INTERNATIONAL MONETARY FUND

IMF Country Report No. 18/270

REPUBLIC OF THE MARSHALL ISLANDS

September 2018

2018 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR REPUBLIC OF THE MARSHALL ISLANDS

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2018 Article IV consultation with Republic of the Marshall Islands, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its September 5, 2018 consideration of the staff report that concluded the Article IV consultation with the Republic of the Marshall Islands.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 5, 2018, following discussions that ended on May 28, 2018, with the officials of the Republic of the Marshall Islands on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 10, 2018.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and International Development Association (IDA).
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for the Republic of the Marshall Islands.

The document listed below has been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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INTERNATIONAL MONETARY FUND

COMMUNICATIONS DEPARTMENT

Press Release No. 18/342
FOR IMMEDIATE RELEASE
September 10, 2018

International Monetary Fund
700 19th Street, NW

IMF Executive Board Concludes 2018 Article IV Consultation with the Republic of the Marshall Islands

On September 5, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of the Marshall Islands.

The Republic of the Marshall Islands (RMI) is a small and remote country in the Northern Pacific with a dispersed population. RMI is vulnerable to climate change because of its low elevation, and it has experienced natural disasters such as droughts and floods repeatedly. The RMI economy is highly dependent on external aid.

Growth in the Marshallese economy is estimated to have accelerated to about 3½ percent in FY2017 (ending September 30) with a strong pick-up in fisheries and construction, with the latter due to the resumption of infrastructure projects. Consumer prices started to rise again in mid-2017, with annual CPI inflation at 1.1 percent in 2017Q4. Despite rising fishing license fee revenue, the overall fiscal surplus is estimated to have narrowed to 3 percent of GDP in FY2017 because of continued increases in recurrent spending.

Growth is expected to remain robust at about 2½ percent in FY2018 and about 1½ percent over the medium term, underpinned by further increases in infrastructure spending. Inflation is expected to rise gradually to around 2 percent over the medium term. The fiscal surplus is projected to narrow further to 1¾ percent of GDP in FY2018 and turn into a deficit of 1½ percent by FY2023, as government spending is expected to continue growing strongly while fishing license revenues remain stable in nominal terms.

The RMI's only domestic commercial bank is at risk of losing its last U.S. dollar correspondent banking relationship (CBR) with a U.S.-based bank as a result of heightened due diligence by banks in the U.S. In addition, RMI plans to issue a decentralized digital currency as a second legal tender in addition to the U.S. dollar and the relevant law was enacted in February 2018.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment[2]

Executive Directors welcomed the rebound of economic activity but noted that Republic of the Marshall Islands continues to face significant challenges, including those arising from the scheduled decline in the U.S. Compact grants and weather-related events. Directors underscored the importance of sound macroeconomic policies to safeguard financial stability, ensure long-term fiscal sustainability, reduce vulnerabilities, and promote sustainable growth.

Directors encouraged the authorities to be cautious about issuing a decentralized digital currency as a second legal tender and carefully consider the macroeconomic and financial stability risks. They noted that the potential benefits from revenue gains could be considerably smaller than the potential costs arising from economic, reputational, and governance risks. Directors commended the progress made in addressing correspondent banking relations risks. They emphasized the need for additional steps to strengthen the AML/CFT framework, including the successful completion of the national risk assessment and the subsequent development of an action plan. In addition, they recommended that the AML/CFT framework should be compliant with the FATF standards and cover the offshore and maritime registries. Directors also called for further steps to enhance the banking supervision framework.

Directors emphasized that fiscal consolidation over the medium term is key to reduce risks to long-term fiscal sustainability. They recommended a multi-pronged strategy, including reversing the recent increase in recurrent spending and improving revenue administration and implementing tax reform. Directors noted that accelerating the pace in implementing reforms of the medium-term fiscal framework and public financial management will help in achieving the needed fiscal adjustment.

Directors emphasized the need for continued efforts to adapt to climate change, including by strengthening the early disaster warning system and improving coastal protection and planning. They noted that the explicit budgeting of climate-change adaptation costs would help ensure continuity in project implementation.

Directors emphasized that structural reforms are needed to promote sustainable growth. They recommended implementing the planned state-owned enterprises (SOEs) reform, in particular reducing subsidies to SOEs that are not justified by the provision of the essential community services. This would help the fiscal consolidation efforts and could free up resources for other purposes.

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Marshall Islands: Selected Economic Indicators, FY2014–2023 1/

Nominal GDP for FY2016 (in millions of U.S. dollars): 196.3
Population (2016): 54,153
GDP per capita for FY2016 (in U.S. dollars): 3624.3
Quota: SDR 3.5 million

	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
				Est.	Proj.					
Real sector										
Real GDP (percent change)	-0.5	-0.6	2.0	3.6	2.5	2.3	2.2	2.0	1.8	1.6
Consumer prices (percent change)	1.1	-2.2	-1.5	0.0	1.4	1.5	1.7	1.8	1.9	2.0
Central government finances (in percent of GDP)										
Revenue and grants	52.6	59.9	62.3	68.0	64.0	64.1	64.1	63.7	63.5	63.4
Total domestic revenue	23.6	27.5	32.2	38.4	31.0	30.5	29.9	29.4	29.0	28.7
Grants	29.1	32.4	30.1	29.6	33.0	33.6	34.1	34.2	34.5	34.7
Expenditure	49.4	57.0	58.4	65.1	62.2	63.1	63.9	64.1	64.3	64.6
Expense	46.5	53.2	55.2	57.4	53.8	53.8	53.9	53.7	53.6	53.6
Net acquisition of nonfinancial assets	2.9	3.8	3.1	7.6	8.4	9.3	10.0	10.4	10.7	11.1
Net lending/borrowing	3.2	2.8	4.0	3.0	1.8	1.0	0.1	-0.4	-0.8	-1.3
Compact Trust Fund (in millions of US$; end of period)	240.1	247.1	294.5	356.9	393.7	432.9	474.5	518.6	565.5	615.3
Balance of payments (in percent of GDP)										
Current account balance 2/	-1.2	15.0	7.6	-0.3	-0.6	-1.0	-1.9	-2.7	-3.0	-3.1
Good and service balance	-58.3	-55.5	-56.3	-56.5	-56.2	-56.2	-56.3	-56.3	-56.1	-55.9
Primary income	26.5	38.3	33.2	29.6	29.8	29.6	29.1	28.6	28.3	28.0
o/w fishing license fee	8.9	13.4	12.3	11.5	11.1	10.8	10.4	10.1	9.8	9.6
Secondary income	30.6	32.2	30.7	26.6	25.9	25.6	25.3	25.0	24.9	24.7
o/w compact current grants	15.7	18.3	16.4	14.7	14.5	14.0	13.6	13.1	12.7	12.4
o/w other budget and off-budget grants	13.4	13.0	13.6	11.0	10.9	11.2	11.4	11.6	11.9	12.2
Current account excluding current grants	-30.3	-16.3	-22.4	-25.9	-25.9	-26.2	-26.9	-27.4	-27.6	-27.7
External PPG debt (in millions of US$; end of period) 3/	94.6	89.0	83.5	78.4	73.4	67.5	65.4	63.8	63.0	63.4
(In percent of GDP)	51.1	49.1	42.5	35.2	31.9	28.4	26.6	25.1	24.2	23.7
Exchange rate										
Real Effective Exchange Rate (2010 =100)	102.7	102.2	99.9	98.8	…	…	…	…	…	…
Memorandum Item:										
Nominal GDP (in millions of US$)	185.2	181.3	196.3	222.3	229.9	237.7	245.8	253.8	260.7	267.4

Sources: RMI authorities; and IMF staff estimates and projections.

1/ Fiscal year ending September 30.
2/ Includes current grants.
3/ In this table, it is assumed that RMI will continue to benefit from its grant-only status. On the other hand, in the LIC-DSA, for World Bank (IDA) and other MDBs, regular credit terms on all lending is assumed for all years in the projection period for which grant finance has not already been committed. This is because the DSA serves to test a country’s capacity to take on WB and ADB financing on credit terms.

INTERNATIONAL MONETARY FUND

REPUBLIC OF THE MARSHALL ISLANDS

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

August 10, 2018

KEY ISSUES

Outlook and Risks. The economy rebounded in FY2016 after a two-year recession, and growth is expected to remain robust driven by continued infrastructure investment. Overall risks remain tilted to the downside. The issuance of a decentralized digital currency as a second legal tender would increase macroeconomic and financial integrity risks, and elevate the risk of losing the last U.S. dollar correspondent banking relationship. Insufficient fiscal consolidation before the reduction of the U.S. Compact grant after FY2023 remains the main medium- to long-term risk.

Key Policy Recommendations

- **Digital currency.** The potential benefits from revenue gains appear considerably smaller than the potential costs arising from economic, reputational, AML/CFT, and governance risks. In the absence of adequate measures to mitigate them, the authorities should seriously reconsider the issuance of the digital currency as legal tender.
- **Financial sector.** Continued efforts are needed to further strengthen the AML/CFT framework and enhance financial sector supervision to lower the risk of losing the last U.S. dollar correspondent banking relationship.
- **Fiscal.** A gradual fiscal adjustment of about 4 percentage points of GDP over the next five years is needed to reduce risks to long-term fiscal sustainability after the reduction of the U.S. Compact grant. Multi-pronged efforts are required to achieve the needed medium-term fiscal adjustment by reversing the recent increase in recurrent spending, improving revenue administration, and implementing tax reform.
- **Climate change.** Continued efforts are needed to adapt to climate change, including by strengthening the early disaster warning system and improving coastal protection. Explicit budgeting of climate-change adaptation costs would help ensure continuity in project implementation.
- **State-owned enterprise (SOE) reform.** The planned SOE reforms should be implemented to reduce subsidies to SOEs that are not justified by the provision of the essential community services.

Approved By
Thomas Helbling and Johannes Wiegand

Discussions took place in Majuro during May 15–28, 2018. The team comprised Mr. Joong Shik Kang (head, APD), Ms. Mareta Kaiteie, Mr. Kazuaki Miyachi, Ms. Huan Zhang (APD), Ms. Nadine Schwarz (LEG), and Ms. Leni Hunter (Resident Representative in Fiji), joined by Mr. Gwibeom Kim (OED). Representatives from the World Bank and the Asian Development Bank also participated in the mission. The mission met with the Minister of Finance Mr. Brenson Wase, the Minister in Assistant to the President Mr. David Paul, other senior government officials, and private sector representatives.

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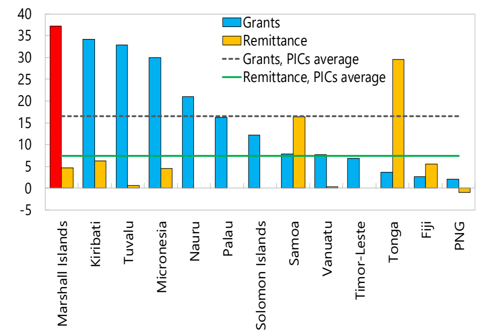
BACKGROUND

1. The Republic of the Marshall Islands (RMI) is a small and remote country in the Northern Pacific with a dispersed population. RMI is vulnerable to climate change because of its low elevation, and it has experienced droughts and floods repeatedly. The economy is highly dependent on external aid, with annual grants averaging about 35 percent of GDP over the past decade. RMI's policy priorities have been to prepare for a reduction in the U.S. Compact grant after FY2023 (about 10 percent of GDP), to adapt to climate change, and to promote sustainable growth.

Grants and remittances, 2016
(In percent of GDP)



Sources: IMF, latest Article IV Staff Reports; and staff calculations.

2. RMI's connections to the global financial system are at risk. The country has one domestic commercial bank, Bank of Marshall Islands (BOMI), which is at risk of losing its last U.S. dollar correspondent banking relationship (CBR) with a U.S.-based bank as a result of heightened due diligence by banks in the United States. The CBR is currently renewed every year, conditional on progress in improving the anti-money laundering and combatting the financing of terrorism (AML/CFT) framework (Selected Issues Paper 1). In addition, RMI plans to issue a decentralized digital currency as a second legal tender in addition to the U.S. dollar and the relevant law was enacted in February 2018 (Selected Issues Paper 2).

DEVELOPMENTS, OUTLOOK AND RISKS

A. Recent Developments and Outlook

3. The economy rebounded in FY2016 and momentum accelerated in FY2017, driven by public investment. Real GDP growth is estimated to have accelerated to about 3½ percent in FY2017, with a fall in copra production more than offset by the strong pick-up in fisheries and infrastructure projects, with the latter due to the resumption of U.S. capital grants. Growth is expected to remain robust relative to the historical norms in the near term, at about 2½ percent in FY2018 and about 1½ percent over the medium term, underpinned by gradual increases in infrastructure spending. Consumer prices started to rise again in mid-2017, with annual CPI inflation at 1.0 percent in 2018Q2. Inflation is expected to rise gradually to around 2 percent over the medium term.

4. The overall fiscal surplus narrowed despite large fishing license fees (Box 1). Government revenue from fishing licenses (including a one-off transfer of reserves from the Marine Resources Authority) increased significantly, from 6¼ percent of GDP in FY2014 to 18 percent in FY2017. But the overall fiscal surplus is estimated to have narrowed by ¼ percentage point to 3 percent of GDP during this period, given strong increases in recurrent spending, in particular purchase of goods and services and subsidies. The fiscal surplus is projected to narrow further to

1¾ percent of GDP in FY2018 and turn into a deficit of 1½ percent by FY2023, as government spending is expected to continue growing strongly, particularly on goods and services, while fishing license revenues remain stable in nominal terms.

5. The current account has shown large swings in recent years. Surging fishing license fees and the temporary hold on Compact grant-funded infrastructure projects saw the current account surplus widen to 15 percent of GDP in FY2015, before narrowing to 7½ percent in FY2016 because of the resumption of infrastructure-related imports. The current account balance is estimated to have turned into a small deficit in FY2017 and is projected to widen to about 3½ percent of GDP in the medium term, as infrastructure-related imports should continue to rise while fishing license fee income should remain stable in nominal terms. Such a deficit in the medium-term projection can reasonably be expected to be financed by concessional financing from donors and investment earnings from the Compact Trust Fund (Appendix I). On this basis, the external sector position is assessed to be broadly in line with underlying fundamentals and desirable policy settings, but it remains vulnerable to risks arising from possible problems with the fiscal adjustment to lower Compact grants, unresolved AML/CFT issues, and the planned issuance of digital currency (Appendix II). However, the possible margin of error in this assessment is large, given data limitations and special circumstances, especially the large expected structural change in external financing in FY2024 due to substantially lower U.S. Compact grant flows.

B. Risks and Spillovers

6. Overall risks remain tilted to the downside (Appendix III). In the absence of adequate risk-mitigating measures, the issuance of a decentralized digital currency as a second legal tender would not only increase macroeconomic and financial integrity risks but elevate the risk of losing the last U.S. dollar CBR. If RMI's only domestic bank lost its last U.S. dollar CBR, external aid and other flows could be disrupted, which would result in a significant drag on the economy. Insufficient fiscal consolidation is the main medium- to long-term risk to growth. Government spending would need to be curtailed to maintain fiscal sustainability after FY2023. Alternatively, if the government resorted to additional external financing, external debt distress risks, which is already high as indicated by DSA analysis, would rise further, putting growth at risks because of repercussions on external financing.[1] Extreme weather-related events also remain a downside risk to the economy. On the upside, decisive SOE reforms, if combined with well-managed large infrastructure projects, could raise potential growth. Because of its limited international linkages other than those to the U.S. via the Compact agreement, RMI remains insulated from spillovers from external developments.

The Authorities' View

7. The authorities broadly agreed with staff's assessment of the economic outlook. A strong pick up in fisheries activity also contributed to strong growth in FY2017. The pickup is

[1] RMI remains at a high risk of debt distress as new disbursements from WB and ADB are assumed to be in credit terms despite its grant-only status. To a large extent the high risk of debt distress, therefore, is by design, as the DSA serves to test a country's capacity to take on WB and ADB financing on credit terms.

expected to be temporary, and growth is expected to moderate to robust levels in FY2018, supported by continued strength in the construction sector. The authorities also expect that, over the medium term, infrastructure projects funded by the U.S. and other development partners will be the main driver of growth. They agreed that foreign grants would continue to provide stable funding for large current account deficits (excluding grants).

8. The authorities saw the grant revenue loss after FY2023, the potential U.S. dollar CBR loss, and climate change as the main risks to the outlook. They noted that the planned reduction of the U.S. Compact grant after FY2023 created significant economic uncertainty, leading them to explore new revenue sources, including the issuance of a digital currency as a second legal tender. The authorities agreed that the potential loss of the remaining U.S. dollar CBR would have a strong negative economic impact although RMI could still be connected to global financial system through a branch of a foreign bank and an Australian dollar CBR. The frequency of extreme weather episodes due to climate change has increased in recent years with adverse effects on the economy.

PROTECTING FINANICAL STABILITY

A. Avoiding Risks from Issuing a Digital Currency as Legal Tender

9. RMI has recognized a decentralized digital currency ("SOVEREIGN" or "SOV") to be issued by a third party as a second legal tender in addition to the U.S. dollar. A foreign private company—an Israel-based start-up with limited financial sector experience—will be in charge of the issuance and receive half of the initial SOV issuance. The authorities expect sizeable revenue gains from the other half of the SOV issuance, which would help prepare for the reduction of U.S. Compact grant after FY2023: 20 percent of the initial coins accruing to RMI will be distributed to the resident RMI citizens to jump-start the use of the SOV, while the rest of initial coins will be allocated to trust funds to supplement the current Compact Trust Fund, support citizens who were affected by the previous U.S. nuclear tests, and finance infrastructure projects. As a first step, a law was passed in February 2018 to recognize the SOV as second legal tender, signal the RMI's strong commitment, and help the foreign private company secure the financing needed for the development of the technology for the new digital currency.

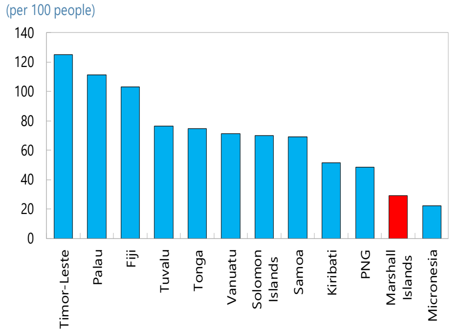
10. The issuance raises serious economic, reputational, AML/CFT, and governance risks.

- *Unless strong AML/CFT measures are implemented, the issuance of the SOV, as contemplated, will elevate the already high risks of losing the last U.S. dollar CBR.* The law requires that all users of the SOV undergo standard "Know Your Customer (KYC)" procedures and that their identity be recorded on the blockchain. However, neither the content of the "standard KYC procedures," nor the modalities of their implementation have been established. In addition, other key measures such as transaction monitoring, reporting of suspicious transactions, compliance monitoring, and sanctioning of compliance failures are not addressed. In light of the potential for digital currencies to be misused for money laundering and terrorist financing (ML/FT) purposes, the issuance of the SOV without effective implementation of comprehensive AML/CFT measures could offset recent progress in strengthening the AML/CFT framework, leading to increased scrutiny from the AML/CFT standard setter and potential countermeasures, including, possibly, the immediate loss of the CBR.

- *SOV issuance in the currently planned form and in the absence of a monetary policy framework could also result in monetary instability and pose significant challenges to macroeconomic management.* The SOV will, by design, be an international currency and subject to large volatility in its exchange rates.[2] The challenges would be amplified by the planned distribution of SOVs to citizens, which would be equivalent to a monetary expansion through "helicopter money." Depending on the exchange rate of the SOV against the U.S. dollar at the time of distribution, the implied transfer of purchasing power could be significant and require a sizable reduction in other government spending to prevent an unsustainable increase in aggregate demand.[3] And as the SOV can be used to settle debts and taxes, the government and banks could experience adverse balance sheet effects and face U.S. dollar liquidity risks under currency convertibility.[4]

- *The SOV also raises cybersecurity and other operational risks*. In the case of the SOV, these risks are compounded by the fact that the development and management of the SOV protocol are outside of the authorities' control and in the hands of a foreign private company. In addition, the dual role of issuer and private investor bestowed to that company creates a significant conflict of interest. The limited telecommunication infrastructure in RMI will likely be an obstacle to the SOV becoming a widely used medium of exchange for some time.

Mobile cellular subscriptions
(per 100 people)



Notes: 2015 data for Palau and Marshall Islands; 2016 for remaining countries.
Sources: World Bank, *World Development Indicators*.

11. Considering the significant risks, staff recommends that the authorities seriously reconsider the issuance of the digital currency as legal tender. The potential benefits from revenue gains appear considerably smaller than the potential costs arising from economic, reputational, AML/CFT, and governance risks. While technology may help to address some of these risks, others would need to be mitigated through institutional changes. Furthermore, the use of the SOV as a means of exchange in transactions would require significant additional costs to upgrade the RMI's telecommunication infrastructure.

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[2] The SOV is not equivalent to a central bank digital currency, which is a digital form of the central bank's liability (cash and reserves) because RMI uses the U.S. dollar as a legal tender and the SOV's exchange rates would be determined on global cryptocurrency exchanges.

[3] For example, if the SOV was issued at the price of about $50 as targeted at the Initial Coin Offering and distributed to resident RMI citizens as planned, it would be equivalent to a transfer to households of about 11 percent of GDP per year over the next five years.

[4] The liquidity backstop to guard against potential liquidity problems is limited in the absence of deposit insurance and small government deposits. However, with a loan-to-deposit ratio of less than 60 percent, the Bank of Marshall Islands holds a substantial share of its asset abroad, which could help boost liquidity should such pressures arise.

The Authorities' View

12. While acknowledging the risk from issuing the SOV, the authorities were confident that advanced technology would provide for sufficient risk mitigation. They anticipated that the risks of the SOV being misused for ML/TF purposes will be sufficiently mitigated by the fact that the identity of the SOV users will be recorded on the blockchain and that the SOV could only be traded through global cryptocurrency exchanges approved by the RMI government. They also added that the risks of monetary instability would be limited by a mechanism which will automatically adjust the SOV supply to prevent excessive price volatilities. The authorities noted that the SOV would only be issued once the planned issuance and use of the SOV are deemed to comply with Financial Action Task Force (FATF) standard and U.S. regulations and its use in transactions in the U.S. financial system has been approved by the U.S. government (as in the case of other countries' fiat currencies). The authorities also added that they would shift their focus to addressing challenges to macroeconomic management at later stage. Considering all of these preparations, they expected it would take few years to issue the SOV. They noted that there would be no financial costs for the RMI because the Act explicitly provides that the costs related to the issuance of the SOV are to be borne by the foreign private company.

B. Enhancing Financial Sector Supervision to Address CBR Risks

13. Good progress has been made in address CBR risks. The authorities have amended the Banking Act, with a view to align the AML/CFT provisions with the FATF 40 recommendations and have started the first national risk assessment with World Bank support. The Banking Commission is re-establishing a framework for prudential banking supervision in line with international standards. The Commission is also undertaking a regulatory reform project for banking legislation and prudential standards, with assistance from PFTAC. The BOMI (only domestic commercial bank) also continues to strengthen its own AML/CFT framework by instituting additional controls, including through an AML/CFT software upgrade, and is undertaking an independent audit of its AML/CFT system. As an alternative arrangement to CBR, the authorities also support the domestic bank's effort to obtain U.S. Federal Reserve's approval for establishing a clearing house in Hawaii to gain direct access to check-clearing and wire transfer services in the U.S.

14. Maintaining the U.S. dollar CBR is very important for the RMI because the country uses the U.S. dollar as its legal tender and is highly dependent on receiving and spending U.S. grants. To address the country's ML/TF risks arising from the presence of offshore and maritime registries, the authorities amended the Association Law in November 2017, which notably require that reasonable measures be taken to identify the beneficial owners of legal persons established in the RMI and to register bearer shares. However, despite these efforts, the country's reputational risks remain elevated, notably due to ongoing concerns related to the offshore and maritime registries and the implementation of the amendments to the Association Law, as well as to tax transparency.

15. Staff recommends that the authorities take additional steps to lower further the risk of losing the last U.S. dollar CBR, irrespective of the issuance of the SOV.

- *AML/CFT*. Once the national risk assessment is completed, an action plan should be developed to address the main risks identified. Domestic capacity in the AML/CFT area should be strengthened, building on the technical assistance of international organizations. Since the offshore and maritime sectors still present ML/TF risks, staff recommends imposing AML/CFT obligations on both relevant registries, as well as ensuring that requirements aimed at increasing transparency of beneficial ownership of legal persons are duly implemented (including with respect to existing legal persons and bearer shares issued prior to November 2017) and that competent authorities have timely access to up-to-date beneficial ownership information of non-resident companies.
- *Banking supervision.* Staff recommends enhancing the prudential banking supervision framework further, including by complying with the relevant international standards and introducing prudential requirements covering key banking risk areas, and strengthen its implementation. Regularizing offsite supervision and the banking sector report production are needed to monitor banking sector developments and take timely actions if needed. The introduction of a ceiling on the debt service ratio would help control the already high and rising household debt, which is mostly consumer credit and amounts to about 40 percent of GDP.
- *Cooperation.* The communication with the last U.S. dollar correspondent bank as well as U.S. regulators should be further enhanced, as the potential issuance of the digital currency could increase the ML/FT risk profile of the country.

The Authorities' View

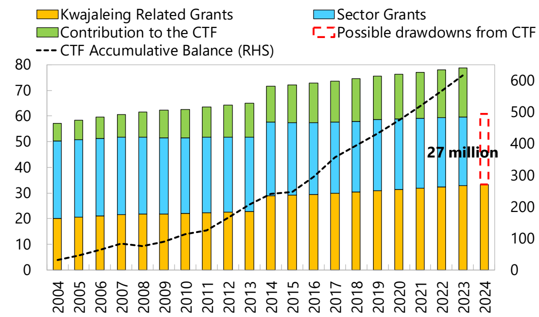
16. The authorities agreed on the need to further strengthen financial supervision and regulation. They noted that the framework for onsite and offsite AML/CFT supervision of financial institutions was strengthened with the assistance of technical assistance providers. The BOMI was recently inspected and found to have put in place the main pillars for effective AML/CFT controls. These developments, as well as the progress made in other areas (such as the strengthening of the financial intelligence unit's technical expertise and the new requirements to identify the beneficial owners of offshore companies) helped eased the short-term risk of losing the last U.S. dollar CBR. However, the authorities noted that the enactment of the law on the digital currency in February 2018 had unexpectedly increased the country's risk profile and acknowledged the risk of the CBR not being renewed if the digital currency is issued without adequate AML/CFT measures in place.

SECURING LONG-TERM FISCAL SUSTAINABILITY

17. The Compact Trust Fund (CTF) was set up in FY2004 to compensate for the expiring portion of the U.S. Compact grant after FY2023 (Appendix I). The CTF assets amounted to US$357 million (203 percent of GDP) as of the end of FY2017, with contributions mostly from donors (U.S. and Taiwan Province of China), and they are projected to reach US$615 million (230 percent of GDP) by the end of FY2023. The design of the Fund is such that the expected investment earnings will replace the expiring portion of the U.S. Compact grant after FY2023, although it does not provide for real value preservation.

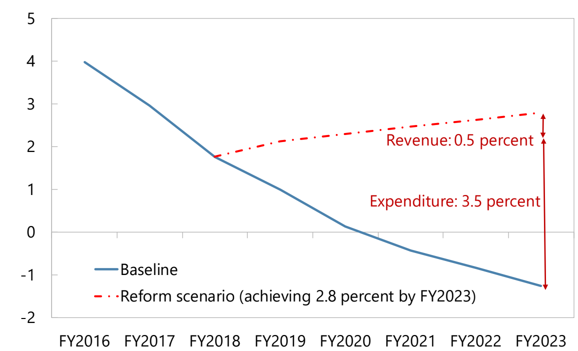
18. With fiscal adjustment of 4 percentage points of GDP relative to the baseline by FY2023, real value preservation for the CTF could be achieved and risks to long-term fiscal sustainability be reduced. Reinvesting a portion of the investment earnings rather than using them for revenue purposes would be sufficient to achieve real value presentation. But drawing on 3 percent of the CTF assets annually rather than the full investment return of 5 percent would require a fiscal surplus of 2½ percent of GDP (US$7 million) by FY2023 to absorb the revenue loss implied by the expiring U.S. Compact grant (US$27 million, 10 percent of GDP). Without this adjustment, the government would have to count on additional external financing to maintain government spending on the baseline path, putting long-term fiscal sustainability at risk.

US Annual Compact Grants and Contribution to CTF
(In USD million)



Note: All the grants are based on original agreement, and adjusted for inflation.
Sources: Country authorities and IMF staff estimates.

Fiscal Balance Path
(In percent of GDP)



Sources: Authorities and IMF staff calculations

19. Staff recommends multi-pronged efforts to achieve the needed medium-term fiscal adjustment. In particular, in the order of priority, the authorities should reverse the recent increase in recurrent spending (3½ ppt) while improving revenue administration and implementing tax reform (½ ppt).

- *Expenditure compression.* Staff strongly supports the government's initiative to lower recurrent spending, including costs of travel, supplies and personnel while preserving spending on health and education. The recently proposed ceilings for ministries' recurrent spending (yet to be approved by the Cabinet) should play a key role to discipline the total expenditure throughout the budgeting process.

- *Revenue administration.* Staff welcomes recent progress in improving registration, filing, and payment voluntary compliance. Staff recommends further efforts to enhance tax administration, with PFTAC support, including (i) further improving the information exchange between Social Security Administration and the government to increase taxpayer registration, (ii) improving return and payment collection processes, and (iii) strengthening tax audits.

- *Tax reform.* The authorities should enact the tax reform bill, which includes (i) reforming the personal income tax; (ii) introducing a net profits tax; (iii) introducing a consumption tax to replace the gross revenue tax; and (iv) replacing the existing import duties with excise taxes. Although the reform package is expected to be revenue neutral, its less-distortionary and growth-friendly measures including the introduction of a consumption tax and a net profit tax could help promote inclusive growth and bring additional revenues from efficiency improvement. The authorities should continue increasing implementation capacity in this area in cooperation with international institutions, including PFTAC.

20. In addition, given that the needed adjustment entails multiple years, accelerating the pace of medium-term fiscal framework (MTFF) and public financial management (PFM) reforms will help implement the needed fiscal adjustment.

- *MTFF*. Staff welcomes the government's effort to prepare a multi-year budget framework and recommends further refinements to the framework (with PFTAC assistance), including improving estimates of baseline revenues and introducing a new template for ministries' budget submissions that classifies expenditure by output and expenditure type.
- *PFM.* Staff encourages continued efforts to improve PFM in priority areas: the legal and policy framework, the budgeting framework, the accounting system, fiscal reporting, and cash management. Debt management function also needs to be strengthened given the growing appetite for project loans.
- *Social security*. Staff welcomes the recent reform, including the gradual increase of the retirement age to 65 and the increase of the contribution rate by 1 percent, which is expected to generate annual savings of more than US$4 million (2 percent of GDP). More ambitious reform, in particular further reduction in benefits, is needed as the remaining annual financing gap of about US$3 million will further widen over the medium to long term (Box 2).

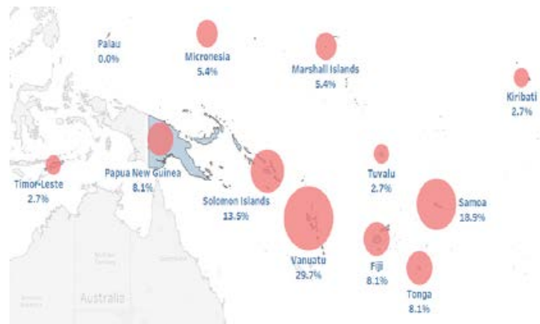
The Authorities' View

21. The authorities broadly agreed that fiscal adjustment of 4 percentage points of GDP by FY2023 was needed to be prepared for the reduction of the U.S. Compact grant. They acknowledged that the fiscal balance had not improved in recent years despite the large revenue gains from fishing license fees, and agreed that the fiscal balance would deteriorate over the medium term if recurrent spending was not contained. They also noted that even larger adjustment might be required if negative shocks were to materialize, including natural disasters. The authorities underscored, however, that important progress in fiscal reforms had been made, including a long-awaited social security reform. They stressed that more reforms would be undertaken, including improving revenue mobilization and PFM, and growth-friendly tax reforms, while they would also seek additional donor contributions to the CTF.

ADAPTING TO CLIMATE CHANGE

22. RMI is one of the countries expected to be most affected by climate change. The vulnerability arises from the exposure to rising sea levels, given its low elevation, and to natural disaster such as droughts and floods. Historical data on natural disasters from the Emergency Events Database indicate that the average likelihood of a severe natural disaster is 5.4 percent per year, with about 25 percent of total population being affected by a severe disaster event. Staff estimates that expected annual GDP growth would be lower by about 0.1 percent if the baseline projection is adjusted for the expected impact of severe natural disasters.[5] In the case of a one-time extreme disaster event, annual GDP growth could be lower by about 2 percentage points compared to the baseline (Box 3). For the latter, the LIC-DSA indicates that the debt-to-GDP ratio could rise further by about 5 percent.

Probability of Severe Natural Disasters



Note: The size of the circle represents the probability that each country is hit by a severe natural disaster (above 75th percentile)
Sources: Lee, Zhang and Nguyen, 2018 (IMF working paper, No.18/108).

23. **Staff encourages the authorities to proceed with climate resilience projects**, with the assistance of the World Bank and the Green Climate Fund, to strengthen early disaster warning system, improve coastal protection and planning, and promote renewable energy. It will also help provide contingency funds for emergency response to medium-size hazards. The climate-change adaptation costs are estimated to be about 2½ percent of GDP per year,[6] and staff recommends recognizing these costs explicitly in the budget and the medium-term fiscal framework to ensure continuity and efficiency on both spending and funding sides.

The Authorities' View

24. **The authorities agreed on the need for continued efforts in building resilience and mitigating disaster risk**. Noting the increasing risks of natural disasters due to climate change, the authorities actively sought assistance in the international community for climate adaptation and mitigation projects. Climate resilience projects are on track and currently focus on strengthening early warning system, climate resilient investment in shoreline protection, and immediate response and assistance to emergencies. They agreed on the need to include climate-change adaptation costs in the budget but it was viewed to be challenging given the competing demands for other expenditures.

PROMOTING SUSTAINABLE GROWTH

25. **The planned state-owned enterprise (SOE) reforms should be fully implemented.** As the population is spread out over more than 20 coral atolls, the provision of community services—such as electricity, airline, and shipping—is costly. However, progress in SOE reforms has been limited since the enactment of the SOE Act in 2015. Subsidies to SOEs rose from 5¾ percent of GDP in FY2014 to 7½ percent in FY2017, suggesting that the budget discipline of SOEs is deteriorating.

[5] The baseline projections after FY2023 take into account the expected impact of natural disasters in the LIC-DSA analysis, while assuming no natural disasters for FY2018–2023 to avoid complication in near-term policy discussions.

[6] The ADB estimated that the climate-change adaptation costs would be 1½–2½ percent of GDP annually for the Pacific region (ADB, 2013) and the Intergovernmental Panel on Climate Change (2014) suggested that the costs of sea level rise impacts in the Pacific would be highest for Micronesia, Palau, RMI, and Nauru.

Staff welcomes the recent establishment of the SOE monitoring unit within the Ministry of Finance, which will oversee the implementation of the SOE Act and estimate the costs for community service obligation (CSO). Staff recommends reducing subsidies to SOEs that are not justified by such services. This would help the fiscal consolidation efforts and could free up resources for other purposes.

26. Improving the business environment for sustainable private sector development remains key to promote sustainable growth. Private sector development is handicapped by remoteness, small economic size, and geographical dispersion, as well as a poor regulatory framework and business environment. The World Bank's ease of doing business survey indicates that RMI is lagging its peers in the areas of registering property and resolving insolvency. Staff recommends land registration reforms which can help collateralize properties—thereby improving access to credit—and lower hurdles for long-term land leases by nonresidents—thereby facilitating foreign direct investment.

The Authorities' View

27. The authorities plan to accelerate SOE reforms, which is also key to promote private sector development. They noted that SOE losses in part reflected service provision to remote outer islands but agreed on the necessity of fully costed and approved CSOs. The establishment of the SOE monitoring unit was a milestone in the SOE reform. The unit will start focusing on four SOEs to develop their CSO frameworks and improve their performances. While acknowledging the potential conflict of interest, the authorities explained that the amendment of the SOE Act in 2016—allowing for increased representation of public officials on SOE Boards—was needed to tap expertise in the public sector. They acknowledged the need to consider novel approaches in land registration reform for private sector development. Skilled labor shortage arising from ongoing migration of workers to the U.S. remained an important hurdle for private sector development. The authorities also noted that they continued to make progress toward Sustainable Development Goals, building on the progress with core Millennium Development Goals, including reducing poverty, promoting gender equality and empowering women (Appendix IV).

DATA

28. Staff welcomes the progress in improving domestic capacity for independent national account data compilation. National accounts statistics have long been compiled by US-supported external consultants, with limited attention to developing the capacity of the local statistics office. A series of PFTAC TAs and trainings have improved RMI's capacity for data compilation in recent years. Staff encourages the authorities to continue working closely with PFTAC for a successful independent compilation of the national accounts statistics and moving to independent BOP compilation over the medium term. Staff also recommends the development of standard financial soundness indicators for the overall banking sector.

STAFF APPRAISAL

29. Outlook. Economic activity rebounded in FY2016 and growth accelerated in FY2017 as a strong pick-up in fisheries and construction activity more than offset lower copra production. Growth is expected to remain robust in the near term driven by continued infrastructure investment. The external sector position is assessed to be broadly in line with underlying fundamentals and desirable policy settings, but it remains vulnerable to risks arising from possible problems with the fiscal adjustment to lower Compact grants, unresolved AML/CFT issues, and the planned issuance of digital currency.

30. Risks. Overall risks remain tilted to the downside. The issuance of a decentralized digital currency as a second legal tender in the absence of adequate risk-mitigating measures would increase macroeconomic and financial integrity risks as well as elevate the risks of losing the last U.S. dollar correspondent banking relationship. Inadequate fiscal consolidation before the reduction of the U.S. Compact grant in FY2023 is the main medium- to long-term risk as government spending including on public investment would need to be curtailed to maintain fiscal sustainability after FY2024.

31. Digital currency. Unless strong AML/CFT measures are implemented, the issuance of the SOV will elevate the already high risks of losing the last U.S. dollar CBR. SOV issuance in the absence of a monetary policy framework could also result in monetary instability and pose significant challenges to macroeconomic management. Thus, the potential benefits from revenue gains at this point appear considerably smaller than the potential costs arising from economic, reputational, AML/CFT, and governance risks. The authorities should, therefore, seriously reconsider the issuance of the digital currency as a second legal tender.

32. Financial sector policy. The authorities should take additional steps to strengthen AML/CFT framework, which would help address CBR risks. Following the completion of the national risk assessment, an action plan should be developed to address the main risks identified. Domestic capacity in the AML/CFT area should be strengthened and AML/CFT obligations should be imposed on both the offshore and maritime registries. The prudential banking supervision framework should be enhanced further, including by complying with the relevant international standards and introducing prudential requirements covering key banking areas.

33. Fiscal policy. The government needs fiscal adjustment of 4 percentage points of GDP relative to the baseline by FY2023 to reduce risks to long-term fiscal sustainability. Multi-pronged efforts are required to achieve the needed medium-term fiscal adjustment by reversing the recent increase in recurrent spending and improving revenue administration and implementing tax reform. Accelerating the pace of medium-term fiscal framework and public financial management reforms will be critical in implementing the needed fiscal adjustment.

34. Climate change. The authorities should continue the work needed to adapt to climate change, including by strengthening early disaster warning system and improving coastal protection and planning. Explicit budgeting of climate-change adaptation costs would help ensure continuity in project implementation.

35. SOE reform. The authorities should fully implement the planned SOE reforms. Staff welcomes the recent establishment of the SOE monitoring unit and recommends reducing subsidies to SOEs that are not justified by the provision of the essential community services as this would help the fiscal consolidation efforts and could free up resources for other purposes.

36. Data. Staff welcomes the progress in improving domestic capacity for independent national account data compilation. Staff encourages the continued efforts for a successful independent compilation of the national accounts statistics and moving to independent BOP compilation over the medium term.

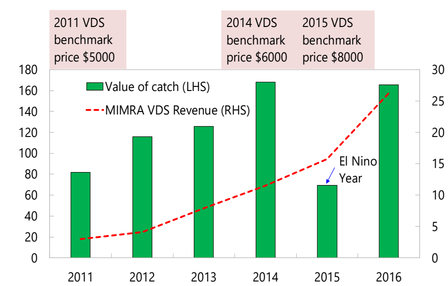
37. It is recommended that the next Article IV consultation take place on the current 24-month cycle.

Box 1. Fishing License Revenues[1]

Collective efforts have been made to secure long-term sustainability of tuna in the region. The Party to Nauru Agreement (PNA) is a regional initiative by 8 countries[2] in Western Central Pacific Ocean (WPCO)[3] which discusses terms and conditions for tuna purse seine fishing licenses to secure long-term sustainability of tuna in the region. In 2008, the PNA introduced the Vessel Day Scheme (VDS), which sets a maximum number of annual fishing vessel days in the region as well as a minimum benchmark daily price per vessel.[4] The PNA allocates annual fishing vessel days to each member country based on tuna availability and scientific advices to maintain currently spawning biomass levels. Member countries usually charge vessel days at a higher price above the benchmark through negotiations in advance, and are flexible to trade vessel days with other members in necessary situations (e.g. extreme weather events or El Nino) based on mutual agreements. With such regional corporation, PNA member country's fishing license revenue is partially shielded from tuna price volatility and short-term weather variability.

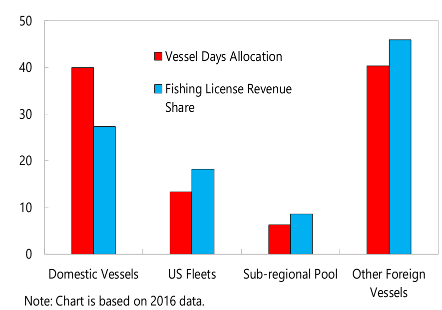
Fishing license revenues in RMI have increased significantly since the introduction of the VDS minimum benchmark price. The VDS benchmark price per vessel was initially set at US$5,000 per day in 2011, and subsequently increased to US$6,000 in 2013 and to US$8,000 in 2015. Under the VDS scheme, RMI has been allocated about 3,000 annual fishing vessel days and has distributed them to foreign and domestic vessels at different prices. Aiming at promoting domestic fishing industry, RMI has sold about 40 percent of its annual fishing vessel days to domestic fleets at discounted prices (for example, US$6,000 in 2016). The remaining 60 percent of fishing vessel days have been sold to foreign vessels at negotiated prices which are usually higher than the benchmark price at over US$10,000 per day. More recently in 2015, five PNA countries[5] launched the sub-regional pool scheme which allows foreign vessels to access multiple countries' fishing zones by paying a premium price of about US$12,000 per day.[6] Benefitting from the increase of VDS benchmark prices and increase value of vessel catch in its national water, fishing license revenues have increased significantly from US$3 million in FY2011 to US$25.6 million in FY2017 (excluding a one-off transfer of reserves from MIMRA[7]).

Fishing License Revenue and Value per Catch
(In USD millions)



Sources: MIMRA Annual Report and Oceanic Fisheries Program

RMI: Vessel Days Allocation and Fishing License Revenue
(In percent of the total)



Note: Chart is based on 2016 data.
Sources: MIMRA and IMF staff estimates.

Going forward, fishing license revenues are expected to remain stable in nominal terms over the medium term. The benchmark prices and fishing vessel days are not expected to increase further given the difficulty to reach a consensus among PNA members. Short-term tuna price volatility and environmental variability are less likely to influence the fishing license revenues given the structure and flexibility of the VDS scheme.

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[1] Prepared by Mareta Kaiteie and Huan Zhang.

[2] Federated States of Micronesia, Kiribati, RMI, Nauru, Palau, Papua New Guinea, Solomon Islands and Tuvalu.

[3] WPCO represents 60 percent of the world tuna catch, of which PNA water accounts for about a half.

[4] VDS minimum benchmark price was officially implemented in 2011, three years after the introduction.

[5] Tuvalu, Nauru, RMI, Solomon Islands, and Tokelau

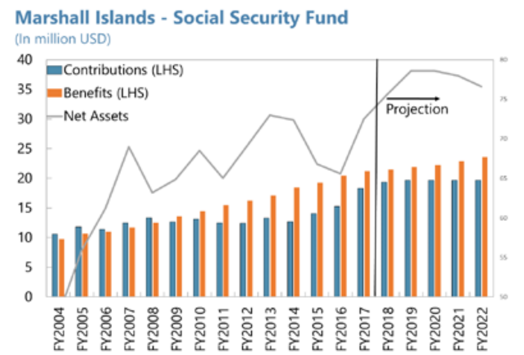
[6] Given that tuna is highly migratory and follows the Western Pacific Warm Pool, regional pool scheme effectively mitigates the risks of low tuna catch due to the El Nino Southern Oscillation variability. For example, during El Nino years (e.g. in 2015), tuna migrates to Kiribati and Samoa, therefore leaving RMI a low tuna catch rate. Being aware of this risk, RMI increased its contribution to regional pool from 9 days in 2015 to 352 days in 2017.

[7] The Marshall Islands Marine Resources Authority (MIMRA) administers fishing licenses on behalf of the government. The government secured US$15 million in FY2017 by tapping into MIMRA's pooled deposits.

Box 2. Social Security Reform[1]

The authorities adopted a long-awaited social security reform in FY2017. Without reforms, social security fund (SSF) was projected to deplete its reserves over the medium to long term, potentially adding a large fiscal drain. This reform includes (i) increase in the contribution rate by 1 percentage point (from 7 to 8 percent) for both employers and employees; (ii) gradual increases in retirement age from 60 to 65 years old (by 1 year every two years); (iii) increase in the maximum annual taxable income from US$20,000 to US$40,000; and (iv) reduction in benefit for those receiving US$300 or more per month among others. The reform is projected to substantially improve the prospect of SSF with annual fiscal savings of more than US$4 million (2 percent of GDP). Together with favorable investment returns and subsidies from the government, the SSF reserves improved from US$66 million in FY2016 to US$72 million in FY2017.

Nevertheless, more ambitious reforms are needed to put the social security system on a sustainable path. The remaining gap between benefits and contributions is still about US$3 million in FY2017, and would further increase over the medium to long term, posing additional fiscal burdens. If the government would not provide subsidies, SSF reserves would start declining from FY2021. To put the social security system on a sustainable path, more ambitious reforms will be needed. In particular, given that about 90 percent of current beneficiaries have received more than what they contributed, the authorities intend to focus on further reduction in benefits.



Sources: MISSA; IMF staff calculations.

[1] Prepared by Kazuaki Miyachi.

Box 3. Implications from Natural Disaster and Climate Change[1]

RMI is one of the most vulnerable countries to climate change. The vulnerability arises from the exposure to rising sea levels due to very low elevation (average 2 meters), and RMI is highly dependent on rainfall for water supply. Droughts, floods, king tides, tropical cyclones, and erosion are the main threatening disasters for RMI. The disaster interval, defined as the years in between two disasters, was about 1.5 years during 2011-2016. According to the Emergency Events Database (EM-DAT)[2], two severe droughts during the past five years (in 2013 and 2016) hit RMI and affected about 50 percent of the population in total.

The expected economic impact of severe natural disasters is expected to remain small as the probability of such event should remain small compared to other countries in the region. Based on the EM-DAT database and WEO data, Lee, Zhang and Nguyen (2018) find that the average likelihood of a severe natural disaster is 5.4 percent per year in RMI, a bit below the regional average, with about 25 percent of total population being affected on average by a disaster event. They estimate that expected annual GDP growth would be lower by about 0.1 percent, and the annual trade deficit higher by 0.3 percent of GDP, if the baseline projection were adjusted for the expected impact of severe natural disasters. In the case of a one-time extreme natural disaster event, real GDP growth could be lower by about 2 percentage points compared to the case of no disaster.

Yearly Impact From Natural Disasters in Pacific Island Countries
(In percentage point)

	Probability of Severe Disasters	Real GDP Growth	Real GDP Per Capita	Trade Balance/GDP
Fiji	8.1%	-0.13	-0.13	-0.34
Kiribati	2.7%	-0.04	-0.04	-0.11
Marshall Islands	5.4%	-0.09	-0.08	-0.23
Micronesia	5.4%	-0.09	-0.08	-0.23
Palau	0.0%	0.00	0.00	0.00
Papua New Guinea	8.1%	-0.13	-0.13	-0.34
Samoa	18.9%	-0.31	-0.30	-0.80
Solomon Islands	13.5%	-0.22	-0.21	-0.57
Timor-Leste	2.7%	-0.04	-0.04	-0.11
Tonga	8.1%	-0.13	-0.13	-0.34
Tuvalu	2.7%	-0.04	-0.04	-0.11
Vanuatu	29.7%	-0.49	-0.46	-1.25

*Lee, D., Zhang, H. and Nguyen, C., 2018. The Economic Impact of Natural Disasters in Pacific Island Countries: Adaptation and Preparedness (No. 18/108). International Monetary Fund.
*Yearly impacts are calculated as the product of probability of severe natural disasters (above 75th percentile) and the coefficients of severe natural disaster dummy (above 75th percentile) from the fixed effects regressions.

The costs from climate change could rise further in the long run. Climate change is likely to result in higher global temperatures, which could increase risk of droughts and intensity of storms (NASA, 2005)[3]. While the estimated impact of severe natural disasters is low, the recent study by the ADB estimates that the broader climate change cost in Pacific region could be about 2.2 to 3.5 percent of the country's annual GDP by 2050 when all the key factors that are affected by climate changes are considered such as agriculture, water, costal, energy, human health, and ecosystems (ADB, 2014)[4].

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[1] Prepared by Huan Zhang.

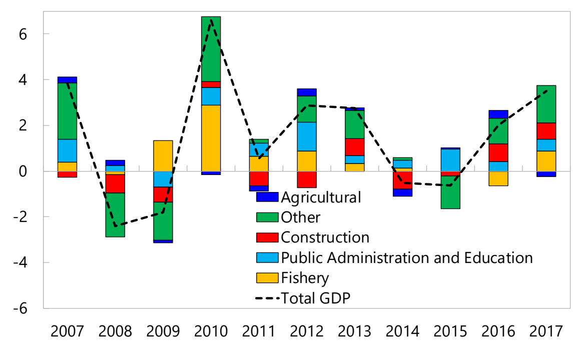
[2] Established by the Center for Research on the Epidemiology of Disasters and the database is available at http://www.emdat.be/.

[3] Riebeek, H. The Rising Cost of Natural Hazards. 2005. Retrieved from NASA Earth Obsevatory.

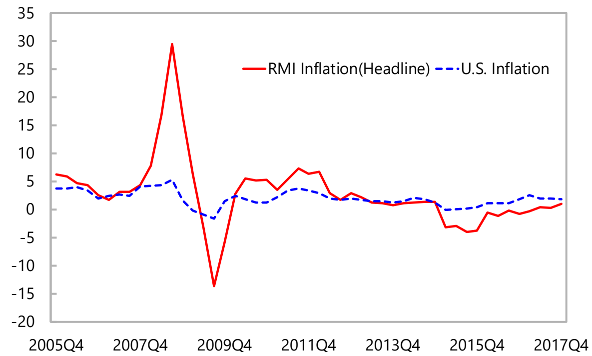
[4] *The Economics of Climate Change in the Pacific*. 2014. Asian Development Bank.

Figure 1. Marshall Islands: Real Sector Developments

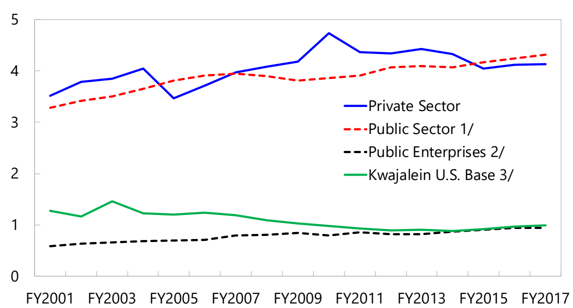
Real GDP Growth Contribution
(In percent)



CPI Inflation
(In percent, year-on-year change, quarterly)

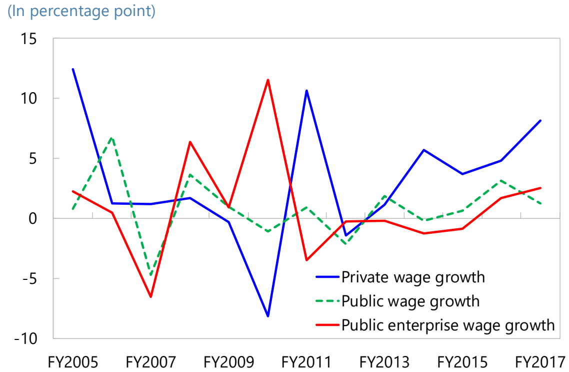


Employment
(Workers, thousand)

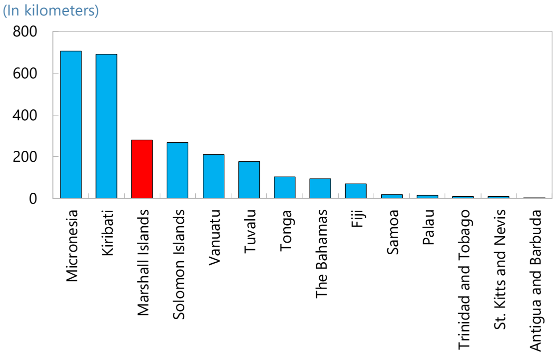


1/ Central and local government.
2/ State-Owned Enterprises
3/ U.S. military base hired workers

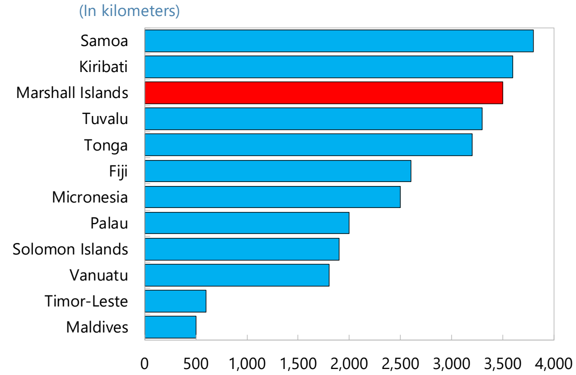
Average Public and Private Sector Wages
(In percentage point)



Geographical Dispersion: Average Sea Distance Between Two Inhabitants of the Same Country
(In kilometers)

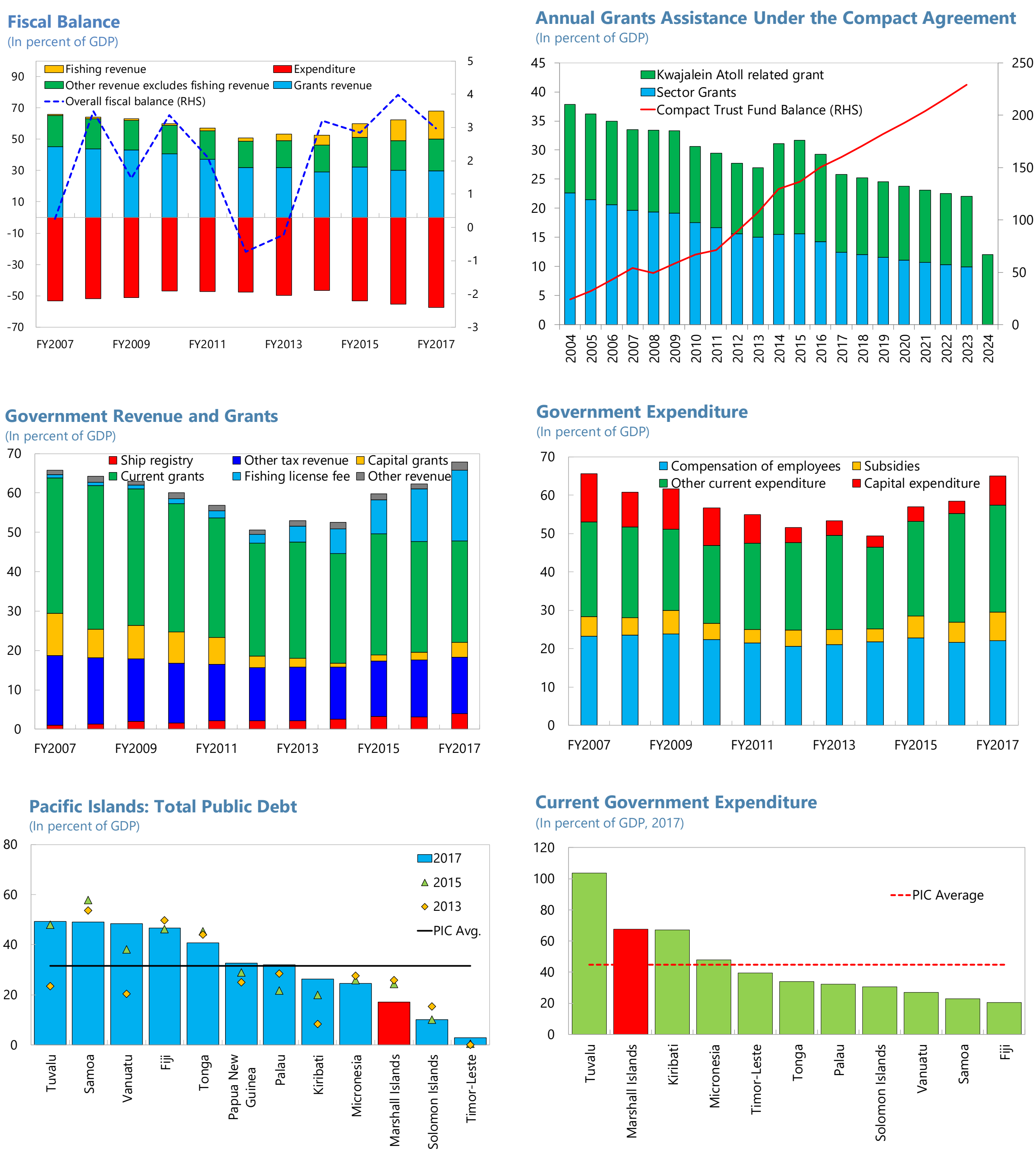


Pacific Islands: Distance to the Closest Continent
(In kilometers)



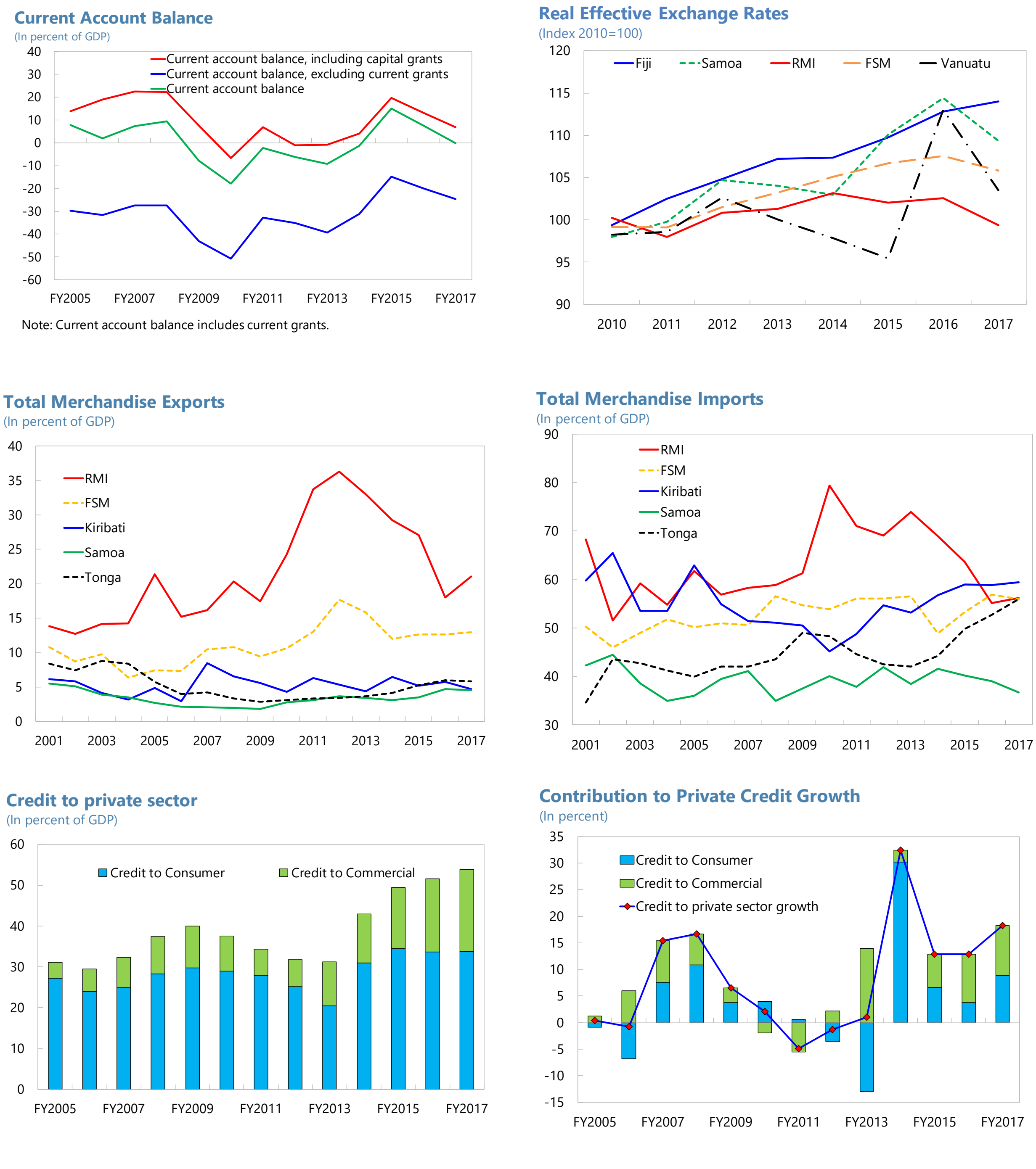
Sources: Country authorities; and IMF staff estimates.

Figure 2. Marshall Islands: Fiscal Sector Developments



Sources: Country authorities, WEO, and IMF staff estimates.

Figure 3. Marshall Islands: External and Credit Developments



Sources: Country authorities; and IMF staff estimates.

Table 1. Marshall Islands: Selected Economic Indicators, FY2014–23 1/

Nominal GDP for FY2016 (in millions of U.S. dollars): 196.3
Population (2016): 54,153
GDP per capita for FY2016 (in U.S. dollars): 3624.3
Quota: SDR 3.5 million

	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
				Est.	Proj.					
Real sector										
Real GDP (percent change)	-0.5	-0.6	2.0	3.6	2.5	2.3	2.2	2.0	1.8	1.6
Consumer prices (percent change)	1.1	-2.2	-1.5	0.0	1.4	1.5	1.7	1.8	1.9	2.0
Central government finances (in percent of GDP)										
Revenue and grants	52.6	59.9	62.3	68.0	64.0	64.1	64.1	63.7	63.5	63.4
Total domestic revenue	23.6	27.5	32.2	38.4	31.0	30.5	29.9	29.4	29.0	28.7
Grants	29.1	32.4	30.1	29.6	33.0	33.6	34.1	34.2	34.5	34.7
Expenditure	49.4	57.0	58.4	65.1	62.2	63.1	63.9	64.1	64.3	64.6
Expense	46.5	53.2	55.2	57.4	53.8	53.8	53.9	53.7	53.6	53.6
Net acquisition of nonfinancial assets	2.9	3.8	3.1	7.6	8.4	9.3	10.0	10.4	10.7	11.1
Net lending/borrowing	3.2	2.8	4.0	3.0	1.8	1.0	0.1	-0.4	-0.8	-1.3
Compact Trust Fund (in millions of US$; end of period)	240.1	247.1	294.5	356.9	393.7	432.9	474.5	518.6	565.5	615.3
Balance of payments (in percent of GDP)										
Current account balance 2/	-1.2	15.0	7.6	-0.3	-0.6	-1.0	-1.9	-2.7	-3.0	-3.1
Good and service balance	-58.3	-55.5	-56.3	-56.5	-56.2	-56.2	-56.3	-56.3	-56.1	-55.9
Primary income	26.5	38.3	33.2	29.6	29.8	29.6	29.1	28.6	28.3	28.0
o/w fishing license fee	8.9	13.4	12.3	11.5	11.1	10.8	10.4	10.1	9.8	9.6
Secondary income	30.6	32.2	30.7	26.6	25.9	25.6	25.3	25.0	24.9	24.7
o/w compact current grants	15.7	18.3	16.4	14.7	14.5	14.0	13.6	13.1	12.7	12.4
o/w other budget and off-budget grants	13.4	13.0	13.6	11.0	10.9	11.2	11.4	11.6	11.9	12.2
Current account excluding current grants	-30.3	-16.3	-22.4	-25.9	-25.9	-26.2	-26.9	-27.4	-27.6	-27.7
External PPG debt (in millions of US$; end of period) 3/	94.6	89.0	83.5	78.4	73.4	67.5	65.4	63.8	63.0	63.4
(In percent of GDP)	51.1	49.1	42.5	35.2	31.9	28.4	26.6	25.1	24.2	23.7
Exchange rate										
Real Effective Exchange Rate (2010 =100)	102.7	102.2	99.9	98.8	…	…	…	…	…	…
Memorandum Item:										
Nominal GDP (in millions of US$)	185.2	181.3	196.3	222.3	229.9	237.7	245.8	253.8	260.7	267.4

Sources: RMI authorities; and IMF staff estimates and projections.

1/ Fiscal year ending September 30.

2/ Includes current grants.

3/ In this table, it is assumed that RMI will continue to benefit from its grant-only status. On the other hand, in the LIC-DSA, for World Bank (IDA) and other MDBs, regular credit terms on all lending is assumed for all years in the projection period for which grant finance has not already been committed. This is because the DSA serves to test a country's capacity to take on WB and ADB financing on credit terms.

Table 2. Marshall Islands: Statement of Government Operations, FY2014–23 1/

	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
				Est.			Proj.			
	(In millions of U.S. dollars)									
Revenue	97.5	108.6	122.4	151.2	147.1	152.4	157.5	161.6	165.5	169.4
Taxes	29.1	31.4	34.6	40.8	41.6	42.7	43.9	45.0	46.0	46.9
Taxes on income, profits, and capital gains	11.5	11.9	13.8	15.7	16.3	16.8	17.4	18.0	18.4	18.9
Taxes on goods and services	10.6	11.1	11.9	15.2	15.3	15.5	15.7	16.0	16.1	16.3
Taxes on international trade and transactions	6.9	7.7	8.2	9.6	9.9	10.3	10.6	11.0	11.3	11.5
Other taxes	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Grants 2/	53.9	58.7	59.1	65.9	75.8	79.9	83.9	86.9	89.8	92.8
o/w current	51.7	55.9	55.2	57.0	58.3	59.9	61.4	62.8	64.3	65.8
o/w capital	1.9	2.6	3.8	8.3	17.0	19.5	22.0	23.5	25.0	26.5
Other revenue	14.5	18.4	28.7	44.6	29.7	29.7	29.7	29.7	29.7	29.7
o/w fishing license fee	11.5	15.8	26.3	40.0	26.3	26.3	26.3	26.3	26.3	26.3
Expenditure	91.5	103.4	114.5	144.6	143.1	150.0	157.2	162.6	167.7	172.8
Expense	86.1	96.4	108.4	127.6	123.6	128.0	132.5	136.2	139.7	143.2
Compensation of employees	40.3	41.4	42.4	49.0	49.5	50.0	50.6	51.2	51.7	52.2
Use of goods and services	25.3	26.3	32.0	36.7	38.2	41.3	44.4	46.7	48.9	51.2
Interest	0.7	0.7	0.8	0.7	0.6	0.5	0.5	0.5	0.5	0.5
Subsidies	6.2	10.3	10.4	16.6	11.2	11.6	12.0	12.4	12.8	13.1
Grants	6.4	10.7	11.2	13.3	13.7	14.1	14.6	15.0	15.4	15.8
Other expense	7.2	7.1	11.6	11.4	10.4	10.4	10.4	10.4	10.4	10.4
Net acquisition of nonfinancial assets	5.4	7.0	6.2	17.0	19.4	22.0	24.6	26.4	28.0	29.6
Net operating balance 3/	11.4	12.1	14.0	23.6	23.5	24.4	25.0	25.3	25.8	26.2
Net lending/borrowing	**5.9**	**5.2**	**7.8**	**6.6**	**4.1**	**2.3**	**0.3**	**-1.1**	**-2.2**	**-3.3**
	(In percent of GDP)									
Revenue	52.6	59.9	62.3	68.0	64.0	64.1	64.1	63.7	63.5	63.4
Taxes	15.7	17.3	17.6	18.3	18.1	18.0	17.8	17.7	17.6	17.5
Taxes on income, profits, and capital gains	6.2	6.6	7.0	7.1	7.1	7.1	7.1	7.1	7.1	7.1
Taxes on goods and services	5.7	6.1	6.1	6.9	6.6	6.5	6.4	6.3	6.2	6.1
Taxes on international trade and transactions	3.7	4.3	4.2	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Other taxes	0.1	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Grants	29.1	32.4	30.1	29.6	33.0	33.6	34.1	34.2	34.5	34.7
o/w current	27.9	30.8	28.1	25.7	25.4	25.2	25.0	24.8	24.7	24.6
o/w capital	1.0	1.5	1.9	3.7	7.4	8.2	9.0	9.3	9.6	9.9
Other revenue	7.8	10.1	14.6	20.0	12.9	12.5	12.1	11.7	11.4	11.1
o/w fishing license fee	6.2	8.7	13.4	18.0	11.4	11.1	10.7	10.4	10.1	9.8
Expenditure	49.4	57.0	58.4	65.1	62.2	63.1	63.9	64.1	64.3	64.6
Expense	46.5	53.2	55.2	57.4	53.8	53.8	53.9	53.7	53.6	53.6
Compensation of employees	21.7	22.8	21.6	22.1	21.5	21.0	20.6	20.2	19.8	19.5
Goods and Services	13.7	14.5	16.3	16.5	16.6	17.4	18.1	18.4	18.8	19.2
Interest	0.4	0.4	0.4	0.3	0.3	0.2	0.2	0.2	0.2	0.2
Subsidies	3.3	5.7	5.3	7.5	4.9	4.9	4.9	4.9	4.9	4.9
Grants	3.4	5.9	5.7	6.0	6.0	5.9	5.9	5.9	5.9	5.9
Other expense	3.9	3.9	5.9	5.1	4.5	4.4	4.2	4.1	4.0	3.9
Net acquisition of nonfinancial assets	2.9	3.8	3.1	7.6	8.4	9.3	10.0	10.4	10.7	11.1
Net operating balance	6.1	6.7	7.1	10.6	10.2	10.3	10.2	10.0	9.9	9.8
Net lending/borrowing	**3.2**	**2.8**	**4.0**	**3.0**	**1.8**	**1.0**	**0.1**	**-0.4**	**-0.8**	**-1.3**
Memorandum item:										
Compact Trust Fund (in millions of US$)	240.1	247.1	294.5	356.9	393.7	432.9	474.5	518.6	565.5	615.3
Outstanding government debt (in millions of US$)	65.0	62.2	59.0	56.7	53.8	51.1	50.6	50.9	51.9	54.0
Outstanding government debt (percent of GDP)	35.1	34.3	30.0	25.5	23.4	21.5	20.6	20.1	19.9	20.2
Nominal GDP (in millions of US$)	185.2	181.3	196.3	222.3	229.9	237.7	245.8	253.8	260.7	267.4

Sources: RMI authorities; and IMF staff estimates and projections.

1/ Fiscal year ending September 30.
2/ Does not include Compact funds earmarked for Kwajalein rental payments and Trust Fund contributions.
3/ Net operating balance is the difference between revenue and expense

Table 3. Marshall Islands: Balance of Payments, FY2014–23 1/

	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
				Est.	Proj.					
	(In millions of U.S. dollars)									
Current account balance	***-2.2***	***27.1***	***14.9***	***-0.6***	***-1.3***	***-2.3***	***-4.8***	***-6.8***	***-7.8***	***-8.4***
Goods Balance	-72.8	-65.7	-72.9	-78.4	-80.5	-83.3	-86.4	-89.3	-91.6	-93.7
Exports, f.o.b.	53.5	48.7	35.3	47.0	49.2	50.8	52.2	53.8	55.4	57.1
Imports, f.o.b.	-126.3	-114.4	-108.2	-125.3	-129.7	-134.0	-138.6	-143.1	-147.0	-150.8
Services Balance	-35.2	-35.0	-37.7	-47.3	-48.8	-50.4	-52.0	-53.5	-54.7	-55.9
Exports of Services	19.2	18.2	17.5	18.6	19.2	19.8	20.5	21.1	21.7	22.2
Imports of Services	-54.4	-53.2	-55.3	-65.9	-68.0	-70.2	-72.5	-74.7	-76.4	-78.1
Primary Income Balance	49.1	69.4	65.2	65.9	68.5	70.4	71.4	72.6	73.8	75.0
o/w: Kwajalein atoll related	36.3	40.2	42.2	47.1	47.9	48.8	49.5	50.2	51.0	51.7
o/w fishing licence fees	16.5	24.3	24.2	25.6	25.6	25.6	25.6	25.6	25.6	25.6
Secondary Income Balance	56.6	58.4	60.3	59.2	59.5	60.9	62.2	63.5	64.8	66.2
o/w compact current grants	29.1	33.1	32.2	32.7	33.3	33.4	33.3	33.3	33.2	33.2
o/w other budget and off-budget grants	24.7	23.5	26.7	24.4	25.0	26.5	28.0	29.6	31.1	32.6
Current account excluding current grants	-56.1	-29.5	-44.0	-57.6	-59.6	-62.2	-66.1	-69.7	-72.1	-74.2
Capital account balance	9.6	8.5	10.9	15.6	17.0	19.5	22.0	23.5	25.0	26.5
o/w compact capital grants	1.9	2.6	3.8	8.3	16.0	16.0	16.0	15.9	15.9	15.9
o/w other capital grants to government	7.7	5.8	7.1	7.2	1.0	3.5	6.0	7.6	9.1	10.6
Financial account balance	5.7	-4.5	-10.1	-13.6	-15.7	-17.2	-17.2	-16.7	-17.2	-18.1
Errors and ommisions	-13.0	-31.0	-15.7	-1.4	0.0	0.0	0.0	0.0	0.0	0.0
	(In percent of GDP)									
Current account balance	-1.2	15.0	7.6	-0.3	-0.6	-1.0	-1.9	-2.7	-3.0	-3.1
Goods Balance	-39.3	-36.2	-37.1	-35.2	-35.0	-35.0	-35.1	-35.2	-35.1	-35.0
Services Balance	-19.0	-19.3	-19.2	-21.3	-21.2	-21.2	-21.2	-21.1	-21.0	-20.9
Primary Income Balance	26.5	38.3	33.2	29.6	29.8	29.6	29.1	28.6	28.3	28.0
o/w: Kwajalein atoll related	19.6	22.2	21.5	21.2	20.8	20.5	20.1	19.8	19.5	19.3
o/w fishing licence fees	8.9	13.4	12.3	11.5	11.1	10.8	10.4	10.1	9.8	9.6
Secondary Income Balance	30.6	32.2	30.7	26.6	25.9	25.6	25.3	25.0	24.9	24.7
o/w compact current grants	15.7	18.3	16.4	14.7	14.5	14.0	13.6	13.1	12.7	12.4
o/w other budget and off-budget grants	13.4	13.0	13.6	11.0	10.9	11.2	11.4	11.6	11.9	12.2
Current account excluding current grants	-30.3	-16.3	-22.4	-25.9	-25.9	-26.2	-26.9	-27.4	-27.6	-27.7
Capital account balance	5.2	4.7	5.6	7.0	7.4	8.2	9.0	9.3	9.6	9.9
o/w ompact capital grants	1.0	1.5	1.9	3.7	6.9	6.7	6.5	6.3	6.1	5.9
o/w other capital grants to government	4.2	3.2	3.6	3.3	0.4	1.5	2.5	3.0	3.5	4.0
Financial account balance	3.1	-2.5	-5.1	-6.1	-6.8	-7.2	-7.0	-6.6	-6.6	-6.8
Errors and ommisions	-7.0	-17.1	-8.0	-0.6	0.0	0.0	0.0	0.0	0.0	0.0

Sources: RMI authorities; and IMF staff estimates and projections.

1/ Fiscal year ending September 30.

Table 4. Marshall Islands: External Vulnerability Indicators, FY2014–17

	FY2014	FY2015	FY2016	FY2017 Est.
Financial indicators				
Commercial bank deposits (12-month percent change)	31.0	28.6	19.9	13.3
Private sector credit (12-month percent change)	32.4	12.8	12.8	14.9
Foreign assets/total assets (percent)	41.2	46.2	52.3	52.2
Consumer loans (in percent of total private sector loans)	72.2	69.9	65.3	68.6
External indicators				
Exports (percent change)	-15.0	-9.0	-27.4	32.9
Imports (percent change)	-10.4	-9.4	-5.4	15.8
Current account balance (percent of GDP)	-1.2	15.0	7.6	-0.3
Capital and financial account balance (percent of GDP)	8.2	2.2	0.4	0.9
Of which : FDI (percent of GDP)	2.3	1.8	2.5	2.6
Gross official reserves (in millions of U.S. dollars) 1/	6.6	9.2	9.1	13.6
Gross official reserves (in months of imports of goods and services)	0.4	0.7	0.7	0.9
External PPG debt (percent of GDP) 2/	51.1	49.1	42.5	35.2
External PPG debt (in percent of exports of goods and services) 2/	130.2	133.1	157.9	119.4
External debt service (In percent of exports of goods and services)	9.3	10.8	13.5	11.2

Sources: RMI authorities; and IMF staff estimates and projections.
1/ Measured by the end-of-period stock of government financial assets held in commercial banks.
2/ Public and publicly-guaranteed external debt.

Table 5. Marshall Islands: Deposit Money Banks, FY2014–17

	FY2014	FY2015	FY2016	FY2017 Est.
	(In millions of U.S. dollars)			
Assets and Liabilities				
Assets	156.9	189.4	220.4	261.8
Foreign assets	64.7	87.6	115.4	135.7
Total Credit/loan	88.4	95.8	103.8	121.5
Claims on central and local governments	0.3	0.0	0.0	0.1
Claims on public enterprises	8.7	6.2	2.7	1.8
Claims on private sector	79.4	89.6	101.1	119.7
Consumer	57.4	62.6	66.0	75.0
Residential Mortgage	2.5	0.0	0.0	0.0
Others	54.8	62.6	66.0	75.0
Commercial	22.1	27.0	35.1	44.7
Unclassified assets	3.8	6.1	1.2	4.5
Liabilities	156.9	189.4	220.4	261.8
Deposits	118.9	152.9	183.3	227.2
Central government deposits 1/	6.6	9.2	9.1	13.6
Foreign liabilities	4.4	5.1	5.4	4.1
Capital accounts	32.7	30.4	30.5	29.1
Unclassified liabilities	0.8	1.0	1.2	1.3
Memorandum items:				
Loan/deposit ratio (in percent)	74.4	62.6	56.6	53.5
Deposits (percent change)	31.0	28.6	19.9	23.9
Loans (percent change)	38.2	8.3	8.4	17.1
Consumer loans (in percent of total loan)	64.9	65.4	63.6	61.7
Income and expense				
Interest Income	9.1	9.8	10.5	12.9
Interest and fees on loans	9.0	9.7	10.1	11.9
Deposits with banks	0.1	0.2	0.4	1.0
Interest Expense	1.1	1.3	1.6	1.3
Deposits	1.1	1.3	1.6	1.3
Net interest income	8.0	8.0	8.9	11.7
Provision for loan losses	0.1	0.1	0.2	0.5
Net interest income after loan loss provisions	8.0	7.9	8.7	11.2
Non-interest Income	2.5	2.8	3.4	3.3
Non-interest Expense	5.3	5.8	6.3	7.0
Net Income (Loss)	5.1	4.9	5.8	7.5
Interest rates (percent) 2/				
Deposit rates				
Savings accounts 3/	0.6	0.2	0.2	0.0
Time deposits 4/	3.5	3.0	3.0	2.6
Loan rates 5/				
Consumer loans	16.1	14.0	12.3	12.9
Commercial loans	8.5	5.2	4.7	5.7
Memorandum item:				
Return on assets	3.3	2.6	2.6	2.9

Sources: RMI authorities; and IMF staff estimates.

1/ Includes deposits of social security administration and other trust funds.

2/ Yearly average.

3/ Average of rates offered by deposit money banks.

4/ Average of minimum rates offered by deposit money banks.

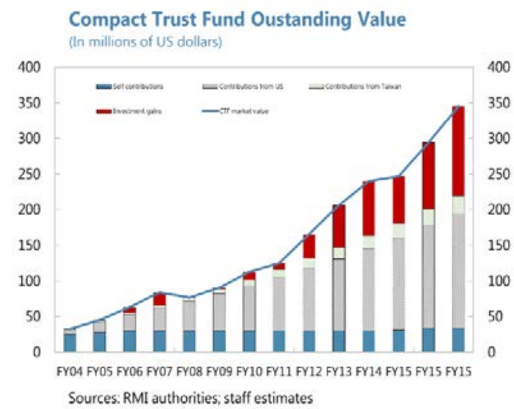
5/ Average of maximum rates charged by deposit money banks.

Appendix I. The Compact Trust Fund and Its Long-Term Outlook[1]

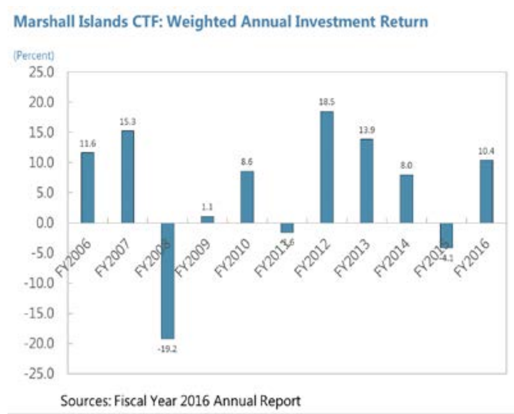
The Compact Trust Fund is expected to build sufficient resources to compensate for expiring Compact grants in FY2023. But, to preserve the value of the fund in real terms, medium-term fiscal adjustment of about 4 percentage of GDP is needed.

1. **The Compact Trust Fund (CTF) was created in 2004 to contribute to the long-term budgetary self-reliance of the RMI.** The CTF aims to provide the RMI with a stable source of revenue to compensate for the reduction of US Compact grants after FY2023. This reduction of US Compact grants will amount to US$27 million (about 10 percent of GDP) in FY2024.

2. **Structure of the fund**. The contributions to the CTF are not available for withdrawal prior to FY2024. From FY2024 onwards, annual investment earnings from the CTF can be withdrawn to finance budget needs up to a limit.[2] In years when investment earnings are not sufficiently high, the C account of the fund can be used to make up for the shortfall.[3] A separate account (Account D) to which the RMI and Taiwan Province of China (POC) have contributed can also be used as a buffer as long as its assets exceed US$10 million.



3. **Contributions to the fund**. The value of the CTF (excluding the D account) was US$357 million as of end-FY2017. Of this amount, US$219 million came from contributions by the U.S. (US$161 million), the RMI (US$ 33 million), and Taiwan POC (US$26 million). The D account amounted to US$13 million as of end-FY2016.



4. **Fund performance**. The current investment strategy of the CTF (adjusted in 2014) stipulates that 30 percent of the fund is invested in the U.S. equities, another 30 percent in international equities, while the rest is split between fixed income (20 percent) and alternative investments (20 percent). As of end-FY2016, the fund's average annual nominal return rate since inception was 6.7 percent, net of fees.

5. **Governance of the fund**. The CTF is administered by an independent committee that exercises oversight and fiduciary responsibility over the fund (except for the D account). Four voting members on the committee are appointed by the United States (from Departments of Education, Interior, and State), two by

[1] Prepared by Kazuaki Miyachi.

[2] Annual distributions from the CTF, starting in FY2024, can only come from investment earnings from the previous year up to a maximum limit equivalent to expired grant assistance amount as of FY2023, fully adjusted for inflation.

[3] Investment earnings above 6 percent are transferred to the C account of the fund. The C account is capped at three times the projected grant assistance in FY2023. As of end-FY2016, it held US$59.8 million (about 2.2 times of the projected amount).

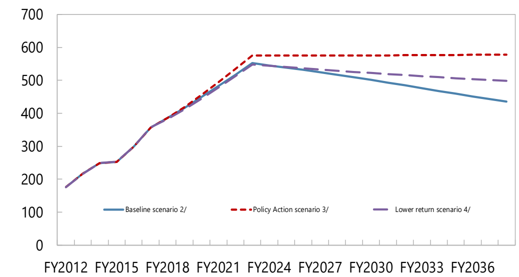
the RMI, and one by Taiwan POC. A custodian bank (State Street Bank) and a professional investment advisor (Mercer Investment Management) help manage the fund.

Scenarios

6. **Two scenarios are considered to assess the long-term outlook and the implications for RMI's fiscal sustainability**. Under the baseline scenario, the projected value of the CTF is likely to generate sufficient income to supplement the reduction of Compact grants in FY2024, but not preserve the *real* value of the CTF. In the policy action scenario, the real value of the CTF is preserved.

Compact Trust Fund Balance1/

(In millions of FY2017 dollars)



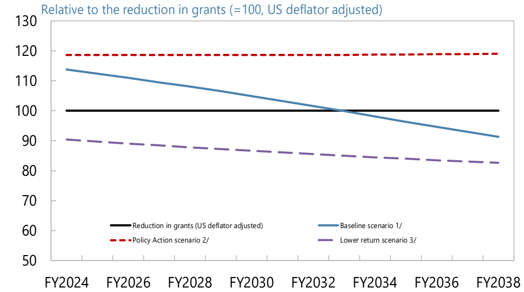
1/ Includes the market value of the CTF and accumulation of fiscal surpluses.
2/ Assume 5 percent return from FY 2018, with no fiscal adjustment.
3/ Assume 5 percent return from FY 2018, achieve fiscal surplus of 2.5 percent by FY 2023.
4/ Assume 4 percent return from FY 2018, achieve fiscal surplus of 2.5 percent by FY 2023.
Sources: Fund staff estimates.

7. **Baseline scenario.** If the CTF earns a 5 percent nominal return annually from FY2018 onwards, the distribution from the estimated assets for FY2024 would generate sufficient income to fully offset the revenue loss implied by the expiring Compact grants (US$27 million). Under this scenario, however, long-term self-sufficiency would not be secured because the real value of the CTF will likely decline over time.

8. **Policy action scenario.** Under this scenario, the government is assumed to undertake a fiscal adjustment of about 4 percentage of GDP over the medium term (from FY2018 to FY2023) to build an overall fiscal surplus of 2½ percent of GDP (about US$7 million) by FY2023. Under this course of action, drawdowns from the CTF can be contained at around 3 percent (about US$20 million) of fund balances. The remaining 2 percent of fund balances can be preserved in the CTF, which enables to maintain the real value of CTF (with about 2 percent inflation adjustment).

Compact Trust Fund Investment Returns

Relative to the reduction in grants (=100, US deflator adjusted)



1/ Assume 5 percent return from FY 2018, with no fiscal adjustment.
2/ Assume 5 percent return from FY 2018, achieve fiscal surplus of 2.8 percent by FY 2023.
3/ Assume 4 percent return from FY 2018, achieve fiscal surplus of 2.8 percent by FY 2023.
Sources: Fund staff estimates.

9. **Sensitivity to investment returns**. It should be noted that preserving the real value does not eliminate the risk of future shocks to fiscal income from the CTF. CTF investment returns are highly volatile, and the outcome of scenario analysis is sensitive to the assumption used for these returns. Staff estimates suggest that a permanent decrease in expected returns of 1 percentage point (from 5 to 4 percent) would increase the fiscal adjustment need by 2¼ percentage point of GDP from the recommended policy action scenario. The U.S. Government Accountability Office (GAO) projected that, with a 15 percent probability, the CTF would not be able to disburse any funds in 1 or more years during the first decade due to return volatility,[4] underscoring the importance of further building assets in the CTF.

[4] U.S. Government Accountability Office, "Compacts of Free Association, Actions Needed to Prepare for the Transition of Micronesia and the Marshall Islands to Trust Fund Income." 2018.

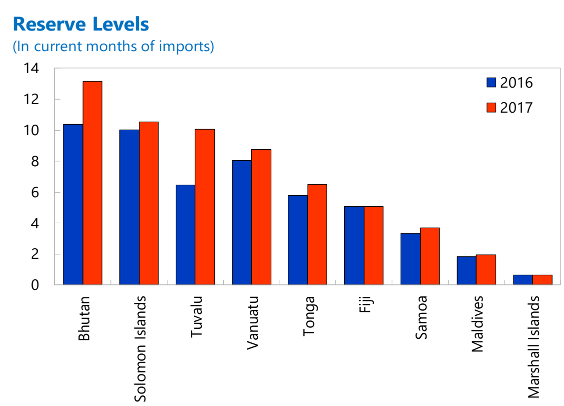
Appendix II. External Sector Assessment[1]

External balance assessment. The external sector position is assessed to be broadly in line with underlying fundamentals and desirable policy settings, but it remains vulnerable to risks arising from possible problems with the fiscal adjustment to lower Compact grants, unresolved AML/CFT issues, and the planned issuance of digital currency.[2] The assessment is also complicated and subject to a large margin of error, given serious data limitations, the vulnerabilities of a small island economy in general, and the anticipated large structural change in external financing in FY2024 from substantially lower U.S. Compact grant flows.

- **The External Sustainability approach** estimates the current account norm to be a deficit of 3.0 percent of GDP, compared to the projected medium-term current account deficit of 3.1 percent. Hence, with a gap of 0.1 percent of GDP, the projected current account balance is assessed to be broadly in line with the level that would stabilize the net international investment position and also allow to maintain the real value of the Compact Trust Fund after FY2023.

- **The Current Account and REER approaches are** less applicable due to data limitations that result in large margins of statistical variation around the estimates. These backward-looking approaches cannot take into account the structural break in FY2024 arising from the reduction of U.S. Compact grant.

Reserves. RMI's government U.S. dollar deposits effectively serve as reserves and are the main instrument to absorb short-term liquidity shocks, given that the country has no central bank and uses U.S. dollar as its official currency. Compared with other Pacific island countries, RMI has relatively low level of reserves, at about 0.6 months of imports as of FY2017, but the stable foreign grants inflow shields the country from liquidity squeezes.



Competitiveness. RMI's external competitiveness is hampered by domestic labor shortage, especially skilled labor. Under the U.S. Compact Agreement, people from RMI can work in the U.S. without separate permit, resulting in an increasing number of skilled workers migrating to the U.S. motivated by higher wages, better health care and education systems. However, this negative impact is partly offset by higher remittances to RMI. The capital projects in the pipeline supported by ADB/WB could potentially raise the country's competitiveness by improving infrastructure capacity.

[1] Prepared by Huan Zhang.

[2] The recommended fiscal adjustment of 4 ppt of GDP over the medium term is to preserve the real value of the CTF and would lower the risks that the external position will not be consistent with underlying fundamentals.

External Financing. The long-standing trade deficit is offset by fishing license fee income and official transfers. Fishing license fee income is expected to stabilize around US$25 million in nominal terms, and grants from other donors are expected to continue after the Compact grant agreement with the U.S. expires in FY2023. Most of public investment would continue to be financed by capital grants.

Appendix III. Risk Assessment Matrix 1/

Likelihood	Impact	Policy Response
	UPSIDE	
	Medium	
Medium	**1. Steadfast implementation of structural reform**. Decisive SOE reforms and comprehensive efforts to develop private sector, if combined with well-managed donor-financed large infrastructure projects, could raise potential growth.	Save additional revenues for the needed fiscal consolidation, which would also help avoid overheating of the economy, and embark structural reforms to improve the business environment for private sector development.
	DOWNSIDE	
	High	
High	**2. Issuance of cryptocurrency as legal tender.** The issuance would elevate the already high risks of losing the last U.S. dollar CBR as the financial integrity risks are not fully addressed. The issuance in the absence of a monetary policy framework could also result in monetary instability and pose significant challenges to macroeconomic management.	Reconsider the issuance of the digital currency as legal tender until strong policy frameworks are in place to address economic, reputational, AML/CFT, and governance risks.
High	**3. Withdrawal of correspondent bank relationship (CBR).** The termination of the last U.S. dollar CBR would have significant repercussions to the economy with US dollar as legal tender owing to the lack of access to US dollar clearing services and potential disruptions to the flows of external aid.	Take additional steps to strengthening AML/CFT framework, including the successful completion of the national risk assessment and development of an action plan to address the main identified risks.
Medium	**4. Slow progress in fiscal consolidation.** As investment earnings from the Compact Trust Fund (CTF) would not be enough to replace the expiring portion of the U.S. Compact grant after FY2023, the government should limit its expenditures or incur other sources of financing, which would drag growth over the medium term.	Multi-pronged efforts for fiscal consolidation, including reversing the recent increase in recurrent spending, improving revenue administration, and implementing tax reform.
	Medium	
Medium	**5. Delays in implementation of infrastructure projects.** A near-term growth would be adversely affected.	Improve oversight on project selection and implementation and seek for technical assistances from relevant international organizations to strengthen public investment management.
Medium	**6. Natural disaster and climate change.** Staff estimates based on the last 30-year data in the region indicate that the annual GDP growth would be lower than the baseline by about 0.1 percent if adjusted for and average likelihood and impact of severe natural disasters, and by about 2 percent in the case of extreme disasters.	Facilitate climate resilience projects to strengthen early disaster warning, improve coastal protection and planning, and provide contingency funds for emergency response.
	Low	
Low/Medium	**1. Persistent low rates of return on CTF.** The revenue shortfall would be US$2½ million (about 1 percent of GDP) in FY2024 if the expected return on the CTF assets is lower by 1 percent permanently.	Secure additional contribution to the CTF from donors. In the case of temporary lower return, seek for budget support from WB/ADB if temporary spending cut is not enough.

1/The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term" and "medium term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Appendix IV. MDG and Strategic Surveillance Matrix

Millennium Development Goal Achievements	
Goals /Targets	**Assessment**
Goal 1: Eradicate extreme poverty and hunger	Not achieved [1]
Goal 2: Achieve universal primary education	Mixed
Goal 3: Promote gender equality and empower women	Mixed
Goal 4: Reduce child mortality	Achieved
Goal 5: Improve maternal health	Achieved
Goal 6: Combat HIV/AIDS, malaria and other diseases	Mixed
Goal 7: Ensure environmental sustainability	Mixed
Goal 8: Develop a global partnership for development	Not Assessed

1/ Sources: 2015 Pacific Regional MDGs Tracking Report, PIFS

Multi-year Surveillance Matrix including SDG[1]

Issues to Cover	Macro-criticality	Traction with authorities	Article IV		Background Work	TA / Training	
			2016	2018		2017	2018
1. Traditional macroeconomic Issues (Real, Fiscal, BOP, MON)	H	H	X	X		X	X
Issues for Further Integration							
2. Macro-financial Issues							
2-1. Capital Inflows and Spillovers	L	L					
2-2. Financial Development, Deepening and Inclusion	H	H		X	Cryptocurrency		X
2-3. Financial Cycle and Macro-implications	L	L					
2-4. Balance Sheet Analysis	N/A	L					
2-5. Macroprudential Policy	N/A	L					
2-6. Financial Supervision and Regulation	H	H	X	X	CBR Withdrawal	X	X
2-7. Macroeconomic Shocks and Financial Stress	N/A	H		X	High consumer loan		X
3. SDGs/FfD Commitments							
3-1. Domestic Revenue mobilization	H	H	X	X	MT Fiscal Adjustment	X	X
3-2. Infrastructure Investment	M	M		X	Sustainable growth		
3-3. Building Policy space/economic resilience	H	M	X	X	SOE / Compact Trust Fund		
3-4. Environmental sustainability, equity/inclusion	M	M					
3-5. Fragile and Conflict-Affected States need	N/A	N/A					
3-6. Domestic financial market promotion	H	M	X	X	Private sector development		
3-7. Data enhancement	H	H	X	X	GDP, BOP, GFS	X	X
4. Fund's New "Core" Issues							
4-1. Gender	L	L					
4-2. Income Inequality	L	L					
4-3. Climate Change	H	H	X	X			

*1/ Based on staff assessment of macro-criticality and priority for the RMI. **H**, **M**, **L** stand for High, Medium and Low*

Appendix V. Main Recommendations of the 2016 Article IV Consultation

Fund Recommendations	Policy Actions
Fiscal policy:	
Objective: Build fiscal buffers ahead of the FY2023 reduction of Compact grants though fiscal adjustment of 5 percent of GDP over 7 years, to achieve a medium-term fiscal surplus of 3 percent of GDP. Support efforts toward climate change adaptation.	
- Expenditure consolidation	Recurrent spending increased significantly, by more than 10 percentage points of GDP from FY2014 to FY2017, leading to little fiscal consolidation despite significant revenue increases from fishing license fees.
- Tax reform	Good progress has been made in tax administration including registration, filing, and payment voluntary compliance. A tax reform bill has been prepared including the introduction of a net profits tax and a consumption tax, but is yet to be enacted.
- Reform of social security systems	A long-awaited reform, including the gradual increase of the retirement age and the increase of the contribution rate by 1 percent, was implemented in 2017, with expected annual savings of US$4 million (2 percent of GDP).
- Ensure explicit budgeting of fiscal provisions for climate change adaptation.	While several projects are included in the budget for climate change adaptation, explicit budgeting remains a challenge.
- Seek climate change funding from diverse sources, including grants and disaster risk insurance.	The authorities are working on climate change funding, in discussion with the World Bank and Green Climate Fund.
Growth policy:	
Objective: Facilitate private sector development.	
- Building on the SOE Act, continue SOE reforms including the clarification of community service obligations and the establishment of a centralized SOE monitoring unit.	Progress has been limited, with subsides to SOEs rising sizably, by 1¾ percentage points of GDP to 7½ percent in FY2017 over the past three years. A central SOE monitoring unit was established in May 2018.
Financial sector policy:	
Objective: Safeguard financial stability.	
- The capacity and oversight of the Banking Commission should be strengthened to safeguard financial stability and address the challenges posed by withdrawal of correspondent banking relationships.	Good progress has been made in re-establishing a prudential banking supervision framework. The authorities have amended the Banking Act with a view to align the AML/CFT provisions with the FATF 40 recommendations and started the first national risk assessment.

INTERNATIONAL MONETARY FUND

REPUBLIC OF THE MARSHALL ISLANDS

August 10, 2018

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

Asia and Pacific Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of July, 31, 2018)

Membership Status: Joined May 21, 1992; Article VIII

General Resources Account:

	SDR Million	Percent Quota
Quota	3.50	100.00
Fund holdings of currency	3.50	100.00
Reserve tranche position	0.00	0.01

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	3.33	100.00
Holdings	3.36	101.08

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Overdue Obligations and Projected Payments to Fund[1]

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2018	2019	2020	2021	2022
Principal					
Charges/Interest		0.00	0.00	0.00	0.00
Total		0.00	0.00	0.00	0.00

Exchange Rate Arrangements.
The U.S. dollar is legal tender and the official currency. The Marshall Islands maintains an exchange system that is free of restrictions on the making of international payments and transfers for current and capital transactions.

Article IV Consultation:

The Marshall Islands is on a 24-month consultation cycle. The 2016 Article IV Consultation discussions were held during May 9–18, 2016. The Executive Board discussed the staff report and concluded the consultation on July 25, 2016.

Technical Assistance: Technical assistance on revenue administration, social security reform, public financial management, bank supervision, and statistics has been provided mainly through PFTAC.

Resident Representative: Ms. Leni Hunter has been the Resident Representative for Pacific Island Countries in since March, 2018. She is based in Suva, Fiji.

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

RELATIONS WITH OTHER IFIS

Relations with other IFIS:

- World Bank Group: http://projects.worldbank.org/search?lang=en&searchTerm=&countrycode_exact=MH
- Asian Development Bank: https://www.adb.org/countries/marshall-islands/main
- Pacific Financial Technical Assistance Center: https://www.pftac.org/content/PFTAC/en1/reports11.html#tab_5

STATISTICAL ISSUES

Assessment of Data Adequacy for Surveillance
(As of July 2018)
General: Data provision is broadly adequate for surveillance and the authorities willingly share available data, though some shortcomings tend to constrain policy analysis, especially on trade statistics. The Economic Policy, Planning and Statistics Office (EPPSO) was established in February 2003 and took efforts in building local capacity to collect and disseminate economic and social statistics. Through the close collaboration of EPPSO and various ministries, an external consultant team in the Pacific Islands Training Initiative (www.pitiviti.org), funded by the U.S. Department of Interior, prepares a comprehensive set of annual statistics covering key areas beginning FY2008. Previously, extensive Fund technical assistance was provided through the Pacific Financial Technical Assistance Center (PFTAC) in preparation of the balance of payments and national account statistics. Data shortcomings include the coverage and timeliness of data releases.
National Accounts: National income accounts from (the latest data through FY2016) have been prepared by the external consultants dating back to FY1997, though the official website lags far behind in presenting what is available. Some shortcomings remain, for instance, investment, consumption and savings indicators are not available. The national census was conducted in early 2011.
Employment: Data on employment and wages are available and classified by sectors based on the filings to Social Security Administration. However, no unemployment data are available.
Price statistics: The new consumer price index (CPI), rebased in 2003Q1, and replaced the previous CPI developed in the 1980s. The updated CPI is based on the information from the Household Income and Expenditure Survey 2002, conducted with assistance from the U.S. Department of the Interior and the U.S. Census Bureau. Currently, the CPI basket is under review with help from the World Bank and Secretary of Pacific.
Government finance: Fiscal data are regularly compiled for budget control, and with the help of the consultants they are consolidated into a format suitable for analysis. Annual financial audits on the central government and component units were published. The RMI presents fiscal data using Government Finance Statistics Manual 2001 (GFSM 2001) format and has submitted data to the Government Financial Statistics Yearbook for 2008–13. Recent TA work successfully mapped various elements to GFSM 2014 to enable public sector consolidation.
Monetary statistics: A reporting system has been established for domestic banking institutions on the basis of monthly reporting forms and guidelines developed by the 1993 STA mission. Even though data are reported by banks to the Banking Commissioner, they are not published or reported to the Fund. Tables on basic balance sheet items as well as income and expenses are prepared for inclusion in the Annual Compact Report.
Balance of payments: The EPPSO has made important progress in the improvement of Marshall Islands' ESS during the JSA ESS Project. The sixth edition of the Balance of Payments and International Investment Position Manual (BPM6) was adopted and balance of payments and international investment position (IIP) statistics started to be submitted to STA in 2014. Following the implementation of a unit dedicated to the compilation of statistics, the EPPSO took over the ownership of ESS compilation, currently conducted solely by external consultants. Nevertheless, the unit is staffed by a sole compiler and some reliance on the consultants still remains. Further actions still need to be undertaken by the EPSSO to collect proper data on external debt statistics (EDS), foreign direct investment (FDI) statistics, and proper data on banks' external assets and liabilities.
Data Standards and Quality
Does not participate in the IMF's General Data Dissemination System. No data ROSC is available.
Reporting to STA (Optional)
BOP data is reported to STA by EPPSO.

Marshall Islands: Table of Common Indicators Required for Surveillance
As of July 2018

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	Jun 2018	Jun 2018	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	FY2016	Aug 2017	A	A	A
Reserve/Base Money	NA	NA	NA	NA	NA
Broad Money	NA	NA	NA	NA	NA
Central Bank Balance Sheet	NA	NA	NA	NA	NA
Consolidated Balance Sheet of the Banking System	FY2016	Aug 2017	A	A	A
Interest Rates[2]	FY2016	Aug 2017	A	A	A
Consumer Price Index	FY2016	Aug 2017	Q	Q	Q
Revenue, Expenditure, Balance/Composition of Financing[3] General Government[4] and Central Government	FY2016	Aug 2017	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	FY2016	Aug 2017	A	A	A
External Current Account Balance	FY2016	Aug 2017	A	A	A
Exports and Imports of Goods and Services	FY2016	Aug 2017	A	A	A
GDP/GNP	FY2016	Aug 2017	A	A	A
Gross External Debt	FY2016	Aug 2017	A	A	A
International Investment Position [6]	FY2016	Aug 2017	A	A	A

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).

INTERNATIONAL MONETARY FUND

REPUBLIC OF THE MARSHALL ISLANDS

August 10, 2018

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITYANALYSIS

Approved By
Thomas Helbling (IMF), and John Panzer (IDA)

Prepared by the staffs of the International Monetary Fund (IMF) and the International Development Association (IDA)[1]

The 2018 Debt Sustainability Analysis (DSA) assesses that the Republic of the Marshall Islands (RMI) remains at high risk of debt distress. The ratios of the present value (PV) of external public and publicly-guaranteed (PPG) debt to GDP and to exports are currently just below their respective policy-dependent indicative thresholds. The PV of the PPG debt-to-GDP ratio is expected to decline slightly in the near term, but to start increasing and exceed its indicative threshold in the medium to long term. Stress tests confirm the vulnerability of the debt position to lending terms as well as macroeconomic shocks. Although the RMI does not currently face debt servicing risks, helped by government revenue from fishing licenses and a stable flow of funds from the U.S. Compact grants until FY2023, a lack of fiscal buffers after FY2023 and risks from contingent liabilities call for a fiscal reform strategy. Containing the risk of debt distress requires continuation of grants to support the country's large development needs, and implementation of fiscal and structural reforms to promote fiscal sustainability and growth.

[1] This DSA was prepared jointly with the World Bank, in accordance with the standard Debt Sustainability Framework for Low-income Countries approved by the Executive Boards of the IMF and the IDA (This DSA was prepared prior to July 1, 2018 based on the 2013 staff guidance note). Debt sustainability is assessed in relation to policy-dependent debt burden thresholds. The RMI, with an average Country Policy and Institutional Assessment (CPIA) score of 2.6 over the last three years, is considered to have weak policy and institutional capacity for the purposes of the DSA framework, and assessed against relatively lower debt thresholds. Thus, the external debt burden thresholds for the RMI are: (i) PV of debt-to-GDP ratio: 30 percent; (ii) PV of debt-to-exports ratio: 100 percent; (iii) PV of debt-to-revenue ratio: 200 percent; (iv) debt service-to-exports ratio: 15 percent; and (v) debt service-to-revenue ratio: 18 percent.

BACKGROUND

1. **The RMI's external public and publicly guaranteed (PPG) debt has been on a downward trajectory since the early 2000s.** It declined from 74 percent of GDP in FY2002 to 38 percent in FY2017.[2] About two-thirds of outstanding debt is central government debt contracted with the Asian Development Bank (ADB), while the rest is state-owned enterprise (SOE) debt guaranteed by the government. Total debt service amounts to US$7 million in FY2018, and remains broadly stable over the medium term. All loans will be redeemed in U.S. dollars, the legal tender and official currency of the RMI. The private sector accounts for about 6 percent of total external debt.

2. **RMI faces a long-term fiscal challenge as some U.S. grants provided under the Compact of Free Association (Compact grants) will expire in FY2023.** RMI is dependent on external grants and fishing license fees to finance public spending. A portion of the Compact grants has been disbursed into the Compact Trust Fund (CTF), jointly managed by the United States and the RMI, with the goal that investment earnings from the CTF could replace the expiring portion of the U.S. Compact grants after FY2023. Nevertheless, the current trajectory of the CTF is not on track to preserve the *real* value of the CTF (with about 2 percent inflation adjustment), highlighting the risk of widening financial gaps.

UNDERLYING ASSUMPTIONS

3. **Key assumptions are consistent with the macroeconomic framework based on updated data provided by the authorities and estimates by staff.** Relative to the previous DSA, the outlook for real GDP growth has been revised up moderately, reflecting a recent resumption of capital investment with gradual expansion in domestic absorption. Also, the view for near- to medium-term fiscal indicators has moderately improved mainly due to the upward revision of fiscal revenues (notably further increases in fishing license fees). Regarding external finance, projected support from IDA has also been revised upward, reflecting IDA's planned scale-up for Pacific Island countries. However, the long-term fiscal challenge of the reduction of the U.S. Compact grants after FY2023 remains largely unchanged.

a. **Real GDP growth** in the long run is projected to register 1.5 percent, which incorporates the potential effects of natural disasters on growth (see section following). The GDP deflator is expected to stabilize at around 1 percent in the long run.

b. **The overall fiscal surplus** is expected to decline gradually and turn into a deficit of 1.3 percent of GDP by FY2023, when the U.S. Compact grants expire. On the revenue side, Compact grants in real terms are projected to decrease as scheduled. Grants from other donors as well as fishing license fees are assumed to be stable in nominal terms, while declining as a share of GDP. The tax revenue-to-GDP ratio is assumed to remain broadly unchanged, as the baseline scenario does not incorporate tax reforms. Beyond FY2023, investment earnings from the CTF are intended to replace the expiring portion of the U.S. Compact grants. While the projected value of CTF would generate sufficient income to supplement the expired Compact grants

[2] Fiscal year ending September 30.

(US$27 million), long-term self-sufficiency will not be secured because the real value of the CTF will decline over time. Total expenditure recorded a peak at 65 percent of GDP in FY2017 and is projected to remain high at around 62–65 percent of GDP until FY2023 as the authorities' high priority projects will be accelerated through financial support from IDA and ADB. Beyond FY2023, expenditures are expected to follow trends in revenues and grants—total expenditure is projected to decrease to 58 percent of GDP in FY2033 as grants and fishing license fees are expected to decline in percent of GDP.

c. **The current account deficit** (including official current transfers) is also expected to worsen gradually from 0.3 percent of GDP in FY2017 to 3.1 percent of GDP by FY2023, due to continued import demand for infrastructure projects while fishing license fee remains stable in nominal terms.

d. **External financing**. In the absence of access to the international capital market and a very limited domestic market, the financing gap is assumed to be closed by a combination of bilateral loans from development partners and multilateral concessional lending. In addition, it is assumed that the additional support from IDA and ADB will be provided on credit terms (see paragraph 6 for more details).

INCORPORATING THE IMPACT OF NATURAL DISASTER

4. RMI is one of the countries expected to be most affected by climate change. The vulnerability arises from the exposure to rising sea levels, given its low elevation, and to natural disaster such as droughts and floods. Historical data on natural disasters from the Emergency Events Database indicate that the average likelihood of a severe natural disaster is 5.4 percent per year, with about 25 percent of total population being affected by a severe disaster event.

5. The DSA incorporates the costs and risks of natural disasters. The baseline scenario considers the impact of future natural disasters, in line with the 2016 IMF Board Paper on "Small States' Resilience to Natural Disasters and Climate Change."[3] For FY2018–2023, staff's projections assume no natural disasters, in line with the guidance from the Board Paper. This ensures that adjustments for natural disasters do not complicate near-term policy discussions. However, for a realistic assumption over the longer horizon, the baseline projections after FY2023 take into account the average annual impact of natural disasters by adjusting downward the average growth rate. In particular, long-term growth is adjusted down by 0.1 percentage points to 1.5 percent, compared with a non-disaster potential growth rate of 1.6 percent. In addition, the near-term risk of a one-off extreme natural disaster is incorporated in the DSA through a standard customized scenario (see Figures 1 and 2). Based on Lee, Zhang and Nguyen (2018), this risk scenario assumes that a one-off extreme natural disaster would decrease real GDP growth by 2 percentage

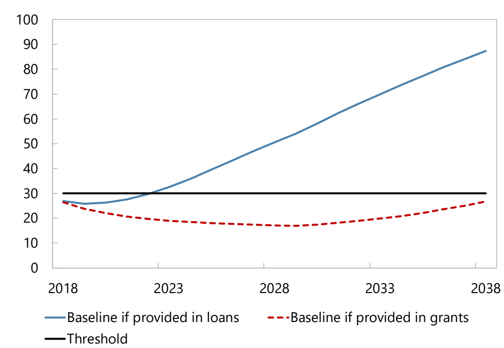
[3] The 2016 Board Paper is available at: https://www.imf.org/en/News/Articles/2016/12/12/PR16550-IMF-Discusses-Small-States-Resilience-to-Natural-Disasters-and-Climate-Change-and-IMF-Role.

points, and increase the trade deficit and public expenditure by 5 percent of GDP respectively in the near term.[4]

EXTERNAL DEBT SUSTAINABILITY ANALYSIS

6. **Under the baseline scenario, RMI's PPG external debt trajectory is projected to exceed the indicative threshold in the medium to long term**. The PV of external debt-to-GDP ratio is expected to ease in the near term following the recent downward trajectory. However, it is expected to start increasing and to exceed the threshold of 30 percent from FY2022 (Figure 1). The ratio of the PV of external debt-to-exports is also expected to increase and remain above the threshold of 100 percent during most of the projection period. As the bulk of external debt is on concessional terms, debt service will be relatively contained. Nonetheless, the debt service-to-exports ratio will gradually approach the indicative threshold by the end of the projection period because of continued debt accumulation. Alternatively, if the RMI continues to benefit from its grant-only status, the PV of debt-to-GDP ratio will gradually decline and stay below the threshold throughout the projection period (see text chart).[5]

PV of Debt-to-GDP ratio



7. **Stress tests confirm the vulnerability of debt dynamics to lending terms, export market conditions as well as macroeconomic shocks**. Given continued debt accumulation in the baseline scenario, the debt trajectory is particularly sensitive to changes in the terms of new lending as shown in the most extreme shock scenario. In addition, other stress-test scenarios, including the severe natural disaster scenario, illustrate the vulnerability of the debt trajectory to external shocks.

PUBLIC DEBT SUSTAINABILITY ANALYSIS

8. **Public debt follows very closely the dynamic of external debt.** Under the baseline scenario, the PV of total public debt-to-GDP ratio is projected to increase from 29 percent of GDP in FY2017 to 50 percent of GDP in FY2028, exceeding the benchmark of 38 percent. A sensitivity analysis on the primary deficit—holding the annual primary surplus at the FY2018 level of 2.6 percent, relative to projected average of 0.2 percent (FY2018–FY2028) in the baseline scenario—will decrease the PV of public debt-to-GDP ratio by 13 percentage points in FY2028. This highlights that fiscal consolidation in the early years of the

[4] Lee, Zhang and Nguyen. *The Economic Impact of Natural Disasters in Pacific Island Countries: Adaptation and Preparedness.* IMF WP/18/108.

[5] In the IMF's macroeconomic framework, it is assumed that the RMI will continue to benefit from its grant-only status. However, in preparing the LIC-DSA, for World Bank (IDA) and other MDBs, regular credit terms on all lending is assumed for all years in the projection period for which grant finance has not already been committed. This is required as lenders link the terms of their assistance and allocation of grants to the DSF risk rating, and hence a clean assessment without possible grants is needed. Grants committed on the basis of the DSA can then be captured at the next DSA cycle.

projections will substantially improve prospects for debt sustainability. As discussed in the staff report, fiscal consolidation could be achieved through unwinding the surge in recurrent spending, improving revenue administration, and implementing growth-friendly tax reforms.

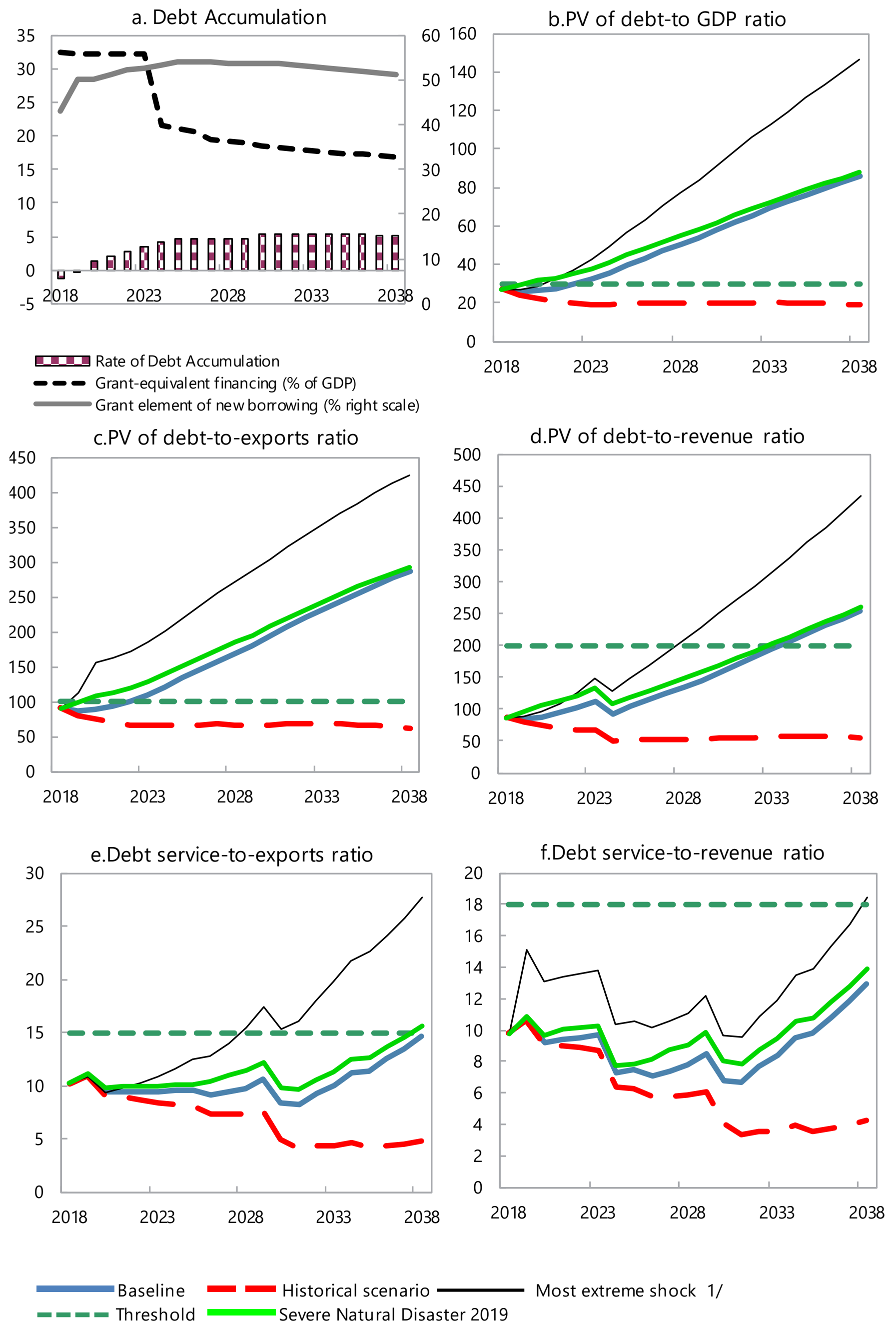
THE AUTHORITIES VIEWS

9. The authorities agreed with the DSA assessment, noting that the current risk of debt distress is high. In addition to continued grants from bilateral donors and international financial institutions, they saw the need to build adequate fiscal buffers by FY2023 through fiscal adjustment to preserve the real value of CTF after the reduction of the U.S. compact grant. To this end, they underscored ongoing fiscal reforms, including revenue mobilization, targeted expenditure cuts, and public finance management reforms. The authorities are also seeking additional concessional loans and grants from bilateral donors and international financial institutions with a view to partly offsetting the reduction in the U.S. compact grants. In this context, the authorities also recognized the need to comply with the non-concessional borrowing policies for securing grant support from the WB and ADB.

CONCLUSION

10. The standard DSA framework for LICs suggests that the RMI is at high risk of debt distress. The baseline scenario indicates that the PV of PPG external debt-to-GDP ratio would breach the indicative threshold during most of the projection period. Furthermore, stress tests suggest that RMI's external PPG debt trajectory could even worsen. RMI's vulnerability to debt distress is mitigated by a number of factors: the decline in external support from the Compact grants will be gradual, sheltering the country from the risk of a sudden stop in foreign financing; the government is building up the CTF that will provide a stable source of funding after FY2023; and RMI currently benefits from its grant-only status. On the other hand, vulnerabilities are exacerbated by the lack of fiscal buffers, uncertainty about prospective SOE losses, volatility in CTF investment returns, and contingent liabilities from climatic events and the social security system. Thus, the government needs to implement fiscal and structural reforms to generate sufficient fiscal surpluses by FY2023 to shore up the CTF while safeguarding social spending and economic growth.

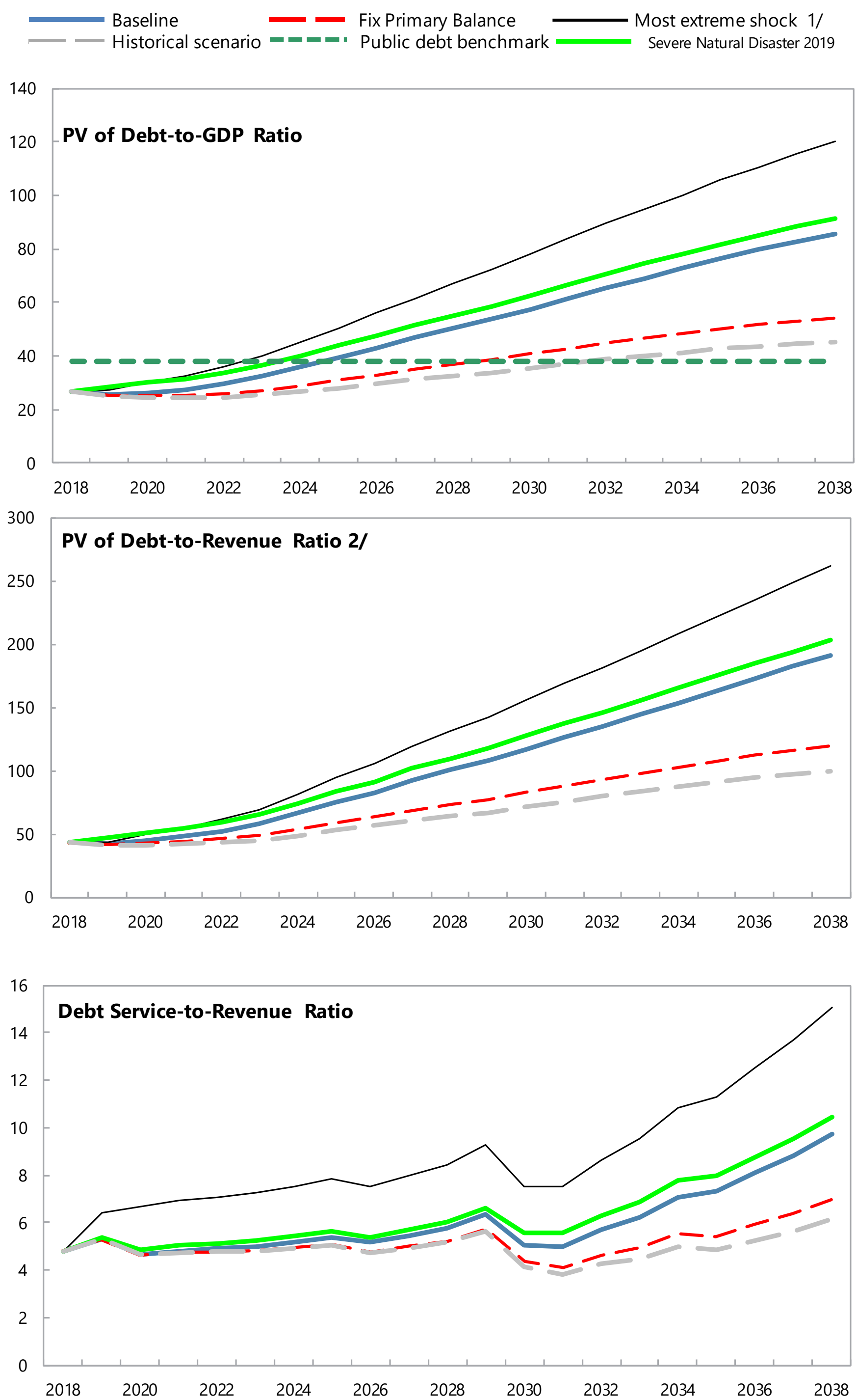
Figure 1. Marshall Islands: Indicators of Public and Public Guaranteed External Debt Under Alternative Scenarios FY2018–38 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2028. In figure b, it corresponds to a Terms shock; in c, to a Exports shock; in d, to a Terms shock; in e, to a Terms shock and in figure f, to a One-time depreciation shock

Figure 2. Marshall Islands: Indicators of Public Debt Under Alternative Scenarios, 2018–38 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2028.

2/ Revenues are defined inclusive of grants.

Table 1. Marshall Islands: External Debt Sustainability Framework, Baseline Scenario, 2015–38 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/ Average	Standard 6/ Deviation	Projections									
	2015	2016	2017			2018	2019	2020	2021	2022	2023	2018-2023 Average	2028	2038	2024-2038 Average
External debt (nominal) 1/	**51.9**	**45.3**	**37.7**			**35.1**	**34.8**	**37.5**	**41.7**	**47.4**	**54.3**		**94.6**	**153.3**	
of which: public and publicly guaranteed (PPG)	49.1	42.5	35.2			32.8	32.5	35.3	39.5	45.3	52.3		92.8	151.9	
Change in external debt	-1.7	-6.5	-7.6			-2.6	-0.3	2.7	4.2	5.7	7.0		7.4	4.4	
Identified net debt-creating flows	-15.7	-14.0	-7.6			-2.9	-2.2	-1.2	-0.3	0.0	0.1		0.4	1.5	
Non-interest current account deficit	**-16.3**	**-8.7**	**-0.6**	**-0.2**	**9.7**	**-0.3**	**0.2**	**1.2**	**1.9**	**2.2**	**2.4**		**3.0**	**4.5**	3.4
Deficit in balance of goods and services	55.5	56.3	56.5			56.2	56.2	56.3	56.3	56.1	55.9		54.6	49.7	
Exports	36.9	26.9	29.5			29.7	29.7	29.6	29.5	29.6	29.7		29.7	29.9	
Imports	92.4	83.3	86.0			86.0	85.9	85.9	85.8	85.7	85.6		84.3	79.6	
Net current transfers (negative = inflow)	-32.2	-30.7	-26.6	-33.3	4.2	-25.4	-24.2	-22.9	-22.0	-21.4	-20.8		-12.9	-11.1	-12.4
of which: official	-31.2	-30.0	-25.7			-24.9	-23.7	-22.5	-21.8	-21.2	-20.6		-12.9	-11.1	
Other current account flows (negative = net inflow)	-39.6	-34.3	-30.5			-31.1	-31.9	-32.3	-32.3	-32.5	-32.8		-38.7	-34.1	
Net FDI (negative = inflow)	**-1.8**	**-2.5**	**-2.6**	**-5.5**	**6.4**	**-2.5**	**-2.4**	**-2.4**	**-2.3**	**-2.3**	**-2.3**		**-2.3**	**-2.3**	-2.3
Endogenous debt dynamics 2/	**2.4**	**-2.8**	**-4.4**			**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.1**		**-0.3**	**-0.7**	
Contribution from nominal interest rate	1.3	1.1	0.9			0.9	0.8	0.8	0.7	0.8	0.8		1.0	1.4	
Contribution from real GDP growth	0.3	-1.0	-1.4			-0.9	-0.8	-0.7	-0.7	-0.7	-0.7		-1.3	-2.2	
Contribution from price and exchange rate changes	0.8	-3.0	-3.9			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**14.0**	**7.4**	**0.0**			**0.3**	**1.9**	**3.9**	**4.5**	**5.7**	**6.8**		**7.0**	**3.0**	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	31.5			29.3	28.0	28.5	29.7	31.7	34.4		52.0	87.2	
In percent of exports	...	...	106.7			98.5	94.4	96.4	100.6	107.3	116.0		175.3	291.2	
PV of PPG external debt	**...**	**...**	**29.0**			**26.9**	**25.7**	**26.3**	**27.6**	**29.6**	**32.4**		**50.2**	**85.7**	
In percent of exports	**...**	**...**	**98.4**			**90.6**	**86.7**	**88.9**	**93.4**	**100.2**	**109.2**		**169.2**	**286.5**	
In percent of government revenues	**...**	**...**	**75.6**			**86.8**	**84.5**	**87.8**	**93.6**	**102.0**	**112.9**		**135.1**	**254.2**	
Debt service-to-exports ratio (in percent)	**11.4**	**13.0**	**10.7**			**10.2**	**10.9**	**9.3**	**9.4**	**9.4**	**9.4**		**9.7**	**14.6**	
PPG debt service-to-exports ratio (in percent)	**11.4**	**13.0**	**10.7**			**10.2**	**10.9**	**9.3**	**9.4**	**9.4**	**9.4**		**9.7**	**14.6**	
PPG debt service-to-revenue ratio (in percent)	**15.3**	**10.9**	**8.2**			**9.8**	**10.6**	**9.2**	**9.4**	**9.5**	**9.7**		**7.8**	**12.9**	
Total gross financing need (Millions of U.S. dollars)	-25.2	-15.0	-0.2			0.5	2.3	3.9	6.2	7.1	7.6		10.8	25.1	
Non-interest current account deficit that stabilizes debt ratio	-14.6	-2.1	7.0			2.2	0.5	-1.5	-2.2	-3.5	-4.6		-4.4	0.0	
Key macroeconomic assumptions															
Real GDP growth (in percent)	-0.6	2.0	3.6	1.4	2.9	2.5	2.3	2.2	2.0	1.8	1.6	2.1	1.5	1.5	1.4
GDP deflator in US dollar terms (change in percent)	-1.5	6.1	9.3	2.4	3.6	0.9	1.0	1.2	1.3	0.9	1.0	1.0	1.0	1.0	1.0
Effective interest rate (percent) 5/	2.4	2.3	2.2	2.6	0.4	2.4	2.4	2.3	2.0	1.9	1.7	2.1	1.2	1.0	1.1
Growth of exports of G&S (US dollar terms, in percent)	-8.1	-20.9	24.1	7.8	20.7	4.3	3.2	3.0	3.0	2.9	2.9	3.2	2.5	2.6	2.5
Growth of imports of G&S (US dollar terms, in percent)	-7.2	-2.5	17.0	4.1	9.8	3.4	3.3	3.3	3.2	2.6	2.4	3.0	1.9	1.8	1.9
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	43.1	50.0	50.3	51.3	52.1	52.5	49.9	53.7	51.2	53.0
Government revenues (excluding grants, in percent of GDP)	27.5	32.2	38.4			31.0	30.5	29.9	29.4	29.0	28.7		37.2	33.7	36.2
Aid flows (in Millions of US dollars) 7/	58.7	59.1	65.9			75.8	80.5	86.2	90.5	94.6	98.7		73.3	85.0	
of which: Grants	58.7	59.1	65.9			73.8	72.9	71.8	71.7	71.7	71.6		39.1	43.0	
of which: Concessional loans	0.0	0.0	0.0			2.0	7.6	14.4	18.8	22.9	27.2		34.2	42.0	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			32.5	32.3	32.2	32.1	32.1	32.1		19.1	16.8	18.6
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			98.5	95.3	91.7	89.9	88.4	86.9		78.4	75.9	78.0
Memorandum items:															
Nominal GDP (Millions of US dollars)	181.3	196.3	222.3			229.9	237.7	245.8	253.8	260.7	267.4		300.2	383.1	
Nominal dollar GDP growth	-2.1	8.2	13.3			3.4	3.4	3.4	3.3	2.7	2.6	3.1	2.5	2.5	2.4
PV of PPG external debt (in Millions of US dollars)			64.6			61.9	61.2	64.6	70.0	77.2	86.6		150.8	328.5	
(PVt-PVt-1)/GDPt-1 (in percent)						-1.2	-0.3	1.4	2.2	2.9	3.6	1.4	4.8	5.1	5.1
Gross workers' remittances (Millions of US dollars)	7.7	8.6	9.6			10.0	10.3	10.6	11.0	11.3	11.6		13.0	16.6	
PV of PPG external debt (in percent of GDP + remittances)	...	...	27.8			25.8	24.7	25.2	26.4	28.4	31.0		48.1	82.2	
PV of PPG external debt (in percent of exports + remittances)	...	...	85.8			79.1	75.6	77.5	81.4	87.4	95.2		147.6	250.3	
Debt service of PPG external debt (in percent of exports + remittanc	...	...	9.3			8.9	9.5	8.1	8.2	8.2	8.2		8.5	12.7	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that PV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 2. Marshall Islands: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2018–38

(In percent)

	Projections							
	2018	2019	2020	2021	2022	2023	**2028**	2038
PV of debt-to GDP ratio								
Baseline	27	26	26	28	30	32	**50**	86
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2018-2038 1/	27	24	22	21	20	19	**20**	19
A2. New public sector loans on less favorable terms in 2018-2038 2	27	27	29	32	37	42	**77**	146
Severe Natural Disaster 2019	27	29	32	33	35	38	**55**	88
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2019-2020	27	27	28	30	32	35	**54**	92
B2. Export value growth at historical average minus one standard deviation in 2019-2020 3/	27	28	33	34	36	39	**58**	91
B3. US dollar GDP deflator at historical average minus one standard deviation in 2019-2020	27	26	28	29	31	34	**53**	90
B4. Net non-debt creating flows at historical average minus one standard deviation in 2019-2020 4/	27	25	24	25	27	30	**48**	84
B5. Combination of B1-B4 using one-half standard deviation shocks	27	24	24	25	27	30	**49**	88
B6. One-time 30 percent nominal depreciation relative to the baseline in 2019 5/	27	37	37	39	42	46	**71**	122
PV of debt-to-exports ratio								
Baseline	91	87	89	93	100	109	**169**	286
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2018-2038 1/	91	81	75	70	67	65	**66**	62
A2. New public sector loans on less favorable terms in 2018-2038 2	91	90	97	109	124	143	**260**	488
Severe Natural Disaster 2019	91	99	107	112	119	128	**185**	293
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2019-2020	91	87	89	93	100	109	**169**	286
B2. Export value growth at historical average minus one standard deviation in 2019-2020 3/	91	112	155	162	172	185	**272**	424
B3. US dollar GDP deflator at historical average minus one standard deviation in 2019-2020	91	87	89	93	100	109	**169**	286
B4. Net non-debt creating flows at historical average minus one standard deviation in 2019-2020 4/	91	84	81	86	93	101	**161**	281
B5. Combination of B1-B4 using one-half standard deviation shocks	91	84	85	90	98	108	**174**	311
B6. One-time 30 percent nominal depreciation relative to the baseline in 2019 5/	91	87	89	93	100	109	**169**	286
PV of debt-to-revenue ratio								
Baseline	87	84	88	94	102	113	**135**	254
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2018-2038 1/	87	79	74	70	68	67	**53**	55
A2. New public sector loans on less favorable terms in 2018-2038 2	87	87	96	109	126	148	**208**	433
Severe Natural Disaster 2019	87	96	106	112	121	132	**148**	260
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2019-2020	87	88	95	101	110	122	**146**	274
B2. Export value growth at historical average minus one standard deviation in 2019-2020 3/	87	92	109	116	125	136	**155**	268
B3. US dollar GDP deflator at historical average minus one standard deviation in 2019-2020	87	86	92	98	107	118	**141**	266
B4. Net non-debt creating flows at historical average minus one standard deviation in 2019-2020 4/	87	82	80	86	94	105	**128**	249
B5. Combination of B1-B4 using one-half standard deviation shocks	87	80	80	85	94	105	**131**	260
B6. One-time 30 percent nominal depreciation relative to the baseline in 2019 5/	87	120	125	133	145	161	**192**	362

Table 2. Marshall Islands: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2018–38 (concluded)

(In percent)

	Projections							
	2018	2019	2020	2021	2022	2023	2028	2038
Debt service-to-exports ratio								
Baseline	10	11	9	9	9	9	**10**	15
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2018-2038 1/	10	11	9	9	9	8	**7**	5
A2. New public sector loans on less favorable terms in 2018-2038 2	10	11	9	10	10	11	**15**	28
Severe Natural Disaster 2019	10	11	10	10	10	10	**11**	16
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2019-2020	10	11	9	9	9	9	**10**	15
B2. Export value growth at historical average minus one standard deviation in 2019-2020 3/	10	13	13	14	14	14	**14**	22
B3. US dollar GDP deflator at historical average minus one standard deviation in 2019-2020	10	11	9	9	9	9	**10**	15
B4. Net non-debt creating flows at historical average minus one standard deviation in 2019-2020 4/	10	11	9	9	9	9	**10**	14
B5. Combination of B1-B4 using one-half standard deviation shocks	10	12	10	10	10	10	**11**	15
B6. One-time 30 percent nominal depreciation relative to the baseline in 2019 5/	10	11	9	9	9	9	**10**	15
Debt service-to-revenue ratio								
Baseline	10	11	9	9	10	10	**8**	13
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2018-2038 1/	10	11	9	9	9	9	**6**	4
A2. New public sector loans on less favorable terms in 2018-2038 2	10	11	9	10	10	11	**12**	25
Severe Natural Disaster 2019	10	11	10	10	10	10	**9**	14
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2019-2020	10	11	10	10	10	10	**8**	14
B2. Export value growth at historical average minus one standard deviation in 2019-2020 3/	10	11	9	10	10	10	**8**	14
B3. US dollar GDP deflator at historical average minus one standard deviation in 2019-2020	10	11	10	10	10	10	**8**	14
B4. Net non-debt creating flows at historical average minus one standard deviation in 2019-2020 4/	10	11	9	9	9	10	**8**	12
B5. Combination of B1-B4 using one-half standard deviation shocks	10	11	10	10	10	10	**8**	13
B6. One-time 30 percent nominal depreciation relative to the baseline in 2019 5/	10	15	13	13	14	14	**11**	18
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	51	51	51	51	51	51	**51**	51

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.

3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 3. Marshall Islands: Public Sector Debt Sustainability Framework, Baseline Scenario, 2015–38

(In percent of GDP, unless otherwise indicated)

	Actual			Average 5/	Standard Deviation 5/	Estimate	Projections								
	2015	2016	2017			2018	2019	2020	2021	2022	2023	2018-23 Average	2028	2038	2024-38 Average
Public sector debt 1/	49.1	42.5	35.2			32.8	32.5	35.3	39.5	45.3	52.3		92.8	151.9	
of which: foreign-currency denominated	49.1	42.5	35.2			32.8	32.5	35.3	39.5	45.3	52.3		92.8	151.9	
Change in public sector debt	-2.2	-6.5	-7.3			-2.5	-0.3	2.8	4.3	5.7	7.0		7.4	4.5	
Identified debt-creating flows	-1.8	-7.7	-8.0			-2.9	-2.1	-1.2	-0.7	-0.2	0.1		-0.5	-0.8	
Primary deficit	-4.1	-5.1	-3.9	-3.7	1.7	-2.6	-1.8	-0.9	-0.3	0.1	0.5	-0.9	0.6	1.3	0.7
Revenue and grants	59.9	62.3	68.0			63.1	61.1	59.2	57.7	56.5	55.4		50.2	45.0	
of which: grants	32.4	30.1	29.6			32.1	30.7	29.2	28.3	27.5	26.8		13.0	11.2	
Primary (noninterest) expenditure	55.7	57.3	64.2			60.5	59.3	58.3	57.4	56.6	55.9		50.8	46.3	
Automatic debt dynamics	2.4	-2.6	-4.1			-0.3	-0.3	-0.3	-0.4	-0.3	-0.4		-1.1	-2.1	
Contribution from interest rate/growth differential	2.4	-2.6	-4.1			-0.3	-0.3	-0.3	-0.4	-0.3	-0.4		-1.1	-2.1	
of which: contribution from average real interest rate	2.1	-1.6	-2.6			0.5	0.5	0.4	0.3	0.4	0.4		0.2	0.0	
of which: contribution from real GDP growth	0.3	-1.0	-1.5			-0.8	-0.7	-0.7	-0.7	-0.7	-0.7		-1.2	-2.2	
Contribution from real exchange rate depreciation	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	-0.4	1.2	0.7			0.5	1.8	4.0	4.9	6.0	6.9		7.9	5.3	
Other Sustainability Indicators															
PV of public sector debt	...	...	29.0			26.9	25.7	26.3	27.6	29.6	32.4		50.2	85.7	
of which: foreign-currency denominated	...	...	29.0			26.9	25.7	26.3	27.6	29.6	32.4		50.2	85.7	
of which: external	...	...	29.0			26.9	25.7	26.3	27.6	29.6	32.4		50.2	85.7	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	0.2	-1.6	-0.7			0.4	1.4	1.9	2.5	2.8	3.2		3.4	5.7	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	42.7			42.7	42.1	44.4	47.8	52.4	58.4		100.0	190.7	
PV of public sector debt-to-revenue ratio (in percent)	...	...	75.6			86.8	84.5	87.8	93.6	102.0	112.9		135.1	254.2	
of which: external 3/	...	...	75.6			86.8	84.5	87.8	93.6	102.0	112.9		135.1	254.2	
Debt service-to-revenue and grants ratio (in percent) 4/	7.0	5.6	4.6			4.8	5.3	4.7	4.8	4.9	5.0		5.8	9.7	
Debt service-to-revenue ratio (in percent) 4/	15.3	10.9	8.2			9.8	10.6	9.2	9.4	9.5	9.7		7.8	12.9	
Primary deficit that stabilizes the debt-to-GDP ratio	-1.9	1.4	3.4			-0.2	-1.5	-3.7	-4.6	-5.7	-6.6		-6.9	-3.2	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	-0.6	2.0	3.6	1.4	2.9	2.5	2.3	2.2	2.0	1.8	1.6	2.1	1.5	1.5	1.4
Average nominal interest rate on forex debt (in percent)	2.5	2.4	2.4	2.7	0.4	2.5	2.6	2.4	2.2	2.0	1.8	2.2	1.2	1.0	1.1
Average real interest rate on domestic debt (in percent)	...	...	...	...	...	...	...	...	...	...	...	...	...	... ...	
Real exchange rate depreciation (in percent, + indicates depreciation)	0.0	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	-1.5	6.1	9.3	2.4	3.6	0.9	1.0	1.2	1.3	0.9	1.0	1.0	1.0	1.0	1.0
Growth of real primary spending (deflated by GDP deflator, in percent)	14.9	4.9	16.1	3.6	6.5	-3.4	0.4	0.4	0.4	0.4	0.3	-0.3	0.5	0.6	0.2
Grant element of new external borrowing (in percent)	...	...	...	...	...	43.1	50.0	50.3	51.3	52.1	52.5	49.9	53.7	51.2	...

Sources: Country authorities; and staff estimates and projections.

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 4. Marshall Islands: Sensitivity Analysis for Key Indicators of Public Debt, 2018–38

	Projections							
	2018	2019	2020	2021	2022	2023	2028	2038
PV of Debt-to-GDP Ratio								
Baseline	27	26	26	28	30	32	50	86
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	27	25	24	24	25	25	32	45
A2. Primary balance is unchanged from 2018	27	25	25	25	26	27	37	54
A3. Permanently lower GDP growth 1/	27	26	27	29	31	35	60	123
Severe Natural Disaster 2019	27	28	30	31	34	36	55	91
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2019-2020	27	27	30	33	36	40	67	120
B2. Primary balance is at historical average minus one standard deviations in 2019-2020	27	26	26	27	29	32	49	85
B3. Combination of B1-B2 using one half standard deviation shocks	27	26	26	28	31	34	58	104
B4. One-time 30 percent real depreciation in 2019	27	37	35	35	35	35	42	66
B5. 10 percent of GDP increase in other debt-creating flows in 2019	27	31	31	32	35	37	56	91
PV of Debt-to-Revenue Ratio 2/								
Baseline	43	42	44	48	52	58	100	191
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	43	41	41	42	43	45	64	99
A2. Primary balance is unchanged from 2018	43	41	42	44	46	49	73	120
A3. Permanently lower GDP growth 1/	43	42	45	49	55	62	117	265
Severe Natural Disaster 2019	43	46	51	54	59	66	110	203
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2019-2020	43	44	49	54	61	69	131	262
B2. Primary balance is at historical average minus one standard deviations in 2019-2020	43	42	43	47	51	57	99	189
B3. Combination of B1-B2 using one half standard deviation shocks	43	42	43	48	53	61	113	228
B4. One-time 30 percent real depreciation in 2019	43	60	60	60	61	63	83	146
B5. 10 percent of GDP increase in other debt-creating flows in 2019	43	50	53	56	61	67	111	202
Debt Service-to-Revenue Ratio 2/								
Baseline	5	5	5	5	5	5	6	10
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	5	5	5	5	5	5	5	6
A2. Primary balance is unchanged from 2018	5	5	5	5	5	5	5	7
A3. Permanently lower GDP growth 1/	5	5	5	5	5	5	6	12
Severe Natural Disaster 2019	5	5	5	5	5	5	6	10
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2019-2020	5	5	5	5	5	5	7	13
B2. Primary balance is at historical average minus one standard deviations in 2019-2020	5	5	5	5	5	5	6	10
B3. Combination of B1-B2 using one half standard deviation shocks	5	5	5	5	5	5	6	11
B4. One-time 30 percent real depreciation in 2019	5	6	7	7	7	7	8	15
B5. 10 percent of GDP increase in other debt-creating flows in 2019	5	5	5	5	5	5	6	10

Sources: Country authorities; and staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.

2/ Revenues are defined inclusive of grants.

Statement by the Staff Representative on Republic of the Marshall Islands
September 5, 2018

1. This statement contains information that has become available since the staff report was circulated. This information does not alter the thrust of the staff appraisal.

2. Recent data releases are in line with staff projections:

- GDP growth in FY2017 was 3.8 percent, driven by a strong pick up in fisheries (contributing 0.9 percentage points) and continued strong construction growth (contributing 0.8 percentage points).

- The current account surplus narrowed to 3.7 percent of GDP in FY2017 on rising infrastructure-related imports.

- The overall fiscal balance improved slightly to 4.5 percent of GDP in FY2017 on strong fishing license revenues.

Statement by Grant Johnston, Alternate Executive Director for Republic of the Marshall Islands and Gwibeom Kim, Advisor to the Executive Director

September 5, 2018

On behalf of our authorities in the Republic of Marshall Islands (RMI) we thank the mission team for their constructive engagement and candid assessment of the country's challenges and opportunities. RMI comprises small, sparsely-populated and low-lying atolls and islands spread across 750,000 square miles of the Pacific Ocean. Its extreme remoteness, low population, small private sector and narrow production base means the country is highly dependent on external aid, with grants making up around half of government revenue. RMI is very low lying, with an average elevation of only 2 meters, and is regularly affected by flooding, storms and drought.

Economic outlook

RMI's economy has recovered from recession. A severe drought in 2016 affected agriculture, especially copra production, but there has since been a pick-up in construction work related to schools, hospitals and government buildings. The authorities note staff's medium-term growth projection of around 1.5 percent. They consider climate change to be one of the main risks to the outlook, as extreme weather episodes have adversely affected the country in recent years.

Fiscal sustainability

RMI's fiscal challenges are shaped to a large extent by the impending expiry of many current grants made under the Compact of Free Association with the United States. From 2024, these will be replaced by ongoing distributions from an investment fund – the Compact Trust Fund (CTF) – which is currently being built up through contributions from the US, Taiwan POC and the RMI itself. However, the current track for contributions, together with expected investment returns, is not enough to ensure that the CTF can replace the expiring grants each year and also maintain the Fund's real value over time.

The authorities agree that a significant fiscal adjustment is needed ahead of 2024 and have been undertaking reforms to reduce expenditure pressures. Social security reforms adopted in 2017, for example, include an increase in the retirement age to 65 by 2025 and greater contributions by both employers and workers. Public financial management reforms are focused on accounting systems and reporting, the budgeting framework, procurement systems, tax administration and the management of non-tax revenue. To contain recurrent expenditure, the authorities are seeking Cabinet's endorsement of expenditure ceilings before each ministry submits their budget estimate. RMI has also introduced a medium-term budget framework with a three-year horizon and will commence work on a long term fiscal framework in fiscal year 2019.

SOEs make up a significant portion of the economy but persistently make losses, in part because of the cost of providing electricity and transport services to remote islands. The authorities agree with the need to accelerate SOE reforms, in particular, to reduce overall government subsidies and make it clear where remaining subsidies exist as a result of specific community service obligations. An important step has been the establishment of an SOE monitoring unit in the Ministry of Finance, which will begin by focusing on four SOEs – the airline, shipping, copra processing, and energy companies – to improve their performance.

RMI receives a considerable amount of revenue from fishing license fees and also gets income from the provision of offshore corporate services and ship registration. Fishing license revenue has increased significantly since the introduction of the Vessel Day Scheme benchmark price. Domestic tax revenue has also risen, and tax administration has been strengthened. The authorities are grateful for the technical assistance they have received on tax reform and would appreciate more of this, including lessons from other countries on the introduction of VAT.

RMI greatly appreciates the support it receives from its international partners. It would value additional donor contributions to the CTF, as well as support for climate mitigation and adaption projects. RMI is expected to be one of the countries most affected by climate change and rising sea levels. Several climate-related projects are already underway as part of the joint national action plan for climate change adaption and disaster risk management.

Financial sector

The potential loss of the country's remaining correspondent banking relationship remains a very significant concern to the RMI authorities. To help prevent this, the authorities have amended the Banking Act to strengthen the legal framework for AML/CFT supervision in line with international standards. A national risk assessment is in progress, helped by technical assistance from the World Bank. The Marshallese authorities have also strengthened financial supervision and regulation in the banking sector. The Banking Commission has been working with PFTAC on improving its monitoring. As a first step, off-site monitoring has been implemented based on existing manuals, including submission of financial information on a regular basis. On-site monitoring was performed for the Bank of Marshall Islands in February and is being planned for the Bank of Guam. The Banking Commission is also working on a financial sector development plan. The government is concerned about high consumer debt, low financial literacy, and consumer lending practices by banks and lenders.

Cryptocurrency

RMI intends to issue a cryptocurrency – the SOV – as a second legal tender, alongside the US dollar. It intends to do this with a foreign private sector partner, which would share the first issuance of SOV with RMI, before an initial coin offering (ICO) was undertaken. The authorities' motivation is to take advantage of the growing enthusiasm for cryptocurrencies, together with the innovation of it being a national currency, to generate much-needed income for the government. This income would be obtained by selling half the RMI's initial allocation of SOV in the ICO and keeping around a quarter in SOV in its trust funds. The remainder would be distributed over time to RMI resident citizens.

The Marshallese authorities are well aware that issuing a legal tender cryptocurrency puts RMI into uncharted waters, and that there are many risks involved in issuing the SOV, including reputational and CBR risks to RMI. However, they believe they can work through these issues. They have created a high-ranking committee to examine all the risks, including those raised by the IMF and the US Treasury, and those discussed during the public hearings on the legislation. Given these sorts of issues, the authorities expect it will take a few years to issue the cryptocurrency. Moreover, they will only issue the SOV once its use complies with the FATF standard and US regulations, and once its use in transactions in the US financial system has been approved by the US government.