ECONOMIC ANALYSIS
(Republic of the Marshall Islands: Public Sector Program)

A. Summary

1. The Republic of the Marshall Islands (RMI) gross domestic product (GDP) has grown at an average rate of less than 1% per annum in real, per capita terms since independence. Exports are low, and the shallow domestic economy has brought high dependence on imports, which are funded largely by the sale of offshore fishing rights and high levels of foreign aid. Foreign aid funds a very large public sector that dominates the economy. This domination and low productivity in the public sector are key causes of the low rate of economic growth. Efforts made in the late 1990s to reform the public sector were initially successful, but they were not sustained and need to be revisited.[1] Foreign aid is now winding down, and large cuts are scheduled over the long term. Economic prospects are weak in the absence of wide-ranging public sector and economic reform.[2]

B. The Growth Record

2. Steady growth was achieved in the first 10 years of independence (Figure 1). Real GDP per capita expanded by 30% from 1986 to 1995, or an average of 4.4% per annum. This growth reflected the front-loaded transfer of financial assistance under the Compact of Free Association agreed with the United States (US). The compact grants were structured in three 5-year blocks from fiscal year (FY) 1986 to FY2001. The bulk of the transfers were received and spent during the first two 5-year periods to 1995, and a rapid increase in the real value of public expenditure fuelled economic growth over the period. Compact grants then commenced what was termed the step-down. As a result of falling foreign grants, real government expenditure declined and GDP per capita declined by almost 20% in the 6 years to FY2001.

3. Negotiations with the US for a new compact economic assistance package took place from FY2001 to FY2003. During this period, the RMI received annual assistance that was close to the initial high levels. Moreover, rising foreign grants from Taipei,China and the retirement in FY2001 of RMI bonds issued in the early years of the compact further boosted government spending. These factors aided a slow recovery from FY2001 to FY2004. The commencement of transfers under a new compact economic package in FY2004 then extended the recovery. By 2004, GDP per capita was $2,518 in 2000 prices, which was higher than the $2,113 recorded at independence but still below the peak of $2,727 in FY1995.[3] The flow-though effects of the rapid rise in government expenditure sustained economic growth to FY2007. The economy then contracted in FY2008 as high world food and fuel prices pushed inflation to 14.8% and reduced purchasing power. There was no economic growth in 2009.[4]

---

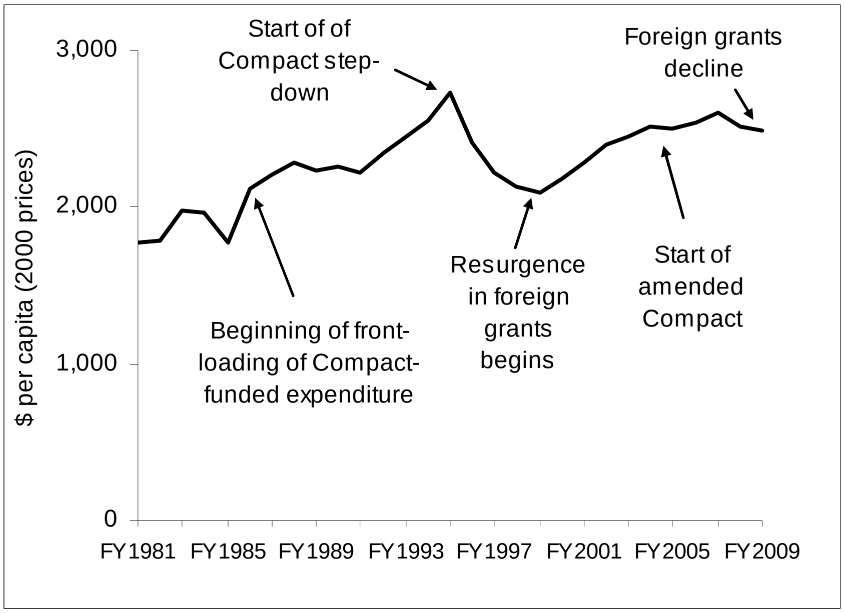
[1] The weaknesses in the public sector are reflected in the RMI's deterioration against the World Bank's indicator for government effectiveness. The RMI's percentile rank of 10 out of 100 in 2008, the latest estimate, compares with 15 in 2004 and 33 in 1998 (http://info.worldbank.org/governance/wgi).

[2] This analysis draws on Pacific Islands Training Initiative. 2009. *RMI Fiscal Year 2008 Economic Review Summary Document.* Honolulu (August); International Monetary Fund. 2009. *Republic of the Marshall Islands—2009 Article IV Consultation, Concluding Statement of the IMF Mission*. Washington; ADB. 2006. *Juumemmej: Republic of the Marshall Islands Social and Economic Report 2005.* Manila; and ADB. 2003. *Republic of the Marshall Islands—A Private Sector Assessment: Promoting Growth Through Reform.* Manila (May).

[3] The RMI's gross national disposal income is substantially higher than real GDP. Changes in income follow similar patterns as does real GDP, and the growth in income has also been low.

[4] Recent economic developments and the outlook are discussed in ADB. 2010. *Asian Economic Outlook 2010*. Manila and ADB. *Pacific Economic Monitor*. various editions.

Figure 1: Real Gross Domestic Product and Income



FY = fiscal year.
Note: Income data are available only from FY1997 to FY2008.
Source: Asian Development Bank estimates based on Economic Policy, Planning and Statistics Office. 2009. *RMI Economic Statistics Tables*. Majuro (August) and IMF. 2010. *IMF Executive Board Concludes 2009 Article IV Consultation with the Republic of the Marshall Islands.* Public Information Notice (PIN) No. 10/30. Washington (February).

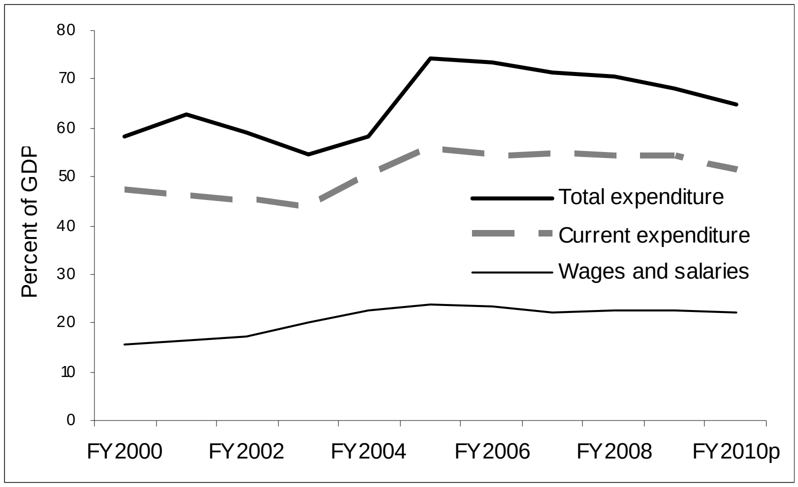
C. The External Position

4. The RMI's exports of goods (mainly copra, coconut oil, fish, and the re-export of petroleum products) and services are modest at around $30 million a year. There has been little success in achieving export expansion and diversification, although fishing, handicrafts, and tourism hold some prospects. Imports of goods and services of about $130 million, the equivalent of 85% of GDP, greatly outweigh exports. The balance of trade on goods and services is typically in deficit on the order of 70% of GDP. This is financed largely by net income and private and official transfers from the sale of access rights to fishing and high levels of foreign aid. As Marshallese have free access to the US labor market, worker remittances have the potential to provide a substantial source of offshore income. However, survey data point to a net outflow in household-to-household remittances.

D. Key Constraints to Economic Growth

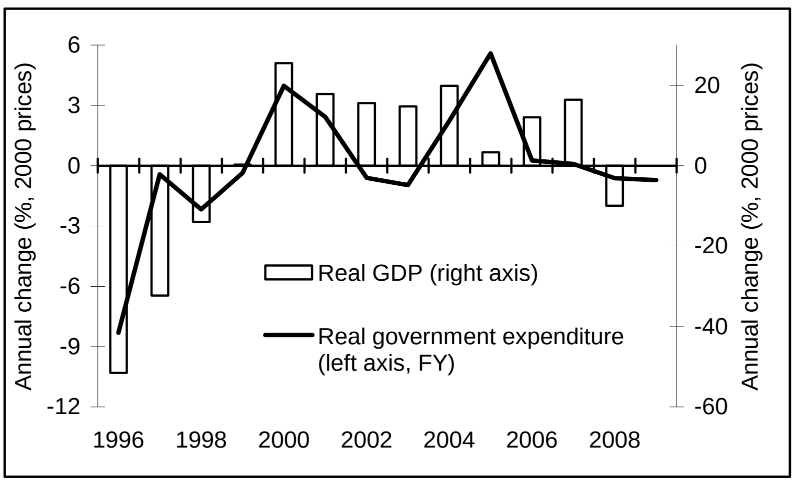
5. The very high level of foreign grants provides important economic and social benefits to the RMI. However, the grants also impose substantial costs because they underpin the public sector's domination of the economy. From FY2000 to FY2010, the ratio of government expenditure to GDP averaged 65% (Figure 2), and the government sector accounted for 37% of wage-and-salary employment. Because government expenditure is so large, variations in government expenditure have a pronounced effect on aggregate demand, employment, and, consequently, annual variations in GDP (Figure 3). As government expenditure cannot grow indefinitely, dependence on government expenditure puts a ceiling on economic growth potential.

Figure 2: The Size of Government



FY = fiscal year, GDP = gross domestic product.
Source: Asian Development Bank estimates based on Economic Policy, Planning and Statistics Office. 2009. *RMI Economic Statistics Tables*. Majuro (August) and IMF. 2010. *IMF Executive Board Concludes 2009 Article IV Consultation with the Republic of the Marshall Islands*. Public Information Notice (PIN) No. 10/30. Washington (February).

Figure 3: Government Expenditure and Economic Growth



FY = fiscal year, GDP = gross domestic product.
Source: Asian Development Bank estimates based on Economic Policy, Planning and Statistics Office. 2009. RMI Economic Statistics Tables, August (Majuro) and IMF. 2010. *IMF Executive Board Concludes 2009 Article IV Consultation with the Republic of the Marshall Islands:* Public Information Notice (PIN) No. 10/30. Washington D.C. (February).

6. Moreover, the public sector has important indirect effects that further undermine prospects for economic growth. The public sector is characterized by excess employment levels and pay rates that diverge from underlying productivity. Average wage and salary rates in the public sector are substantially above those outside the public sector. High public sector pay rates allow the public sector to attract the most productive labor, depriving the private sector of it. High public sector pay rates also create a benchmark wage that the private sector must endeavor to match. But doing so reduces the international competitiveness of the private sector and potential returns from business investment. The result is that growth prospects in existing

private sector activities are dampened and some potentially viable private sector activities fail to emerge.

7. The economy is also adversely affected by the inward-looking effect of dependence on government expenditure. Such an economy dulls the imperative and ability to raise productivity (e.g., through investment in human and physical capital and innovation in production, distribution, and marketing). International experience shows that growth prospects would be enhanced through a more outward-looking, export-led approach.

8. Efforts were made in the mid-1990s to reduce the size of the government and its dominant role in the economy. There was some initial success, as evidenced by a reduction in the number of civil servants from 1,800 in FY1997 to under 1,500 in FY2000. Reform efforts subsequently unwound, however, in part because a resurgence in foreign grants enabled government expenditure to rise. By FY2006, the number of public servants had risen to 2,400 and public sector wages had reached 23.6% of GDP.[5] Government expenditure subsequently stabilized as a percentage of GDP and then eased somewhat, but remained very high. The large government sector weighs down economic growth prospects.

9. A large state-owned enterprise (SOE) sector also constrains the economy. The SOE sector accounts for 7% of wage-and-salary employment and holds assets worth the equivalent of 80% of annual GDP. Yet returns from public investment in SOEs are negative, a result of low productivity and the under-pricing of some goods and services. Substantial subsidies are needed to support SOEs. The result is a very low direct contribution to the economy from them. Low productivity also manifests itself as low service standards in some cases, and this imposes additional constraints on the economy. Moreover, the presence of SOEs and legislated monopolies (e.g., in communications) directly displace the private sector from activities that it is better suited to undertake.

10. As the US dollar is the local currency, RMI policy makers cannot use monetary policy or the exchange rate for economic stabilization or structural purposes. Barriers to flexibility in wage and salary rates, including a legislated minimum wage, and weak links between pay rates and underlying productivity, make it hard for the RMI to adjust to accommodate the erosion of its competitiveness because of a large and inefficient public sector.

10. The RMI's economic prospects are further dulled by a range of other constraints facing the private sector. These include

- (i) the high cost structure arising from small size and remoteness;
- (ii) difficulties in accessing land for development, as traditional land ownership prevails for virtually all land (It is possible to lease land, and access has been improved by recent reforms, but the process is often difficult and carries some risk because of the potential for multiple title holders);
- (iii) underfunding of public infrastructure (see linked document Fiscal Analysis);
- (iv) a poorly developed financial sector and high interest rates, linked in part to the inability to use land as collateral and difficulties in the legal process (A lack of sufficient competition in banking may also inhibit the sector's performance);
- (v) distortions in the tax system; and

---

[5] The experience with the earlier reform program and its unwinding are discussed in ADB. 2006. *Juumemmej: Republic of the Marshall Islands Social and Economic Report 2005.* Manila. Analysis is also provided in ADB. 2009. *ADB Support for Public Sector Reforms in the Pacific: Enhance Results through Ownership, Capacity, and Continuity*. Manila; ADB. 2001. *Special Evaluation Study on Program Lending*. Manila (November); and ADB. 1999. *Reforms in the Pacific: An Assessment of the Asian Development Bank's Assistance for Reform Programs in the Pacific*. Manila.

(vi) weaknesses in the regulatory environment for business (The RMI's overall doing business 2010 ranking was 98 out of 183, near the median.[6] Key impediments include costly and time-consuming requirements for the registration of non-resident labor and import clearances and weak corporate governance regulations for domestic corporations.

E. Economic Outlook

11. US grants are now scheduled to decline every year and to end completely in 2023 (see linked document Fiscal Analysis). The resulting downward pressure on aggregate demand is contributing to a weak economic outlook in the medium to long term in the absence of extensive reform.

Table 1: International Monetary Fund Medium Term Outlook

	FY2009 (est.)	Projections FY2010	FY2011	FY2012	FY2013	FY2014
Real Sector						
Real GDP (percentage change)	0.0	0.5	1.5	1.5	1.5	1.5
Consumer prices (percentage change)	0.5	1.5	2.0	2.5	2.5	2.5
Central Government Finance (% of GDP)						
Revenue and grants	67.9	66.1	64.8	63.5	60.8	60.3
Total domestic revenue	24.0	24.5	24.7	25.0	25.1	25.0
Grants	43.9	41.6	40.1	38.5	35.7	35.3
Expenditure	68.1	64.9	63.3	62.0	59.3	58.8
Current[a]	54.4	51.2	50.1	49.3	47.1	46.8
Capital	13.7	13.7	13.2	12.7	12.2	12.0
Overall balance	(0.2)	1.2	1.5	1.5	1.5	1.5
Compact Trust Fund ($ million, end of period)	97.3	122.3	145.0	169.6	196.4	225.5
Balance of payments ($ million)						
Trade balance	(70.2)	(66.0)	(64.3)	(62.5)	(60.6)	(61.1)
Net services	(35.4)	(33.2)	(32.8)	(32.1)	(31.4)	(31.9)
Net income	33.6	33.6	33.6	33.7	34.1	34.4
Private and official transfers	60.1	57.5	57.5	57.6	55.5	57.0
Current account including official current transfers[b]	(12.0)	(8.2)	(6.0)	(3.3)	(2.5)	(1.7)
Current account excluding official transfers[b]	(66.2)	(59.8)	(57.5)	(54.7)	(51.7)	(52.1)
External debt ($ million, end of period)[c]	94.3	89.9	85.1	80.0	74.4	68.8
percentage of GDP	61.7	57.7	52.7	47.6	42.6	37.9

est. = estimate, FY = fiscal year, GDP = gross domestic product.
[a] In FY2008, a cash advance to the energy utility of $6.75 million is recorded as a subsidy and electricity consumption of $0.76 million is deducted from goods and services.
[b] Official transfers include current transfers but exclude capital transfers and trust fund contributions.
[c] Government and government-guaranteed debt only.
Source: IMF. 2009. *Republic of Marshall Islands—2009 Article IV Consultation, Concluding Statement of the IMF Mission*.Majuro (November) (http://www.imf.org/external/np/ms/2009/111809.htm).

[6] World Bank. 2009. *Doing Business 2010*. Washington.