INTERNATIONAL MONETARY FUND ASSESSMENT LETTER
(Republic of the Marshall Islands: Public Sector Program)

Republic of Marshall Islands – Assessment Letter for the Asian Development Bank
May 3, 2010

Recent Developments and Outlook

1. **The global economic turmoil hit the Marshall Islands hard and led to the first recession in 10 years in 2008**. The economy stabilized in 2009 (0 percent growth) helped by sharply falling domestic food and energy prices, new investment in the fishing sector, and reported increases of remittances. Inflation declined to 0.5 percent in 2009 after reaching 14.7 percent in 2008. The fiscal balance recorded a small deficit of 0.2 percent of GDP, roughly unchanged from 2008.

2. **The economy is on a path to recovery.** IMF staff projects that the economy will grow again in 2010 at a rate of 0.5 percent supported by a further expansion in the fish processing industry and additional foreign grant assistance. The fiscal balance is projected to improve to 1.2 percent of GDP on the back of rebounding tax revenue and expenditure restraint. Risks to the economic outlook remain tilted to the downside. The economy's high import dependence implies that fluctuations in commodity could stoke inflation and stifle domestic demand.

3. **Growth will likely remain subdued over the medium-term.** Potential growth is low and projected to decline. The cresting of foreign grants obtained through the Compact of Free Association with the United States (Compact) reduces public sector activity and constrains domestic demand. Structural impediments hamper investment amidst a challenging business environment. In combination, these factors will limit the underlying growth momentum to 1.5 percent over the medium-term.

4. **The level of gross public debt is high.** Government and government guaranteed debt has been stable at 62 percent of GDP since 2008 and is mostly on concessional terms (40 percent of GDP owed to the Asian Development Bank). The social security and Compact Trust Fund (CTF) suffered significant losses with the collapse in global equity markets, but have largely regained their value by the end of 2009.

Policy Challenges

5. **Achieving long-term economic and fiscal self-sufficiency remains the overarching policy challenge.** The domestic economy depends heavily on income generated from Compact grants which funds the majority of employment and construction projects. The phasing out of foreign grant assistance and low potential growth require decisive policy measures to put the economy on a sustainable growth path.

6. **IMF staff's projections point to significant fiscal underfunding in 2024, when Compact grants expire.** The amended Compact from 2004 introduced a new fiscal

framework, which replaces the grant based budget support with an income stream from a new trust fund starting in 2024. Based on conservative assumptions about economic growth and returns on assets in the CTF, staff estimates a revenue shortfall—the difference between expiring Compact grants and CTF income—of 9 percent of GDP in 2024.

7. **Fiscal sustainability could be achieved through significant fiscal consolidation.** Closing the funding gap in 2024 would require a fiscal surplus of 5 percent of GDP over the medium-term to supplement assets in the CTF. The authorities have recognized this policy challenge and established two reform commissions, the Comprehensive Adjustment Program group, tasked with identifying expenditure reforms, and a Tax and Revenue Reform and Modernization Commission to prepare reform plans. Priority areas for expenditure reductions include the outsized public wage bills and generous subsidies and allowances. Reforms of state owned enterprises are also needed to eliminate losses and raise efficiency. Tax reform should aim to raise additional revenue while improving the efficiency of the tax system.

8. **Unreliable infrastructure services are an obstacle to private sector development.** Public utilities and transportation and telecommunication services are marred by capacity constraints and high service costs. These state owned enterprises are mandated to provide services to remote parts of the country and often do not receive adequate compensation draining resources from commercially viable operations. As a result, the cost of doing business remains high and undermines the development of a private business sector, especially in tourism and the fishing sector. On the positive side, the installation of a new fiber optic cable link to global communication networks should provide important improvements in the efficiency of telecommunication and internet services.

9. **The contribution of the financial sector to private sector growth is limited.** Banks primarily lend to consumers with little impact on economic development, while high household indebtedness poses a risk to banks' balance sheets. Commercial lending is hampered by poor business practices and limitations on the use of land as collateral due to a lack of transferable property rights. A new secured transactions act for moveable property has alleviated some of these constraints. Interest rates have however remained high, limiting the development of new private activities.

Table 1. Marshall Islands: Basic Data, FY2004–10 1/

Nominal GDP (2008):	US$ 152 million
Population (2008):	53,033
GDP per capita (2008):	US$ 2866
Quota:	SDR 3.5 million

					Est.	Est.	Proj
	2004	2005	2006	2007	2008	2009	2010
Real sector							
Real GDP (percent change)	4.0	0.7	2.4	3.3	-2.0	0.0	0.5
Consumer prices (percent change)	2.0	3.5	5.3	2.6	14.7	0.5	1.5
Central government finances (in percent of GDP)							
Revenue and grants	57.1	70.9	74.8	71.7	70.4	67.9	66.1
Total domestic revenue	25.1	25.6	25.1	25.5	25.7	23.9	24.5
Grants	32.0	45.3	49.6	46.1	44.7	43.9	41.6
Expenditure	58.4	74.2	73.4	71.4	70.6	68.1	64.9
Current	50.1	55.9	54.2	54.4	58.5	54.3	51.2
Capital	8.4	18.4	19.3	17.0	12.2	13.8	13.7
Overall balance	-1.3	-3.4	1.3	0.2	-0.2	-0.2	1.2
Compact Trust Fund (in millions of US$; end of period)	32.0	48.9	63.1	85.5	75.7	97.3	122.3
Commercial banks (in millions of US$) 2/							
Foreign assets	51.0	53.6	57.6	60.7	57.1	61.7	...
Private sector claims	43.4	43.6	43.2	49.9	58.2	61.2	...
Total deposits	74.9	74.3	75.5	85.5	89.0	91.8	...
One-year time deposit rate (in percent)	2.1	3.5	4.0	4.1	3.6	6.0	...
Average consumer loan rate (in percent)	17.4	18.5	18.5	18.5	18.5	13.9	...
Balance of payments (in millions of US$)							
Trade balance	-59.9	-68.5	-74.6	-73.8	-74.9	-71.0	-70.6
Net services	-22.1	-27.0	-27.6	-30.9	-32.1	-31.7	-31.3
Net income	32.2	35.0	36.4	34.4	31.8	30.5	30.5
Unrequited transfers (private and official)	45.9	52.1	55.5	63.2	63.0	60.1	57.5
Current account including official current transfers 3/	-3.8	-8.4	-10.3	-7.1	-12.2	-12.1	-13.9
(In percent of GDP)	-2.8	-6.1	-7.1	-4.7	-8.0	-7.9	-8.9
Current account excluding budget grants 3/	-43.8	-54.3	-59.8	-60.7	-69.4	-66.4	-65.5
(In percent of GDP)	-32.9	-39.2	-41.3	-40.2	-45.7	-43.4	-42.0
External debt (in millions of US$; end of period) 4/	94.7	92.1	99.7	98.5	94.3	89.9	85.1
(In percent of GDP)	71.1	66.4	69.0	65.2	62.0	58.9	54.6
External debt service (in millions of US$)	3.8	4.5	6.9	16.2	7.8	12.2	13.1
(In percent of exports of goods and services)	15.5	16.0	36.4	72.6	31.5	59.3	59.7
Exchange rate							
Real Effective Exchange Rate (2000 =100)	94.6	94.5	97.0	96.5	102.8	104.6	...
Memorandum Item:							
Nominal GDP (in millions of US$)	133.3	138.6	144.6	151.0	152.0	152.8	155.8

Sources: Data provided by the Marshallese authorities; and IMF staff estimates.

1/ Fiscal year ending September 30 unless otherwise stated.
2/ 2009 data are the average of three quarters.
3/ Official transfers include current transfers but exclude capital transfers and Trust Fund contributions.
4/ Includes government and government-guaranteed debts.