistance

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

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

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

RMI Response and Preparedness Plan sets framework for COVID-19 mitigation. In June 2020 the government of the RMI prepared a $42 million RMI Coronavirus (COVID-19) Preparedness and Response Plan, which was later extended several times and now stands at $63.3 million. Expenditures have been planned for a series of activities: (i) health response ($25.8 million), (ii) assistance to households ($11.2 million), (iii) support to outer island governments ($13.2 million), (iv) private sector support ($8.3 million), and (v) miscellaneous items ($4.8 million). This Preparedness Plan has been funded through $61.1 million of grants from the RMI's donor partners (including the ADB, US, EU, IOM, World Bank, Taiwan, and Japan) with a small contribution from the RMI of $2.2 million.

Donor health assistance programs

RMI has been the beneficiary of a large donor response to support the Response and Preparedness Plan: The main benefactors to support the Plan have been the US government ($18.4 million) and ADB ($23.6 million). US resources include support under the CARES Act for unemployment benefits, $3.9 million under an OIA TA funded grant, plus a series of other smaller federal programs, such as the CDC, totaling another $3 million. Additional health-related funding was available from the World Bank ($2.5 million) and the European Union ($2.7 million).

ADB COVID-19 Pandemic Relief Option

ADB takes a lead role in funding the mitigation effort. The lead donor for the mitigation program has been the ADB with a program totaling $23.6 million, of which $6 million has been funded through the Disaster Resilience Program (DRP), $16 million through the COVID-19 Pandemic Response Option (CPRO), a further $1 million in grants under the Asia Pacific Disaster Response Fund, and $0.6 million in health-related TA. The DRP and CPRO funds provide budgetary support to cover funding shortfalls in the financing of COVID-19 impact mitigation projects and programs specified under the Preparedness Plan.

US CARES Act and unemployment assistance

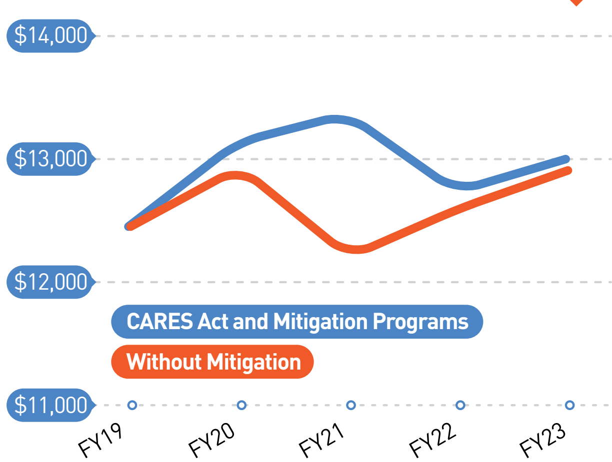
CARES Act unemployment benefits generated significant benefits to affected RMI workers: As in the other Freely Associated States, RMI citizens were made eligible for unemployment support from the US government under the US CARES Act. The program has provided two forms of benefit: the Federal Pandemic Unemployment Compensation (FPUC) and Pandemic Unemployment Assistance (PUA). The FPUC was initially awarded at $600 a week for four months (April-July 2020). A second phase of the FPUC was awarded from January 2021 through early September 2021 at $300 a week. The PUA has been available continuously since July 2020 and is set to expire in September 2021. A benefit of $262 a week has been awarded during the period. Initial funds of $7.9 million were awarded.

> The RMI benefits from a $61 million donor-assisted COVID-19 mitigation program.

Mitigation programs had large beneficial impacts on household incomes. Without the various mitigation programs and CARES unemployment benefits, household incomes were projected to have fallen by 4.9 percent in FY2021, which would have resulted in rising levels of distress in the workforce, see Figure 7. With mitigation, however, average household incomes are projected to attain a level 8.7 percent higher than the projected level had no action had been taken. In fact, the impact

Figure 7: Household incomes are 8.7% higher with mitigation

Hourshold real incomes without and without mitigation, FY15 prices

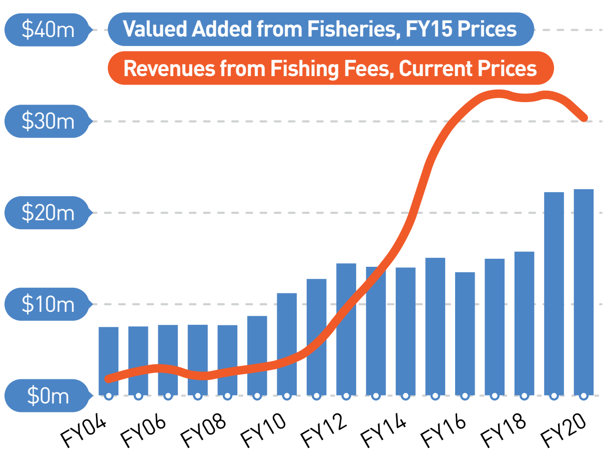


of the various mitigation programs has pushed household incomes above their trend level. However, in FY2022 a reduction in household incomes of 4.2 percent is projected after the various mitigation programs become no longer available. Overall, the magnitude of the coordinated government and donor response has been both timely and significant. The government and donor community should both take credit for rapid and apparently effective mitigation efforts.

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

Figure 8: Strong growth in fisheries valued added and revenues from the VDS

Commercial fisheries value added and fishing fee revenues



3. Fisheries Developments and Policy

RMI recorded massive growth in fishing rents from FY2010 through FY2017, which has had a large impact on the fiscal envelope. The fisheries industry in the RMI comprises provision of shore facilities to skipjack tuna purse-seine operators, a home base for long-line sashimi grade operations, a fish-loining plant, and a variety of small domestic fishing activities. The contribution to the economy has grown significantly during the amended Compact period from $7.5 million in constant prices at the start to $22.5 million in FY2020, with a large increase in the FY2019-FY2020 period due to the addition of two new boats to the Pan Pacific fleet, see Figure 8. Total fish licensing and associated fees collected by the Marshall Island Marine Resources Authority (MIMRA) rose rapidly from $3.5 million in FY2010 (current prices) to $33.5 million in FY2017 but has plateaued since that time and recorded a level of $30.3 million in FY2020. Most of the increase has been due to the implementation of the Vessel Day Scheme (VDS) of the Parties to the Nauru Agreement (PNA). The PNA is a cartel of 9 Pacific Island states, which, due to the introduction of the VDS, have had remarkable increases in revenues. Freely traded bilateral daily fishing rates currently average close to $11,000 per vessel day and the RMI received over $28.0 million in revenue from this one source in FY2020.

Job losses at the loining plant are expected to remain in FY2021. In FY2020 the largest negative impact of COVID-19 was on the loining plant. The plant was originally anticipated to rebound in FY2021. However, access to the US CARES Act has provided incentives for keeping the plant closed and for individuals to remain unemployed. Workers who lost their jobs will receive higher compensation than those working at the plant. From the plant's perspective, a loss-making entity established to qualify for domestic fishing discounts under the PNA FSM agreement, a similar incentive exists. By waiting to rehire employees, the business will reduce losses until the provisions of the CARES Act expire and the demand for employment resumes. Thus, the loining plant is not projected to resume operations until FY2022.

FSM Arrangement provides discounts to domestically flagged vessels at substantially reduced rates. A particular issue of concern for the PNA region is the operation of the FSM Arrangement (FSMa). The FSMa was established to encourage the development of domestic fishing fleets and to permit access to fishing resources of other Parties' fleets. Fishing operators are accorded domestic fishing fleet status under the FSMa and pay a reduced daily rate, which is considerably less than the current bilateral market rate of $11,000 per day. The issue of concern is whether the reduced fishing fee and concurrent loss in revenue will be offset by increases in benefits to the PNA economies. In the RMI case, Koos fishing company operates 4 purse seiners and another boat under a joint equity venture with the government. Pan Pacific operates 5 boats and the loining plant, but at a significant recorded loss in order to take advantage of the reduced domestic fee rate.

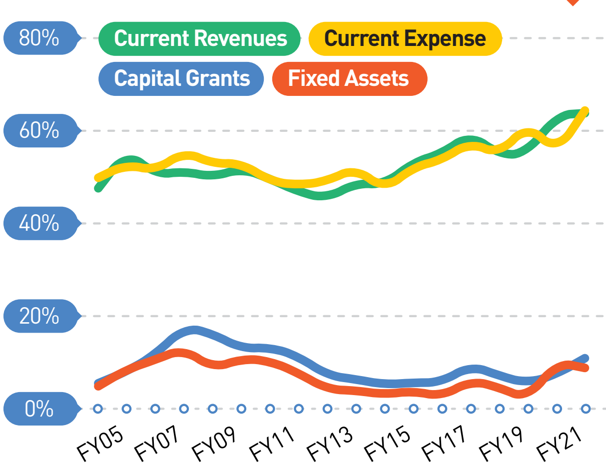
FSMa is an economically inefficient regime that misallocates sovereign rents. A recent unpublished study of the fisheries sector conducted by the GSUSA suggests that the additional economic benefit to RMI from each domestic vessel compared with bilateral vessels is about $500 per day. Therefore, discounts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

4. Fiscal Performance and Policy

The Fiscal Outturn

Revenues fell as a share of the economy in the first ten years of the amended Compact but then rose rapidly with the growth in sovereign rents. Figure 9 indicates recent trends in fiscal performance, that is, current revenues and expenses, together with capital grants and fixed assets, as a share of the economy. During the first ten years of the amended Compact revenues declined as a percent of GDP. This decline reflects the inelastic and outmoded tax regime and the static nature of Compact grants in nominal terms. The FY2014-FY2020 period reflected growth in a new form of revenue (i.e., fishing royalties arising out of the VDS from the PNA) resulting in a 10 percent increase in overall revenues.

Figure 9: RMI executes expansionary budgets since FY2015 but overall fiscal surplus of 1.4 percent projected in FY21
RMI consolidated revenues and expenditures, FY04–FY21



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

Payroll has declined as a share of GDP, but expenses on subsidies and transfers have doubled. Current expenses have followed the trend of current revenues. The decline in the revenues-to-GDP ratio led to a tight fiscal period of constrained expenditures. However, as the revenue base expanded with the increase in fishing fees, expenses also expanded. Within current expenses, payroll declined in relation to GDP, falling from an average of 25 percent at the start of the amended Compact to 21 percent during the last three years. While the use of goods and services has been largely constant, the main area of expansion has been in subsidies to the large SOE sector and transfers to NGOs and households, which have doubled from 12 percent to 24 percent of GDP. On the capital side, expenditures have been primarily covered by grants, which, as with current expenses, have risen and fallen in tandem.

Fiscal policy in the RMI has been driven by revenue availability. While not directly indicated in Figure 9, the fiscal deficit (in essence the difference between current revenues and current expenses) was largely in balance throughout the period. Fiscal policy in the RMI has been driven by revenue availability and the stage of the economic cycle. During the initial period through FY2014, budget expenses were forcibly constrained. Thereafter, with the boom in revenues, expenses were less constrained. The failure to create a fiscal reserve during the period when the fiscal envelope was expanding dramatically carries a lesson for RMI policy makers going forward.

Fiscal responsibility

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

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

Tax Reform

The RMI tax regime is inherently inelastic relative to economic growth and in need of modernizing reforms. The RMI, along with its two sister Freely-Associated States (FAS) of Palau and the FSM, inherited a tax regime from the Trust Territory days. The regime is outdated, distortionary, and in need of reform. Figure 9 indicates the decline in the tax/GDP ratio and inherently inelastic nature of the current batch of taxes: wages withholding tax, the gross receipts tax, and import tax. A tax reform advisor was recruited in 2012 with support from AusAid for a two-year period, a legislative package was drafted, and an implementation program was prepared. Unfortunately, the package failed to garner support and was neither taken up by the Nitijela nor passed into law. The major focus of opposition was from the business community, which resisted the introduction of a Value-Added Tax (VAT).

As the boom in sovereign rents plateaus and the RMI enters a new post-amended Compact era, it needs to reignite the tax

reform agenda once again. Since the tax reform efforts of the early 2010s following shortly after the financial crisis and tight fiscal envelope of the time, reform of the tax regime has not been seriously reconsidered. The donor perspective has been that without commitment to reform of the tax regime, donor support should focus on administrative strengthening. The Pacific Technical Assistance Center (PFTAC) has continued to provide support and in 2020 the ADB launched a TA under the Public Financial Management (PFM) project to provide administrative support in compliance, improved tax collections, internal processes, and risk management. The ADB TA resulted in one major recommendation to improve IT systems to enhance efficiency. However, while such efforts are highly desirable and will result in increased revenue collections in the short-term, they will not overcome the inherent lack of buoyancy of the existing regime. In other words, tax collections will fail to keep up with the growth in the economy, which will constrain the delivery of public services.

External debt management

External debt and debt service fall to low levels. As a result of the IMF/World Bank's Debt Sustainability Analysis (DSA) indicating the nation as being at high risk of debt distress, the RMI has been designated as a "grant only" recipient, making the RMI no longer eligible for loan financing from multilateral donors. The high-risk assessment has been based on two major factors: (i) the historically high ratio of debt to GDP and the (ii) potential shortfalls in resources in an adverse scenario after the end of the amended Compact period. External debt stress had posed significant risk to the RMI fiscal position during the early years under the amended Compact,

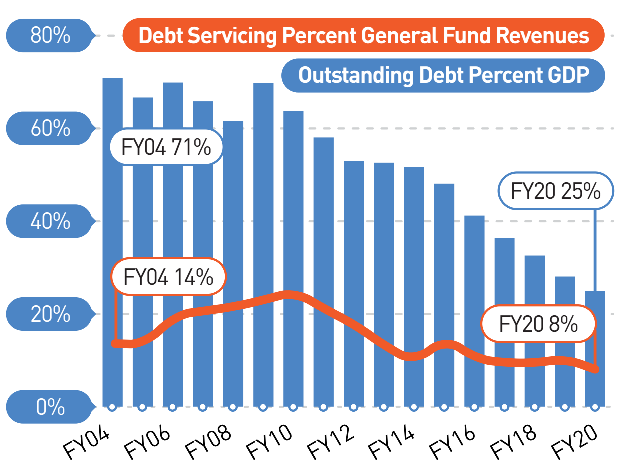
> "Grant only'" status has resulted in a low risk of debt stress and the receipt of a large volume of grant funds, now averaging $45 million a year from multilateral donors.

including periods of delinquency in the late 2000s. However, the current position has improved significantly, and external debt has fallen from 71 to 25 percent of GDP (see Figure 10). Debt service as a ratio of payments to general fund revenues has also fallen significantly from over 20 percent at the height of the global financial crisis, when the RMI was in a state of default, to just 8 percent in FY2020.

The designation of "grant only" status has served the RMI well. External debt has fallen sharply to sustainable levels as a result of being accorded "grant only" status. This status is accorded on the proviso that the RMI does not incur debt from third parties at non-concessional rates.

Figure 10: External debt has been falling rapidly with adoption of grant only status

RMI external debt (percent GDP) and debt service (percent general fund revenues)



This requirement has inhibited the surge of debt that occurred during the original Compact period through FY2003 and during the amended Compact period through FY2010, with much of the debt from ADB loans. However, while grant-only status has inhibited borrowing, this is not to say that a desire to incur debt has disappeared; recent applications to the International Renewable Energy Agency (IRENA) for loan funding and a stream of other proposed loan-financed projects totaling close to $80 million during 2018 suggest otherwise. So far, the DSA provision and analysis has imposed a useful brake on any reemergence of the past debt-financing trends. However, as the Compact-renewal terms become known and with a possible favorable outcome, it may be that a reassessment of the major assumptions of the DSA will result in a changed designation for the RMI regarding loans. The current proposal to implement a well-specified FDRMA reflecting the needs of the RMI is thus viewed as essential for providing guidelines on the proper management of debt at sustainable levels and for well-vetted purposes.

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

The RMI has a need for counter-cyclical fiscal buffers and reserves. The fiscal policies during the amended Compact have resulted in periods of substantial cash-flow shortfalls, which have led to fiscal and economic instability. This was seen in both the failure to service accounts payable and the temporary default on external debt repayments. The RMI, unlike more financially developed nations, has no access to capital markets. Further, the adoption of the US dollar and the lack of a central bank removes the availability of a domestic source of funds for cash-flow management. Under these circumstances the RMI needs to build a pool of savings for funding government operations during cyclical downturns and periods of illiquidity.

Target levels of cyclical reserve funds may be set in relation to domestic revenues. Many Pacific Island Countries (PICs) with their own currencies, fixed exchange rates, and central banks operate on the principle of maintaining foreign reserves at a defined level of imports. In the RMI's case, this objective would translate into maintaining a minimum level of resources equivalent to a target number of months of domestic revenues. This could be determined with reference to historical periods of cyclical volatility. A source of funds to establish the cyclical fund reserve does not presently exist and would need identification. It might be achieved on a matching basis with donor funding and internally generated RMI domestic funds. Once established, the fund would need periodic augmentation to ensure the reserve target was met and a mechanism to replenish the fund after it had been drawn upon was identified. Clear rules would need to be adopted to specify the conditions under which the reserve funds could be accessed.

A Climate Resilience Fund is likely to become increasingly necessary. In the case of periodic climate events and natural disasters, the RMI could establish a climate resilience fund to help mitigate adverse impacts. While the RMI does have access to climate event insurance funds from the World Bank and ADB, there may be events and circumstances for which these funds may either be unavailable or just not available on a timely basis. Contributions from domestic revenues and from donor partners could be set aside into a resilience fund until a target amount is reached. The exact target amount might be based on the World Bank's Pacific Catastrophe Risk Assessment and Financing Initiative

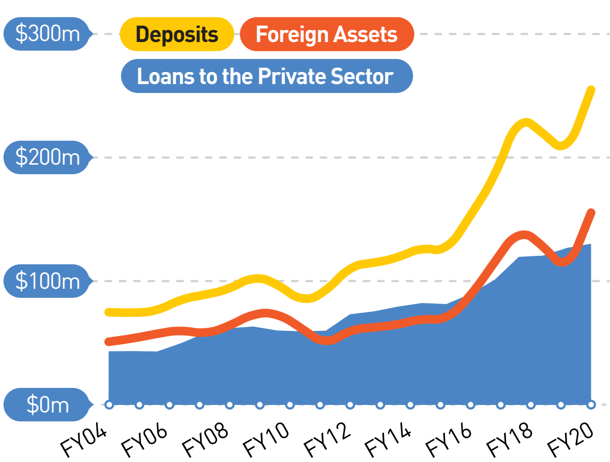
(PCRAFI). In the RMI's case the risk and cost of an annual climate event has been estimated at about 2.0 percent of GDP. The target for the fund might be set in relation to this risk and the availability of other donor contributions. Withdrawal of funds would be permissible once the president declares a state of national emergency. Commitment costs of the World Bank's and ADB's disaster funds, or premium costs for any other such insurance facility, could be drawn from the climate resilience fund.

5. The Financial Sector

Banking

The RMI banking sector operates a more proactive lending policy than its sister Freely-Associated States (FAS). Commercial bank lending in the RMI is more active than in the sister FAS states of the FSM and Palau and achieved a loans-to-deposits ratio of 51 percent, as compared to ratios of 22 percent in FSM and 13 percent in Palau (see Figure 11). The greater lending performance reflects the more active lending policy of the local bank: the Bank of the Marshall Islands (BOMI), which is not FDIC-insured and comes only under local supervision. However, greater financial intermediation has been limited by: the inability of

Figure 11: Commercial bank lending remains weak, funds invested off-shore
Commercial bank loans and deposits (end of period)



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

The RMI banking sector remains at risk due to possible loss of BOMI's correspondent banking relationship. A particular issue for the RMI has been the worldwide phenomena of "de-risking" by international financial institutions. In order to reduce exposure to money laundering, the financing of terrorism, or the stiff penalties imposed by regulatory authorities, international banks have reduced their exposure through limiting Correspondent Banking Relationships (CBR). BOMI has been under threat of loss of its correspondent bank, First Hawaiian Bank. It is understood that First Hawaiian has been satisfied with recent progress at BOMI in tightening Anti-Money Laundering (AML) and Countering the Financing of Terrorism (CFT) procedures, but a permanent CBR solution is needed. Until such time BOMI, and the RMI financial sector as a whole, remain at significant risk.

Households are at risk of high-debt stress due to large indebtedness to commercial banks. A further issue relating to banking is the high ratio of consumer debt to household incomes. Consumer debt represents 31 percent of GDP and 57 percent of compensation of employees. Consumer debt attracts high rates of interest (13 percent in FY2019) and is largely secured against the payroll of public sector employees through direct allotment, which guarantees repayment. Analysis of government payroll indicates allotments for debt repayment average 47 percent of total wages, which leaves the net take-home pay of employees at an average of 15 percent of gross wages. More than 25 percent of employees take home less than 3 percent of their gross wages. As a result, government employees are reported to be at high risk of debt stress. Many national government employees have such low levels of net take-home pay that they are unable to meet their basic family needs.

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

Social Security sustainability management

An actuarial study in 2011 projected collapse of the Social Security System in 2023, motivating a series of important reforms. The financial position of the Marshall Islands Social Security Administration (MISSA) has been a long-

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

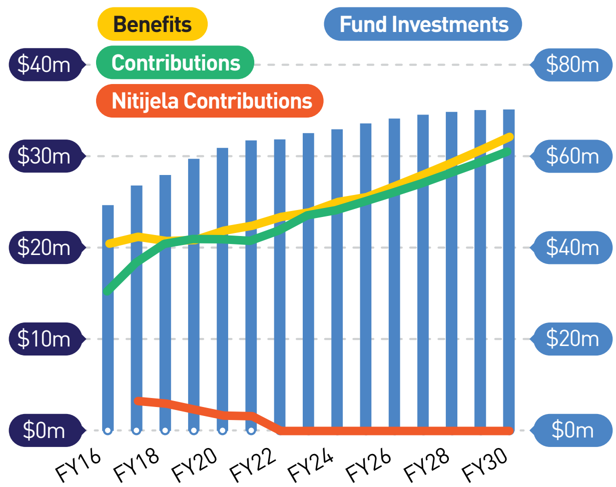
standing issue. MISSA has been identified as being at significant risk and in need of reform. In 2011 an actuarial study projected the threats to the system and the exhaustion of its reserve investments by 2023. As a result of these dire predictions, a series of reforms were proposed in 2013 but failed to be acted upon by the Nitijela. However, given the imminent collapse of the system, a revised version of the reforms was enacted in 2017. Compared with the original reform list, it was recognized that these reforms would likely be insufficient to restore long-term sustainability. The Nitijela acted to provide annual transfers of $3.6 million in FY2017, but these transfers have been gradually reduced to $1.6 million in the FY2021 budget.

Recent audit data indicates MISSA contributions and benefits were evenly matched. The impact of reforms and cash transfers appears to have been significantly greater than originally projected. In both the FY2018 and FY2019 audits MISSA indicates that contributions and benefits were evenly matched, thus allowing annual earnings on investments to accumulate in reserves. Based on the current financial position of the fund, projected contributions (based on recent economic work conducted by GSUSA), and projections of benefit streams from prior actuarial assessments, the outlook for MISSA appears brighter.

Projections indicate MISSA's financial position remains fragile and careful monitoring is needed. Figure 12 suggests that contributions and benefits are likely to remain evenly balanced for the next

Figure 12: Social Security Funds now projected to increase after recvent reforms

MISSA benefits, cnotributions, fund investments and Nitijela contributions



several years. The projections, which are based on a 4.5 percent return on invested assets, the rate assumed in the 2017 actuarial assessment, and termination of government transfers in FY2023, indicate that reserves will continue to rise gradually through FY2030 and peak shortly thereafter. These results suggest that MISSA continues to pose a fiscal risk but the need for immediate remedial action may be less than had been assumed. However, the benefit projections presented here are based on earlier actuarial studies. There remains a need for a reevaluation and careful monitoring of the system.

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

RMI announces intention to issue a digital currency, the SOV, in the RMI as legal currency. In March of 2018 the RMI declared its intent to issue a digital currency based on block-chain technology to be known as the SOV, which will act as legal currency in the RMI in addition to

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

the use of the US dollar. An "appointed organizer," named by the cabinet, is responsible for the Initial Currency Offering (ICO) as well as the development of the block-chain technology and software for transacting in the currency in the RMI. An initial 24 million SOVs are to be issued, half of which will be held by the RMI government and the remainder owned by the organizer. The minister of Finance is to be responsible for regulation of the SOV, and the banking commissioner will be responsible for compliance with standard Know Your Customer (KYC) procedures.

The passage of the law to issue the SOV as legal tender resulted in a widespread interest and concern from international institutions. While there are many cryptocurrencies in existence worldwide, few have been issued as legal tender by a sovereign state. Many central banks are examining the potential to issue a digital currency to the public that is backed by the currency in circulation but have so far been hesitant to issue their own digital currencies. Thus, the RMI proposal is unique. While the potential gains from sale of the SOV could be large, many risks have been identified. Anonymity of transactions has been one of the major concerns, especially the facilitation that cryptos afford to money laundering and financing of terrorism (AML and CFT). The RMI proposes to remedy this concern through the KYC provisions in the law. However, it is not clear how this would be done in jurisdictions outside the RMI or after the ICO. Since anonymity is one of the major attractions of cryptos, its absence would limit the uptake of SOV.

Creation of SOV threatens the RMI's correspondent banking relationship (CBR). Another concern has been the risk to the CBR relationship of the Bank of Marshall Islands with First Hawaiian Bank. Clearly, AML and CFT risks associated with cryptocurrencies may adversely affect BOMI's CBR with First Hawaiian or other international banks. It is also not clear what the position of the FDIC might be regarding the acceptance and holding of SOVs by the other bank in the RMI, the Bank of Guam. A further issue is the high price/value volatility of cryptos. Should the SOV be taken up actively within the RMI, such volatility could prove highly destabilizing and could disrupt orderly payments. While this might not have been the intention in the design of the system, the currency will be issued as legal tender.

Introduction of SOV is delayed as the RMI commissions a due-diligence study. The current position of the government that has emerged since the enactment of the legislation is that the RMI will commission a comprehensive due-diligence study that will serve as the basis for the Nitijela to either proceed or possibly repeal the SOV legislation.

Creation of a Digital Economic Zone in Rongelap Atoll poses high risk to financial stability. In addition to the creation of the SOV, a bill was introduced into the Nitijela for the creation of the Digital Economic Zone in Rongelap Atoll (DEZRA). Rongelap Atoll is a former site of nuclear testing. DEZRA is intended to generate foreign investment through the creation of a virtual means of exchange, including assets, coupled with the creation of a tax-free zone. However, it is likely that most if not all of the transactions would occur offshore. Many of the same criticisms of the SOV also apply to DEZRA. The IMF points out (in the recent Article

IV consultation[2]) that the benefits to the RMI are likely to be limited while the new zone is likely to generate a host of new risks. In an unsophisticated jurisdiction with limited regulatory capacity, DEZRA would be subject to the same AML and CFT risks and concerns as the SOV. This would further compound the issues of maintaining the RMI's CBR with First Hawaiian, which underpins the financial stability of the nation.

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

6. Public Financial Management (PFM)

Public Expenditure and Financial Accountability (PEFA)

The RMI develops a PFM Reform Roadmap, but progress has been slow. In December 2011, the RMI underwent an external PEFA assessment, and the cabinet adopted the report and directed the government to request PFTAC to compile a PFM Reform Roadmap (PFMRR). In collaboration with the government, PFTAC prepared the PFMRR in 2014. Initially commitments were made to focus on 30 components within which 150 actions were identified. An observed weakness at the time of the first PFMRR review in 2015 was the lack of prioritization of the adopted components and activities and the allocation of insufficient resources for implementation of the reform efforts. Progress was slow and fully 12 of the 30 components had yielded no actions to report. However, since then, prioritization has been implicitly expressed through the resourcing of the reform efforts.

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

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

levels and providing a focus upon financial management, accounting, and controls. An additional focus has been the establishment of the SOE monitoring unit that is part of the ADB PFM project. The initial project was largely successfully completed and a 2-year extension period was agreed upon and is underway. The EU has also agreed to provide budgetary support for the reform of the energy sector, and the RMI government has committed to public financial management reforms as part of the conditions of the support. In addition, the World Bank plans to develop a budgetary support program that will entail PFM reforms.

Financial Management Information Systems (FMIS)

Implementation of a new FMIS has been delayed by COVID but should eventually provide a sound basis for financial management. The FMIS in the RMI has reached the end of its effective life as the responsible software company is no longer operational. With $9 million in donor grant support from the World Bank for budget execution and financial reporting systems, a new financial management information system is being actively pursued. The project has been approved by the Bank's board and a request for proposal (RFP) was issued but the initial proposals were deemed unacceptable. A revised RFP was also issued and a vender engaged.

Public Sector Payroll

Government payroll has declined as a share of GDP since the start of the amended Compact. With public payroll representing a high proportion of GDP, 21 percent in FY2020, careful monitoring of trends is warranted with the possibility of declining resources post-FY2023. Before the start of the amended Compact period there were 2,013 public servants as compared to 2,747 today. However, a 21 percent increase of public servants occurred in the first two years after the amended Compact in response to the depressed levels of public employment after the reforms of the late 1990s and with the incorporation of the Head Start Federal Program into government. Since FY2006 only 310 new positions have been added, representing a 0.8 percent annual growth. Payroll costs on the other hand have risen gradually over the period reflecting a 1.5 percent annual wage increase. Payroll costs as a percent of GDP have fallen from 24 percent in FY2004 to 21 percent in FY2020. While the government has maintained discipline since FY2006, the increase at the start of the amended Compact after the depressed years at the end of Compact I may have been excessive in relation to the potential for efficiency gains in the delivery of public services.

State-Owned Enterprise (SOE) Reform

The SOE sector, comprising a dozen public enterprises, has underperformed and poses significant costs and fiscal risks. Given the challenges posed by remoteness, small size, and dispersion, SOEs remain active in numerous crucial sectors of the RMI economy. While in some circumstances there are legitimate reasons for the state to subsidize the provision of key public services, for many years the RMI's SOE sector has underperformed, operating at an average annual loss of up to 5.7 percent of GDP and incurring average subsidies of 6.0 percent of GDP over the last three years, FY2018-FY2020. Figure 13 indicates virtually all of the RMI SOEs operated at a loss over the same period, FY2018-FY2020. Furthermore, rates of return on assets and on equity over the period FY2017–FY2019 were –8 percent and –13 percent, indicating both poor performance and a negative return on government investments.

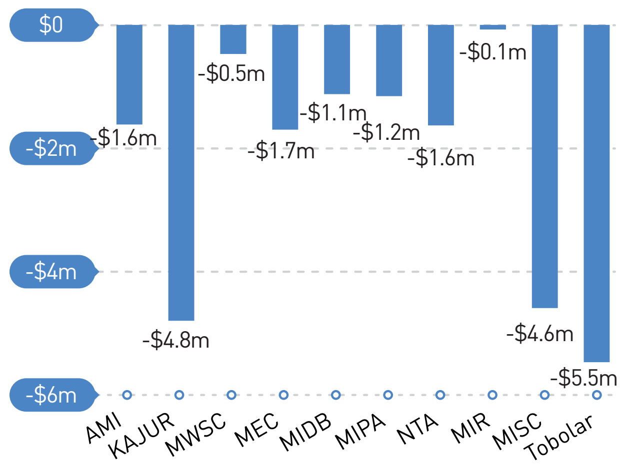
The government of the RMI enacted the SOE Act, which was almost immediately amended to reverse the restriction on the participation of government Ministers and officials on borads. In response to these concerns, in 2015 authorities introduced an SOE Act that was designed to focus public enterprises on achieving commercial viability as well as strengthening governance structures and accountability. The Act included the requirements of annual Corporate Statement Intent (CSI), Business Plans (BP), and the introduction of Community Service Obligation (CSO) contracts. Unfortunately, the law was almost immediately amended to reverse those reforms that had restricted the participation of government ministers and officials on SOE boards.

SOE monitoring unit was created to drive reform process. In 2018 an SOE Monitoring Unit (SOEMU) was created as part of the ADB PFMRR. The unit started with training of Ministry of Finance (MOF) officials and SOE key officials in the contents and

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

Figure 13: Subsidies and capital transfers to ailing SOE sector are a persistent drain on fiscal resources

State-owned enterprises subsidies and capital transfers, average FY18–FY20



implications of the SOE law. Once internal systems and templates were established to fulfill the unit's monitoring mandate, the SOEMU's consultant and 3 staff members began work on capacity-building within each SOE. In FY2019 and FY2020 virtually all SOEs had completed corporate statements of intent for review by the Nitijela and prepared business plans (as required by the SOE law).

Although progress has been slow, the SOEMU has been successful in raising the level of awareness and management in the sector and warrants continued donor support. More recently a selected sample of SOEs: Air Marshall Islands (AMI), Majuro Atoll Waste Company (MAWC), Marshall Islands Shipping Corporation (MISC), and Tobolar were requested to develop Community Service Obligations (CSOs) for the delivery of services. However, development of CSOs requires detailed accounting, information on services delivered, and available trained staff. Progress has been slow due to a variety of factors: diseases such as dengue, the recent COVID-19 pandemic, and some reluctance to depart from earlier practices.

However, the SOE project, given its small size, has been successful in raising the level of awareness and management in the sector compared to prior years. The project warrants further donor support and resourcing to ensure the consolidation of gains made to date and to achieve full compliance with the SOE Act across the entire sector.

7. Private Sector Developments

The World Bank's "Doing Business" Survey

The World Bank's "Doing Business" survey paints a discouraging view of the environment for private sector growth in the RMI. The World Bank's "Doing Business" survey reveals problems for private sector development. Out of 190 countries the RMI currently ranks 153, 81 percent down the list, indicating that there is much room for improvement. The RMI fares worse than Palau but better than the FSM, which are ranked 145 and 158 respectively, but is substantially below most South Pacific nations. Sāmoa is ranked 98, Tonga 103, Vanuatu 107, Fiji 102, and Papua New Guinea 120. Overall, the RMI's scores are weak. For example, their scores in the areas of registering property and protecting investors fall in the bottom decile of countries, while scores for providing electricity and resolving insolvency are also very weak.

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

Private Sector Registration and Licensing

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

Foreign Direct Investment (FDI)

The environment in the RMI for FDI is antiquated, overly bureaucratic, and in need of replacement with a modern system. FDI is implemented under the Foreign Investment Licensing Act 2005 but appears to have failed to simplify the process as the act was intended to do. FDI permitting is done manually and licenses take weeks or months to process. FDI licenses are only issued after all other regulatory requirements, such as corporate registration, local government licensing, foreign work permits, Social Security registration, and others have been fulfilled. To reduce uncertainty, an automated process is needed to allow other legal requirements to be fulfilled on a parallel timeline, as is required for any domestic enterprise. There is a substantial list of restricted activities, which appears not to be enforced. This lack of enforcement encourages "front" businesses, which hide illicit economic activity. In an updated FDI system, businesses are only required to submit information required for statistical and monitoring procedures, and licenses are issued in just a few days.

Land Tenure

The Land Registration Authority (LRA) was introduced to support voluntary registration but start-up has been slow and needs reinvigoration. In the RMI, as in many Pacific Island economies, land is largely owned by customary groups with complex governance structures. Banks are reluctant to take customary land (either owned or leased) for collateral. Non-Marshallese are not allowed to own land, and even transactions between Marshallese are rare. A key objective of economic development is to improve tenure security (i.e., protection against eviction) for both landowners and leaseholders by accurately defining and protecting land rights. In 2004 (with ADB support) a Land Recording and Registration Act was introduced as a means for custom owners to voluntarily register land via an accessible registry of land transactions. The Land Registration Authority (LRA) was introduced to implement the new legislation, but use of the LRA has been minimal. Despite the slow start, the 2004 legislation and LRA are generally considered to provide a sound basis for land administration. The process of improving public awareness, with both government and private sector backing, needs a restart so that secure registration and leasing of land can support its critical role toward business and financial development.

Corporate and Shipping Registry

A transparent evaluation of the costs and benefits of the Corporate and Shipping Registry is needed to assure that the RMI is receiving its fare share of royalties. An issue that has raised questions concerns the corporate and shipping registry services provided to the RMI by the Trust Company of the Marshall Islands (TCMI), which is a subsidiary of a US company, International Registries Inc. The registry provides services for nonresident corporate registration and shipping services. Under the terms of the Compact, vessels registered in the Marshall Islands are treated as if they are US-registered vessels; as a result, many large US shipping companies use the Marshall Islands for registering their ships. At the start of the amended Compact the RMI government received $1 million annually from the registry, which has been budgeted at $8 million in the FY2021 budget. There is a general lack of factual information and transparency on the operations of TCMI. There is neither publicly available financial information on TCMI operations nor knowledge of whether or not the RMI receives its fair share of the TCMI earnings. However, it is known that in similar jurisdictions the host nations receive a far higher return. There is thus a need for a transparent evaluation of TCMI in light of perceived unfairness and possible underpayment of royalties that are due to the RMI. It is understood that the government has commissioned a study to evaluate this issue and to recommend a range of actions.

8. Compact Issues

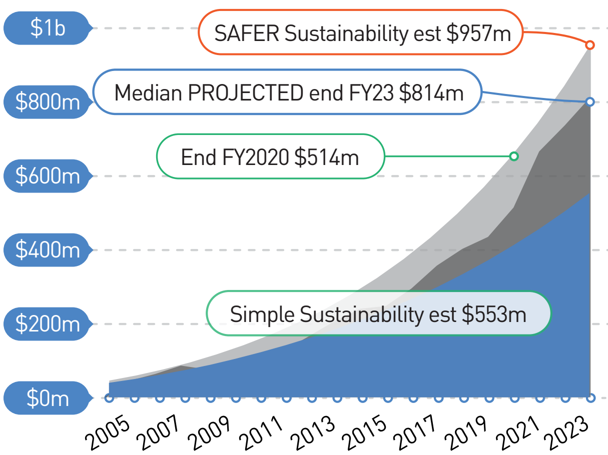
The RMI Compact Trust Fund (FY2019 and FY2020)

Two years of continued contributions and market-driven growth resulted in a balance of $514 million in the RMI Compact Trust Fund at the end of FY2020. The RMI CTF experienced market gains of 2.8 percent during FY2019; these gains, combined with a scheduled contribution from the US of $17.7 million at the outset of the fiscal year, plus $2.4 million from Taiwan in May of 2019 and $250,000 from the RMI in October 2018, enabled the fund to grow by $32.2 million to a balance of $435 million by the end of FY2019. In FY2020, the RMI CTF experienced market gains of 11.6 percent, which (with a scheduled contribution from the US of $18.6 million at the outset of the fiscal year, plus $2.4 million from Taiwan in April 2020 and a total of $5.5 million from the RMI in three deposits during the fiscal year) enabled the fund to grow by $79.8 million to a balance of $514 million by the end of FY2020, see Figure 14. During the period of investment since FY2006, and based on the reported dates of deposits from each source, the annualized rate of return has been 6.92 percent.

Assuming the pledged contributions from Taiwan continue, the CTF would not need any investment growth at all from FY2021-

Figure 14: CTF projected to attain SAFER Sustainability target in 46% of cases after strong investment returns

Compact Trust Fund balances through FY20 and projections through FY23



FY2023 to achieve a level that would enable a smooth transition to CTF distributions from FY2024 onward at the projected real value of FY2023 grants to be replaced ($26.9 million). However, this "simple" sustainability estimate does rely upon stable performance during the distribution period at a 5.0 percent real rate of return and does not allow for market volatility. In the presence of market volatility, the Graduate School USA has modeled outcomes according to the existing CTF distribution rules. The model results for the RMI indicate a still worrisome probability of periodic fiscal shocks, including years in which zero funds would be legally available for distribution. Notably, over the period from FY2024-FY2063, 22 percent of the simulated cases in the model show one or more years of zero distribution.

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

> The median expected value of the RMI CTF at the end of FY2023, estimated at $814 million, would still be significantly below the $957 million estimated to be necessary to achieve sustainable distributions under modified (closer to optimal) CTF rules.

(ii) ensuring distributions at or near the real value of the FY2023 grants, and (iii) avoiding year-to-year volatility of distributions. Certain administrative issues have been raised pointing to the language of the CTF Agreement not being amenable to efficient administration when the distributions phase begins. In addition, recent independent studies have shown that technical improvements to the existing rules could provide objectively better results at no extra cost. A key empirical finding is that once market volatility is accounted for, the size of the CTF would need to be approximately 1.7 times larger than estimates using a simple fixed rate of return with no market volatility. For the RMI, achieving sustainability in the face of volatility implies a CTF value at the end of FY2023 of $957 million. The median expected value of the RMI CTF at the end of FY2023 is now estimated at $814 million, based on actual values through FY2021 followed by expected contributions and 7.0 percent nominal growth for the two remaining years. This value would still be significantly below the $957 million estimated to achieve sustainable distributions under modified (closer to optimal) CTF rules. Of course, making substantial improvements to the administrative and distribution terms of the CTF Agreement would require mutual agreement by the original parties, which for the US entails both executive and congressional approval.

Post-FY2023 Uncertainties

Annual Compact sector operating grants, Compact infrastructure grants, supplemental education grants, support for audits, and disaster assistance are scheduled to expire in FY2024. The loss of approximately $26.9 million annually of operating and infrastructure grants is targeted to be replaced through funding provided from distributions from the Compact Trust Fund; however, there is considerable uncertainty over the continuation of many other special and Federal programs and services provided to the RMI by the US. In particular, the RMI benefits from the Special Education Grant (SEG), which was cashed out from former Federal programs provided in the original Compact, would expire. Funding is provided through annual Congressional appropriations whose continuation post-FY2023 will end under current law. The current level of SEG is $5.4 million annually or approximately 2 percent of GDP. There are many other US Federal programs whose funding is subject to Congressional authorization, such as, Postal Services, FDIC, NOAA, Pell grants, FAA, and health programs.

After accounting for a sustainable level of distributions from the CTF and other losses in a severe outcome scenario, the RMI would face large fiscal and economic disruptions. While the shortfall in fully sustainable distributions from the Compact Trust Fund is estimated to be less than $1 million annually after FY2023, the range of possible values in the loss of all Federal programs may, in a truly severe case, be an additional $22.4 million or more (the sum total of SEG, Federal Programs, and Pell grants in FY2018). Combining the reductions in sustainable drawdowns from the CTF and potential loss of Federal programs and services indicates the possibility of a truly severe case outcome of a reduction in grants of $22.4 million or 8.3 percent of the projected post-COVID-19 GDP of the RMI in FY2023. Given the fiscal impact on an already weakened RMI economy Job losses would be projected at nearly 16 percent of the workforce with proportionate increases in projected migration.

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

9. Other Issues

Outer atoll income-support mechanisms

Increase in copra producer prices to levels well above world market prices to support outer atoll incomes represents a significant fiscal issue. Related to the recent rapid increase in subsidies to the SOE sector, subsidies to Tobolar, the copra processing plant, have also increased. Tobolar collects copra from households/producers in the outer atolls and exports to world markets at prices generally well below the cost of operations. Over the last five years Tobolar has recorded negative value-added. However, support to outer island households has become a high-priority social objective of the government. The rapid increase of the subsidy, which was originally intended as a temporary, pre-Christmas bonus in 2015, appears to have become permanent and represents a significant fiscal threat given the obvious difficulty in restoring grower prices to their original levels in a politically sensitive area.

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

Identification of more economically efficient means of outer island income support is a key public policy objective that has yet to be seriously addressed from either a technical or political perspective.

Statistical Issues

The RMI has significantly improved the nation's economic statistical systems, but the absence of trade data remains a particular weakness. In former Graduate School USA reviews of the RMI, statistical availability has been found to be satisfactory. Since the start of the amended Compact the RMI has developed a wide range of statistics that enable the monitoring of economic performance. The set of annual economic statistics is produced 11 months after the end of the fiscal year, and a new set of quarterly indicators is now being prepared in time for the regular session of the Nitijela in January and August. The annual statistical update is timed to coincide with the release of the government audits and in time for the Joint Economic and Fiscal Accountability Committee (JEMFAC) annual meeting. In some years a preliminary set of statistics has been prepared to support budget preparation and periodic International Monetary Fud (IMF) missions. The 2018 IMF Article IV staff review found "data provision to be broadly adequate for surveillance, though some shortcomings tend to constrain policy analysis, especially on trade statistics." Weak data systems in Tax and Customs for both trade and the gross revenue taxes inhibit comprehensiveness and timeliness and should be replaced with modern systems. While the more frequent provision of biannual quarterly estimates is a welcome addition, the regular provision of estimates earlier in the year to coincide with budget preparation is needed.

10. The Reform Agenda

Progress with Reform

Progress with the reform agenda has been weak despite numerous commitments. During the amended Compact period, the RMI has entertained numerous reform initiatives that have failed to achieve successful implementation. The expenditure proposals of the Comprehensive Adjustment Program (CAP) were not implemented; although there has been some renewed interest in the tax reform initiative, it has failed to take shape. While the SOE Act has become law and progress has been made through the creation of the SOEMU, adoption of the "best practices" enshrined in the Act have not been implemented. There is no doubt that the refinancing of the Marshalls Energy Company (MEC) debt under an ADB program (policy reform) loan had a beneficial result, but the fiscal targets of the program were not achieved. In May 2021, a draft of the Fiscal Responsibility and Debt Management Act was passed by the Nitijela into law. Unfortunately, due to the onset of COVID-19 the bill had been inadequately vetted and failed to include restraint on government behavior to budget all available revenues as well as other prudential policies. The Act now needs major revisions before it is ready to act as a guide for the conduct of responsible and transparent fiscal policy.

Long-Term Fiscal Issues

Since FY2019 the RMI has been running a significant structural fiscal deficit, which has been disguised by the inflow of large grants during COVID-19. With a boom in sovereign rents, the RMI embarked on a series of expansionary budgets in FY2015 through FY2019. During this period expenses grew by an average of 11.2 percent while revenues only grew by 8.7 percent, which resulted in a growing fiscal problem. During FY2015-FY2018 a fiscal surplus averaging 3.4 percent of GDP was achieved, but by FY2019 rising expenditures outstripped revenues and a 1.8 percent deficit was recorded, which indicated a structural deficit and a need for adjustment. Then in FY2020 COVID-19 hit, which resulted in a large influx of aid and donor support and created a fiscal surplus of 5 percent in FY2020. A smaller surplus of 0.9 percent has been projected for FY2021. However, by FY2022 the rapid expenditure growth of FY2019 will recur. Without a major infusion of donor funds, significant deficits of 3.3 percent and 2.7 percent are projected for FY2022 and FY2023, respectively. After all accumulated unspent donor resources have been spent and a new Compact period begins, budgetary adjustments will be necessary.

While the outcome of the coming Compact renewal process looks encouraging, the RMI would be well- advised to prepare for the possibility of a less favorable result. In addition to the need to correct the current structural deficit, the details of a new period of Compact assistance post-FY2023 remain to be negotiated. While it is likely the current package of economic assistance will continue, a less favorable outcome is possible. In the latter scenario the RMI would be required to rely on drawdowns from the Compact Trust

Fund (CTF). As part of the GSUSA's CTF analysis[3] the value of the CTF is estimated to attain a target value sufficient to sustain a perpetual drawdown equivalent to the projected FY2023 inflation-adjusted level of grants in just 46 percent of cases. This implies that in 54 percent of cases, some decrease in drawdowns would be required. Thus, in addition to the existing need to adjust for the current structural deficit, the RMI would be well-advised to take proactive action to conserve resources and protect against the occurrence of a less favorable Compact renewal outcome.

Commitment to Reform

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

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

[3] RMI Country Focus: The Economic Impact of the End of Compact Grant Assistance, GSUSA, 2022, Honolulu, forthcoming.

RMI summary economic indicators, FY2010-FY2020

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20
Per Capita Income measures											
GDP current prices, $ million	160.5	172.1	180.5	184.8	182.5	184.2	201.7	213.1	221.8	239.6	244.5
Population	52,921	53,158	53,356	53,554	53,753	53,952	54,153	54,354	54,556	54,759	54,962
GDP per capita $	3,032	3,237	3,384	3,451	3,395	3,415	3,725	3,920	4,065	4,376	4,448
GNI per capita $	**3,690**	**3,938**	**3,916**	**4,140**	**4,252**	**4,613**	**4,866**	**5,040**	**5,179**	**5,387**	**5,425**
GNDI per capita $	4,683	4,901	4,892	5,200	5,180	5,621	5,843	5,965	6,178	6,502	6,895
National accounts											
GDP, at constant prices $ million, FY2015 prices	**180.7**	**179.3**	**175.3**	**182.4**	**181.2**	**184.2**	**186.2**	**192.3**	**199.2**	**212.4**	**207.7**
GDP, % growth	**6.4**	**-0.8**	**-2.2**	**4.0**	**-0.7**	**1.7**	**1.1**	**3.3**	**3.6**	**6.6**	**-2.2**
GDP, % growth (excl. purse seine fishing boats)	5.0	-1.6	-3.2	4.4	-0.6	1.2	2.1	2.7	3.3	3.5	-2.6
Prices (annual percent change)											
Consumer price index	1.8	5.4	4.3	1.9	1.1	-2.2	-1.5	0.1	0.8	0.0	0.0
Employment and Wages											
Number of employees	10,975	10,690	10,795	10,921	10,850	10,753	11,075	11,260	11,348	11,309	11,051
% change	5.2	-2.6	1.0	1.2	-0.7	-0.9	3.0	1.7	0.8	-0.3	-2.3
Private sedctor	4,811	4,462	4,440	4,521	4,421	4,153	4,230	4,256	4,238	4,170	3,892
% change	14.1	-7.3	-0.5	1.8	-2.2	-6.1	1.9	0.6	-0.4	-1.6	-6.7
Public sector	4,681	4,786	4,932	4,960	4,972	5,103	5,217	5,337	5,401	5,530	5,575
% change	-0.1	2.2	3.0	0.6	0.2	2.6	2.2	2.3	1.2	2.4	0.8
Average annual wage	9,105	9,560	9,496	9,618	9,794	10,177	10,529	10,815	11,185	12,020	12,621
% change	-3.6	5.0	-0.7	1.3	1.8	3.9	3.5	2.7	3.4	7.5	5.0
Private sector	4,931	5,434	5,351	5,396	5,699	5,967	6,204	6,567	7,122	7,876	8,363
% change	-8.7	10.2	-1.5	0.8	5.6	4.7	4.0	5.8	8.5	10.6	6.2
Public sector	12,136	12,224	12,006	12,205	12,185	12,404	12,803	12,909	13,201	13,740	14,054
% change	2.1	0.7	-1.8	1.7	-0.2	1.8	3.2	0.8	2.3	4.1	2.3
Average annual real wage (less inflation)	8,597	8,816	8,723	8,809	8,863	9,150	9,507	9,602	9,821	10,359	10,577
% change	-5.0	2.6	-1.1	1.0	0.6	3.2	3.9	1.0	2.3	5.5	2.1
Government Finance Statistics, $ millions											
Revenue	101.0	100.0	94.8	102.1	97.5	108.6	122.4	145.5	138.6	148.4	171.3
Tax revenue	25.6	25.6	25.6	26.7	24.7	25.9	28.9	30.4	32.1	34.9	34.1
Grants	68.2	65.5	59.2	61.3	53.9	58.7	59.1	65.3	67.3	71.9	95.7
Other revenue	7.3	8.9	10.0	14.0	18.9	23.9	34.4	49.9	39.2	41.5	41.5
Expense	-78.9	-83.2	-88.9	-95.3	-86.1	-96.4	-108.4	-123.2	-122.9	-146.5	-137.7
Compensation of Employees	-37.6	-37.7	-38.6	-40.5	-40.3	-41.4	-42.4	-45.9	-48.2	-50.8	-50.8
Use of goods and services	-24.3	-26.8	-28.1	-28.5	-25.3	-26.3	-32.0	-32.2	-36.8	-50.0	-37.2
Other expense	-17.0	-18.7	-22.2	-26.4	-20.5	-28.8	-34.0	-45.2	-38.0	-45.7	-49.8
Net Worth and its Changes	-22.1	-16.8	-5.9	-6.7	-11.4	-12.1	-14.0	-22.3	-15.7	-1.9	-33.5
Nonfinancial assets	-16.5	-13.1	-7.3	-7.2	-5.4	-7.0	-6.2	-12.9	-10.1	-6.1	-21.4
Financial assets	-6.3	11.2	5.9	-0.4	-2.1	-2.3	-5.8	-10.0	0.0	-2.1	-11.9
Financial liabilities	0.6	-14.9	-4.5	0.8	-3.8	-2.9	-2.0	0.7	-5.6	6.3	-0.2
Overall fiscal balance	5.7	3.7	-1.4	-0.4	5.9	5.2	7.8	9.4	5.6	-4.2	12.2
(In percent of GDP)											
Revenue	*63.0*	*58.1*	*52.5*	*55.2*	*53.4*	*58.9*	*60.7*	*68.3*	*62.5*	*61.9*	*70.1*
Taxes	*15.9*	*14.9*	*14.2*	*14.5*	*13.6*	*14.0*	*14.3*	*14.3*	*14.5*	*14.6*	*13.9*
Domestic revenues	*20.5*	*20.1*	*19.7*	*22.1*	*23.9*	*27.0*	*31.4*	*37.7*	*32.2*	*31.9*	*30.9*
Grants	*42.5*	*38.0*	*32.8*	*33.2*	*29.5*	*31.9*	*29.3*	*30.6*	*30.3*	*30.0*	*39.1*
Expense	*-49.2*	*-48.4*	*-49.2*	*-51.6*	*-47.2*	*-52.3*	*-53.7*	*-57.8*	*-55.4*	*-61.1*	*-56.3*
Compensation of Employees	*-23.4*	*-21.9*	*-21.4*	*-21.9*	*-22.1*	*-22.5*	*-21.0*	*-21.5*	*-21.7*	*-21.2*	*-20.8*
Use of goods and services	*-15.1*	*-15.6*	*-15.6*	*-15.4*	*-13.9*	*-14.3*	*-15.8*	*-15.1*	*-16.6*	*-20.9*	*-15.2*
Non Financial Assets	*-10.3*	*-7.6*	*-4.0*	*-3.9*	*-3.0*	*-3.8*	*-3.1*	*-6.1*	*-4.5*	*-2.5*	*-8.7*
Overall fiscal balance	*3.5*	*2.1*	*-0.8*	*-0.2*	*3.3*	*2.8*	*3.9*	*4.4*	*2.5*	*-1.8*	*5.0*

RMI summary economic indicators, FY2010-FY2020 cont'd

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20
Money and Banking ($ million)											
Assets	133.6	132.0	118.9	110.8	147.3	151.3	156.9	161.2	160.3	180.3	189.4
Foreign assets	71.8	71.9	62.1	52.5	60.9	62.6	64.7	69.9	70.4	81.5	87.6
Loans	63.3	60.2	59.4	60.0	73.3	75.6	79.4	82.3	81.5	85.3	89.6
Commercial loans	14.7	11.2	12.5	20.8	21.0	20.9	22.1	22.4	22.9	26.0	27.0
Consumer loans	48.6	49.0	46.9	39.2	52.3	54.8	57.4	59.9	58.6	59.4	62.6
Other	-1.5	-0.1	-2.6	-1.6	13.2	13.1	12.8	9.0	8.4	13.4	12.2
Liabilities	133.6	132.0	118.9	110.8	147.3	151.3	156.9	161.2	160.3	180.3	189.4
Deposits	102.1	98.2	85.0	90.8	112.4	114.6	118.9	125.4	123.0	143.5	152.9
Other	4.1	4.7	4.2	3.9	4.5	5.4	5.3	5.5	5.8	6.5	6.0
Capital	27.4	29.1	29.7	16.2	30.5	31.3	32.7	30.3	31.5	30.3	30.4
Loans to deposit ratio, %	62.0	61.3	69.9	66.1	65.2	66.0	66.8	65.6	66.3	59.5	58.6
Balance of Payments $ million											
Trade balance	-81.1	-51.2	-44.4	-65.6	-55.8	-52.0	-48.4	-52.5	-62.4	-131.3	-54.3
Service balance	-34.9	-37.4	-40.3	-40.9	-34.8	-37.7	-36.4	-44.9	-41.7	-43.5	-30.0
Primary Income balance	34.8	37.3	28.4	36.9	46.0	64.7	61.8	60.9	60.7	55.3	53.7
Secondary Income balance	52.6	51.2	52.1	56.8	49.9	54.4	52.9	50.3	54.5	61.6	81.9
Current Account, balance	-28.7	-0.2	-4.3	-12.7	5.4	29.3	30.0	13.7	11.1	-57.9	51.4
Capital Account, balance	26.6	21.9	16.0	23.3	17.0	16.1	18.3	20.1	16.5	14.7	0.0
Financial account balance	35.5	21.1	17.3	28.8	6.1	-3.5	-8.9	-11.1	20.8	91.1	0.0
International Investment position (IIP), $ million											
Total stocks, net	244.4	224.9	235.8	235.4	247.9	253.9	277.2	308.7	309.7	303.0	0.0
Direct investment, net	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.0
Portfolio investment, net	276.5	254.4	270.8	281.7	278.5	256.0	245.9	251.5	253.6	256.5	0.0
Other investment, net	-32.1	-29.5	-35.0	-46.2	-30.6	-2.1	31.2	57.2	56.1	46.5	0.0
Memo: COFA Trust Fund	119.6	132.7	175.0	217.5	252.2	259.1	307.8	372.1	418.4	450.4	512.3
External Debt, $ million											
Gross External Debt Total	102.8	100.3	96.0	97.6	94.6	89.0	83.5	77.9	72.5	67.5	61.2
Gross External debt as % of GDP	64.0	58.3	53.2	52.8	51.9	48.3	41.4	36.6	32.7	28.2	25.0
Debt Service	8.7	15.2	6.9	5.7	5.1	7.6	6.9	7.9	7.1	7.6	6.7
Debt service as % of national gov. revenues	24.4	21.1	17.8	13.1	10.8	14.4	10.4	9.5	9.5	9.8	8.1

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ECONOMIC BRIEF

RMI FY 2021

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

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