Marshall Islands

The precarious state of the Marshall Islands economy became more evident in 1995. Although the rate of economic growth improved marginally, debt repayments pushed the overall balance of payments and the government financial outturn into severe deficits; in consequence, the Central Government's financial balances became virtually exhausted. Prospects for the economy are for a fall in GDP over the next few years. The forthcoming stepdown in financial grants from the US under the Compact of Free Association underlines the need for major adjustments in fiscal and economic structure, the nature, extent, and timing of which are now under active consideration by the Government. An ADB-funded Policy Advisory Team is assisting in this task.

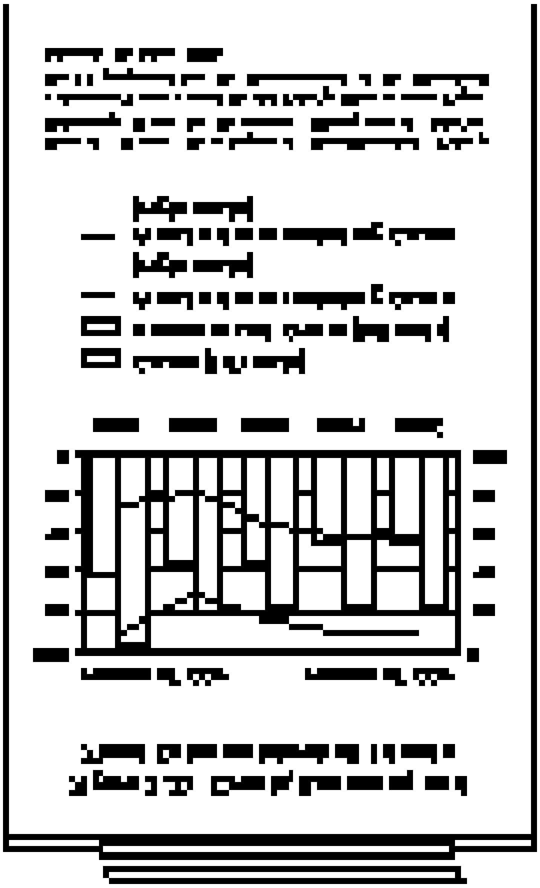
Recent Trends and Prospects

Real GDP growth of the Marshall Islands economy has been very low over recent years, averaging only 0.4 percent per annum during the 1991–1993 period. A better outcome was achieved in 1994 with growth at 0.9 percent, much of which was attributable to fishing. In the services sector, which accounts for over two thirds of GDP, there were increases in financial, trade, and telecommunications services and declines in community services, such as health and education. In 1995, GDP growth is estimated to have risen to 1.5 percent and, although no sectoral details are available, indications are that the pattern of change was similar to that in 1994.

The difficult fiscal position of the Government became starkly evident in 1995. Domestic revenue at 32.6 percent of GDP was slightly higher than in 1994 though much in line with experience in earlier years of the decade. Domestic revenue, however, has usually been sufficient to finance only around one third of total expenditure – the principal revenue source being external grants mainly under the terms of the Compact agreement. Such funding has fallen steadily from 65 percent of total revenue in 1991 to 59 percent in 1995 (Figure 2.27).

Total government expenditure in 1995 was 90 percent of GDP, slightly higher than in 1994 but appreciably lower than in the period 1991–1993 when it averaged 106 percent. The brunt of the expenditure compression has been borne by capital expenditure (including net lending) which in 1994 and 1995 averaged some 12 percent of GDP, about half of what it had been over the previous three years. The overall deficit in 1995 at 10.4 percent of GDP was almost the same as in 1994. However, prior to 1995, the Government had been able to finance its overall deficit by external borrowing against the collateral of future Compact funding. Net borrowing in 1994 amounted to 20.7 percent of GDP; half was used to finance the overall deficit and half to build up the Government's external reserves which reached 42 percent of GDP at the end of 1994. Exhaustion of the Government's external borrowing capacity, however, meant that the 1995 deficit had to be financed by drawing on these reserves. In addition, loan repayments equal to 16 percent of GDP had to be met from that source also. The result was a dramatic fall in financial reserves to less than 3 percent of GDP by the end of 1995.

These fiscal difficulties are reflected in the balance-of-payments position for 1995.



A small increase in exports, mainly fish, was matched by a similar rise in imports, leaving the trade deficit at almost the same level as in 1994 at $51 million. With a small positive balance on services, the current account showed a surplus in 1995, equivalent to 5.2 percent of GDP compared with 4.5 percent in 1994. If official transfers are excluded, the current account deficit was about 53 percent of GDP. The main difference from the 1994 outturn was on the capital account. Net debt repayment pushed the overall balance of payments into a deficit of 36 percent of GDP compared with a surplus of 8.4 percent in 1994.

The outlook for the economy is not encouraging. GDP is likely to contract in 1996 as the Government makes a start on the adjustment process. The 1996 budget provides for total revenue, including grants, to be about the same as in 1995 at around 80 percent of GDP. Expenditure is budgeted to fall to 88.4 percent of GDP from about 90 percent in 1995, mainly through cutbacks in capital spending. The consequent surplus equal to nearly 6 percent of GDP will, nevertheless, be insufficient to meet debt repayment obligations, which amount to some 16 percent of GDP. It will therefore be necessary to draw on funds already earmarked for other purposes. Even more drastic reductions in government expenditure are likely to be necessary in 1997 and later years to generate overall surpluses sufficient to meet debt repayment obligations.

The balance-of-payments outlook for the immediate future is also not encouraging. Export earnings are unlikely to improve. Even if reduced government expenditure, increased import duties, and a contraction in GDP lead to a fall in imports in 1996 and 1997, any improvement in the current account is unlikely to be sufficient to cover the capital account deficit arising from debt repayment. Increased support from the international community over the medium term is likely to be required.

Policy and Development Issues

The large and progressive reductions of public expenditure over the next few years that are unavoidable if the Government is to cope successfully with the fiscal and balance-of-payments difficulties it now faces will have profound repercussions throughout the economy. GDP and GDP per capita can be expected to fall for some years to come and, while that in turn will entail a decline in the demand for imports and thus to some extent alleviate the balance-of-payments problem, it will also mean a decline in government revenue and the need for expenditure reduction. Measures to stimulate exports or to encourage import substitution are not likely to have much success, given the country's very limited resource base. The effects of the necessary reduction in public expenditure could, however, be ameliorated by complementary policies to improve public sector efficiency and to enable the private sector to play a greater role in the economy than is currently the case. There are obvious inefficiencies and a waste of resources that need to be addressed. In addition, decision-making capacity needs to be strengthened, and a program of privatization initiated. The structural reform program developed by the Government with the assistance of the ADB-funded Policy Advisory Team addresses these and other relevant issues. The need now is to press ahead with the reform program with utmost speed.