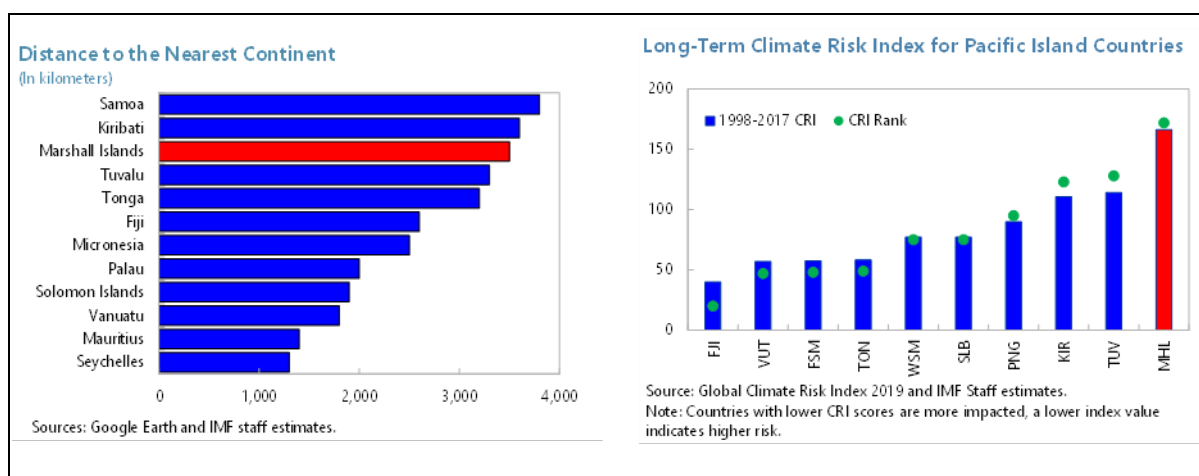


CONTEXT

1. RMI faces several long-standing issues. RMI is a fragile state, located remotely in the Pacific. Its small and dispersed population with high migration rates to the U.S. constrain potential growth. RMI is very vulnerable to climate change because of its low elevation. Sizable budgetary grants under the Compact of Free Association Agreement (COFA) ¹ between the Republic of Marshall Islands (RMI) and the United States (US) will expire in FY23^{2,3}. The loss would be only partially compensated by disbursements from a Compact Trust Fund (CTF) set up for this purpose, and RMI could face substantial budget deficits (“fiscal cliff”) without offsetting policy measures. The US and RMI administrations are currently negotiating a new agreement, but the terms are uncertain.



2. Uncertainties remain in the financial sector, as the Sovereign (SOV)⁴ initiative has been accompanied by a new initiative for a Digital Economic Zone (DEZRA). The current government formed in January 2020 has adopted a more cautious approach towards the SOV. It commissioned a due diligence report, which will inform Parliament’s pending decision on a possible repeal or suspension of the 2018 SOV Act. However, in parallel with potential repeal of the SOV Act, a draft law on a Digital Economic Zone involving digital currency activities has been proposed and is also tabled to be considered by Parliament. Moving forward with either the SOV or DEZRA could introduce significant uncertainties to the RMI’s financial system and broader economy.

¹ Compact of Free Associations is an agreement between the United States of America and Republic of Marshall Island that was established in 1986 and amended in 2003 to create and maintain a close and mutually beneficial relationship with three provisions, which includes the governmental, economic, and security and defense relationships.

² Fiscal year starts from October and ends in September.

³ The COFA itself is not going to expire but its financial chapter (“Fiscal Procedures Agreement”), which covers Compact Sector Grants, Special Education Grants, and access to U.S. Federal Government programs and services are scheduled to expire in FY2023 and are currently being renegotiated.

⁴ The SOV was established as second legal tender in 2018 in addition to the US dollar pursuant to the Declaration and Issuance of the Sovereign Currency Act 2018 (the SOV Act).

THE COVID SHOCK: IMPACT, OUTLOOK, AND RISKS

3. Growth was strong but the fiscal and external positions weakened prior to the pandemic. Real GDP grew at 6.5 percent in FY2019, driven by strong fishery and construction activities. Inflation remained subdued due to falling commodity prices. After a surplus of 2.5 percent of GDP in FY2018, the overall fiscal balance turned into a deficit of 1.8 percent of GDP in FY2019 despite higher fishing revenue, reflecting rising current expenditure—particularly transfers to Tobolar⁵ and spending on goods and services. Correspondingly, the current account (CA) surplus narrowed and recorded a temporary deficit in FY2019⁶.

4. At the onset of the Covid-19 pandemic, the government took strong preemptive measures that successfully limited the risk of a domestic outbreak. The measures included early travel restrictions and mandatory quarantine at all ports, restricting fishing vessels to come on shore for transshipment⁷. As of March 2021, there were zero active Covid-19 case and 4 recovered cases, all of them imported, in the Marshall Islands. RMI has also secured a vaccination plan, supported by the United States. 34 percent of the total population had received their first vaccination as of March 16th, 2021. Outer Island vaccine distribution, however, faces challenging logistics.

5. The pandemic and containment measures have strained the economy. The COVID-19 containment measures impacted economic activity through disruptions to transshipment, restaurant, and hotel services, transportation, and other business activities. Planned large investment projects were delayed because of restrictions on the movement of personnel and materials. Containment measures, disruptions in supply chain, and lower external demand even led to a drop in fishing revenue, although the newly added fishing capacity has helped cushion the fallout. Real GDP is expected to have contracted by 3.3 percent in FY2020, and by another 1.5 percent in FY2021, as continued border closure is expected through end-FY2021. A rebound in economic activity is expected in FY2022, assuming gradually easing health restrictions. Inflation is estimated to have remained subdued in FY2020 and is projected to rise slightly in FY2021, given higher fuel prices. In the medium term, economic growth is projected to moderate to around 1.6 percent, given low labor force growth with continued emigration to the US, while inflation should be converging to U.S. levels of around 2 percent.

⁵ A state-owned copra processing plant.

⁶ The large current account deficit of about 25.4 percent of GDP in FY2019 is mostly explained by an import of 3 fishing vessels valued at USD 62 million (26 percent of GDP).

⁷ Majuro, the capital city of RMI, is one of the largest tuna transshipment centers in the world.

6. Under current policies, RMI is expected to face increasing budget deficits. The budget is estimated to be balanced in FY2020 despite the weaker economy, reflecting higher grants, stable fishing license fees, and improved revenue collection from better compliance and enforcement. A small surplus of 0.6 percent of GDP is projected for FY2021, as an increase in the copra subsidies⁸ will be offset by a small surplus from pandemic-related programs (spending net of grants), given execution capacity limits. In the medium term, assuming reduction of US Compact grants will only be partially compensated by disbursements from the CTF, which, together with projected stagnant fishing license⁹ and tax revenues and continued expense pressures, will lead to a 3.9 percent of GDP budget deficit by 2026.

Marshall Islands: Government Operations, FY 2018-2026							
(Baseline scenario; in percent of GDP)							
	FY 2018	FY 2019	FY 2020	FY 2021	FY 2023	FY 2024	FY 2026
Revenue	62.6	62.0	66.5	85.7	70.2	66.9	64.5
Taxes	14.5	14.6	14.6	14.2	14.5	14.5	14.5
Grants	30.4	30.0	34.2	55.3	38.9	25.8	24.1
US Compact grants	18.1	17.4	16.6	17.1	17.0	4.6	5.3
Other grants	12.3	12.7	17.6	38.2	21.9	21.3	18.8
Other revenues	17.7	17.3	17.7	16.2	16.8	26.6	26.0
Fishing licenses	13.3	12.2	13.4	11.1	11.9	11.8	11.6
Disbursement from CTF						9.9	9.6
Other	4.4	5.2	4.4	5.1	4.9	4.9	4.8
Expenditure	60.0	63.7	66.4	85.1	71.7	70.1	68.5
Expense	55.5	61.2	60.2	76.9	59.8	59.9	60.1
Of which: subsidies	6.2	6.2	6.1	7.3	7.3	7.4	7.5
Of which: interest	0.3	0.3	0.3	0.3	0.2	0.2	0.3
Investment	4.5	2.5	6.2	8.2	11.9	10.2	8.4
Overall fiscal balance	2.5	-1.8	0.0	0.6	-1.5	-3.3	-3.9
CTF balance	181.6	181.5	205.0	224.6	242.6	234.9	221.2
External PPG Debt¹	32.8	27.8	27.5	26.2	25.1	26.7	31.3

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

¹Assumption is that RMI will continue to receive 100 percent of its MDBs financial assistance in the form of grants.

7. The external position is expected to worsen in the medium term. The CA is projected to reach a surplus of 2.2 percent of GDP in FY2020 and 2.6 percent of GDP in FY2021. The surplus was due to increased budget support from development partners and declining imports due to the domestic demand contraction. The CA balance is projected to move into a deficit of about 2.7 percent of GDP in the medium term, assuming lower grants. The CA is assessed to be weaker than implied by fundamentals and desirable policies based on the External Sustainability approach.¹⁰

⁸ The government increased the copra purchase price by 20 percent in December 2020. Tobolar's increasing losses will be financed by additional government subsidies.

⁹ Because the benchmark price and demand of the fishing vessel days are not expected to increase in real terms.

¹⁰ See details in Annex I.

8. Uncertainty around the outlook is exceptionally high and risks are tilted to the downside.¹¹ An extended border closure due to a more protracted Covid-19 pandemic worldwide could prolong subpar economic activity. The issuance of the SOV as a second legal tender would raise risks to macroeconomic and financial stability as well as financial integrity. Establishing the DEZRA would introduce additional financial integrity risks. The potential loss of the last USD corresponding banking relationship (CBR) if the SOV is issued and anti-money laundering and counter terrorism financing (AML/CFT) risks (including those related to the SOV and DEZRA) are not addressed would disrupt external aid and other important financial flows, resulting in a significant drag on the economy. Climate change and related natural disasters are other downside risks.

9. RMI faces important, bimodal fiscal risks. Without adequate fiscal consolidation, the country will face increased risks of a fiscal cliff if Compact grants are reduced in FY2023 and fishing license fee and tax revenue remain stagnant as expected. The cliff situation would arise because the authorities might face budget financing constraints, given shallow domestic markets, lack of international market access, and the possibility that donors might not be willing to finance budget deficits beyond current and already committed grants. In such a situation, the authorities would have to abruptly lower government spending, with negative effects on economic activity and welfare. If the government resorted to non-concessional external financing, external debt distress risks, which are already high according to the DSA analysis¹², could rise further, putting growth at risk. Alternatively, the potential renewal of the expiring Compact grants on favorable terms presents upside risks. In this case, less ambitious fiscal consolidation would be required to stabilize the fiscal position and essential US services would still be provided to RMI.

Authorities' View

10. The Authorities broadly agreed with the staff's assessment of the economic outlook and risks. They noted that the COVID-19 pandemic and domestic containment measures had a negative impact on fisheries, transportation, accommodation, and tourism related activities. Nevertheless, these measures had helped to keep the country COVID-free, and they will take a cautious approach to reopening border, as domestic capacity to contain the outbreak is limited. On this basis, they expected that border would need to remain closed for the rest of FY 2021, which would lead to another annual decline in economic activity. Containment measures would subside in FY2022, however, supporting a strong economic rebound. The authorities noted that planned infrastructure and construction projects had stalled because border closures prevented the arrival of foreign experts and impeded the imports of capital goods. They also acknowledged the uncertainty surrounding the potential expiration of the Compact financial support in FY2023.

¹¹ See details in Annex II.

¹² In the DSA, regular credit terms are assumed for prospective financial assistance from multilateral development banks (MDBs) on all future financing, for which grant finance has not already been committed. This leads to a much steeper debt path than under staff's baseline assumptions.

ENSURE DURABLE POST-COVID RECOVERY AND LONG-TERM FISCAL SELF-RELIANCE

A. Immediate Response to the Pandemic and Near-Term Policy

11. The government has taken comprehensive fiscal measures to mitigate the economic impact of the Covid-19 pandemic. The size of the Covid-19 Response Plan for FY2020-21 has been increased several times, from 42.3 million (18 percent of GDP) in June 2020 to about 63 million USD (27 percent of GDP) currently. The Plan aims to strengthen health preparedness, support firms and households, and protect vulnerable groups. Development partners (with the United States and the Asian Development Bank as the largest contributors) have so far provided grant financing of about 50 million USD (21 percent of GDP), which were used for COVID related spending in the FY 2020-21 budget.¹³ The budget plan has been fully executed in FY2020 and implementation has continued in FY 2021, although the authorities have faced implementation challenges (due to travel restrictions of foreign experts and logistics bottlenecks to reach outer islands).¹⁴ Total implementation of the package reached 21 million USD (9 percent of GDP) as of March 2021.

Marshall Islands: Costs Associated With The Response To Covid-19, FY2020-21 (Million USD)			
	Response Plan FY2020-21	FY2020 Allocation	FY21 Allocation
(1) Health response	25.8	8.2	12.0
Health Cluster	15.1	6.8	8.4
Others	10.7	1.5	3.6
(2) Assistance to households	11.2	0.0	9.9
Unemployment benefit	7.5	0.0	6.6
Others	3.8	0.0	3.3
(3) Support to outer islands and local governments	13.2	0.7	1.4
Neighbouring Islands	10.9	0.7	1.1
Local Governments	2.3	0.0	0.4
(4) Support to firms	8.3	0.8	7.0
Support to SOEs	2.3	0.0	2.1
Support to businesses	6.0	0.8	4.9
(5) Others	4.8	0.3	4.1
(6) Total = (1) + (2) + (3) + (4) + (5)	63.3	10.1	34.4
Source: MHL Authorities and IMF staff estimates			

¹³ The 50 million USD reflect total external funds received so far while the FY 2020-21 budget only included committed financing at the time when the budget was prepared. The authorities also reallocated 0.9 percent of GDP from unspent salaries from various agencies in FY2020 towards the new priorities of the emergency package. The parliament approved in March 2021 a supplementary FY2021 budget that added about 7 percent of GDP to the initial budget, including further support to relevant line ministries to cope with the COVID-19 pandemic.

¹⁴ The COVID measures in FY 2020 focused on health responses and support to firms and outer islands residents. These measures continued in FY 2021, together with repatriating stranded Marshallese overseas and rolling out the unemployment benefits.

12. The implementation of the response plan should continue until the recovery is firmly underway, but the measures could be better targeted and reprioritized. The rapid scaling-up and the large size of the fiscal support package could create risk of inefficiency, especially in the face of capacity constraints. The risks should be mitigated by targeting the most affected sectors and groups, including those that have not been covered by the formal support mechanism. The government could consult with donors to reprioritize and reallocate spending as needed, given the uncertainty about the virus development, the challenge to disburse certain support measures to outer islands, and the need to support economic recovery.¹⁵ The government should also consider reallocating some funds (together with potential additional external funds) to FY2022 to support a sustained recovery as well as structural improvements in the health sector and in social protection, given the challenges in executing the spending plans in the short term.

13. Governance safeguards should be implemented to ensure spending transparency and accountability. Situation Reports containing information of the COVID responses and some beneficiary lists are regularly published by the National Disaster Management Office (NDMO). Building on this, additional pandemic-related spending safeguards should be put in place, such as public access to procurement contracts, availability of beneficial ownership information for awarded entities, and publication of an ex-post audit report of emergency expenditures.

Authorities' View

14. The authorities shared staff's views on the need for continued fiscal support in the near term and fiscal transparency. They noted that spending on health preparedness remained their priority to protect the country from the COVID-19 outbreak and that there are large gaps in the health infrastructure. They acknowledged challenges in implementing the stimulus package because of the departure of many external experts after the border closure and the provision of COVID support to remote outer islands. They also emphasized that they are trying to balance support measures between providing social assistance and facilitating future recovery. The authorities will audit Covid-19 related spending and publish a report by end-FY2022.

B. Recovering from the Pandemic: Fiscal Adjustment Needed

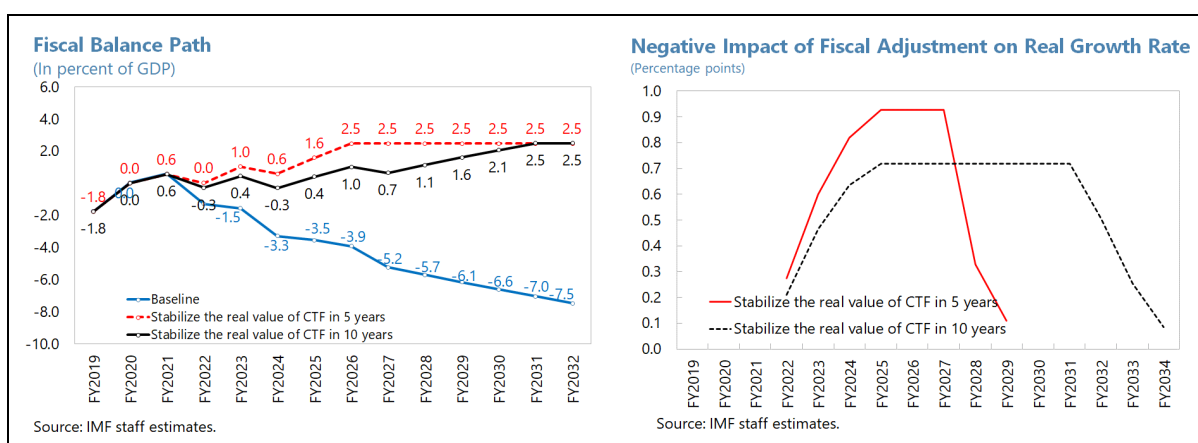
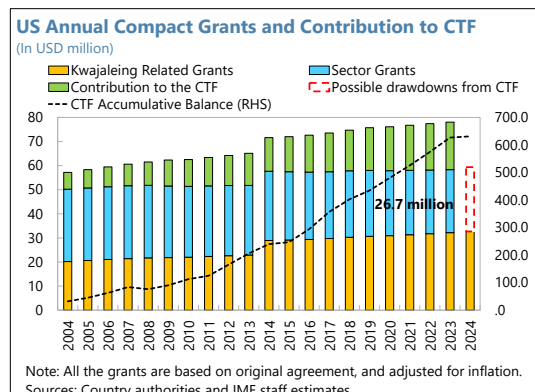
15. A gradual fiscal consolidation is needed once the recovery is underway to prepare for the possible reduction of U.S. Compact grants, reduce risks of a fiscal cliff, protect long-term income, and build fiscal buffers to meet rising financing needs.

- *The fiscal position is projected to deteriorate sharply from FY2024 without adjustment measures.* RMI's recurrent spending is mainly financed by volatile fishing revenues and budget grants, with project grants used for development financing and no access to capital market. If the Compact

¹⁵ For example, the government could properly identify those eligible for unemployment benefits to incentivize people to go back to work (e.g. in the fishery sector).

grants set to expire in FY2023 (about 13.4 percent of GDP) are not renewed¹⁶, disbursements from the CTF (about 10 percent of GDP in FY2024) are not expected to fully compensate this revenue losses.

- Moreover, CTF yield volatility will further add to government financing risks, as it may limit disbursements from the CTF in the future, potentially leading to a liquidity shortage¹⁷. Fiscal costs from climate change adaptation and natural disasters and meeting SDGs goals would impose additional financing needs.
- Once the recovery is firmly underway, it will be prudent to undertake a gradual fiscal consolidation to reduce the fiscal risk. Given the ongoing negotiation on the Compact financial assistance, there is uncertainty about the magnitude of the needed adjustment. The authorities, therefore, face a trade-off: a faster and full adjustment to avoid the fiscal cliff risk will likely incur a higher cost to the economy; alternatively, if they waited, drastic adjustment would be needed if the expiring grants are not renewed or the negotiated terms are not favorable. One approach to balance these considerations is to start with a gradual adjustment early. Even if the expiring Compact grants are renewed, some adjustment will likely still be needed to preserve the real value of the CTF for future generations and to build buffers for rising financing needs and reduce the dependency on external grants. Fiscal adjustment combined with continued grant-financing by donors will also allow to contain the risk of debt distress and ensure long-term debt sustainability (see the DSA).



¹⁶ Grants that are expected to expire include: the supplementary education grants, the sectoral grants, and the contribution to the CTF (managed by the Trust Fund of RMI). (See Annex III).

¹⁷ When the CTF annual yield falls short of the maximum drawing allowed—equivalent to the 2023 U.S. Sectoral Grants corrected by inflation—the COFA allows the government to additionally draw down the amount of the shortfall from the CTF corpse only from a buffer account (C account). Once this account is exhausted, the disbursements from the CTF cannot exceed the previous year's yield. This implies a liquidity risk on financing even when there are sufficient funds available from the CTF.

- Two illustrative adjustment scenarios that highlight the implications of more ambitious vs more gradual adjustment: (i) a 6.4 percent of GDP adjustment over 5 years¹⁸; (ii) a 9.3 percent of GDP over 10 years¹⁹. Both adjustments target a fiscal surplus of 2.5 percent of GDP in the medium-term to mitigate the risks of fiscal cliff and preserve the real value of the CTF. The 10-year adjustment would be preferable, as it would avoid a steeper fiscal adjustment, given the uncertainty on the outcome of the renegotiation.

Marshall Islands: Fiscal Adjustment, FY22- FY31									
(Percentage Points of GDP, unless otherwise indicated)									
	Baseline			Scenario A - 5 years			Scenario B - 10 years		
	2022	2026	2031	2022	2026	2031	2022	2026	2031
Fiscal balance (percent of GDP)	-0.9	-4.0	-7.1	0.5	2.5	2.5	0.2	1.0	2.5
CTF net assets per capita (USD thousands)	8.6	8.8	7.1	8.6	9.6	10.1	8.6	9.4	9.6
Cumulative fiscal adjustment	0.0	0.0	0.0	1.4	6.4	9.2	1.1	5.0	9.3
Revenue	0.0	0.0	0.0	0	0.5	1.0	0.0	0.5	1.0
Expenditure	0.0	0.0	0.0	1.4	5.9	8.2	1.1	4.5	8.3
<i>of which: Goods and services</i>	0.0	0.0	0.0	1.4	4.0	6.0	1.1	3.0	6.0
<i>of which: Others (e.g. Subsidies)</i>	0.0	0.0	0.0	0.0	1.9	2.2	0.0	1.5	2.3

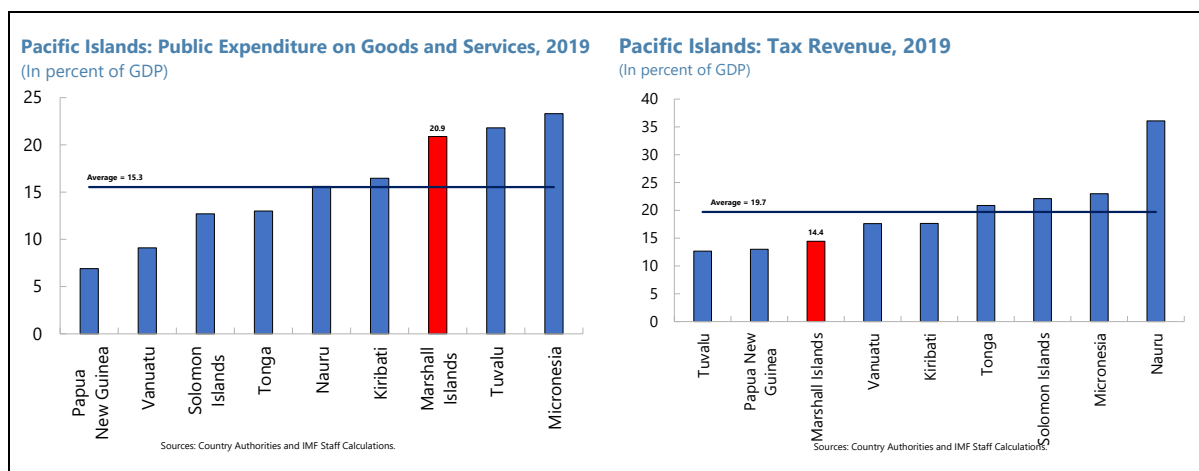
Source: IMF staff estimates.

- To achieve a fiscal adjustment, the authorities should consider a combination of measures of expenditure control, domestic resource mobilization, and public financial management.²⁰
- Expenditure rationalization.** Rationalizing current spending—particularly on goods and services and SOE subsidies—while preserving spending on health and education would be necessary to reduce fiscal pressures. The authorities could build on the findings of the World Bank (WB)’s upcoming public expenditure review to identify and cut unproductive spending.

¹⁸ The larger required 5-year adjustment compared to the 4 percentage of GDP of the 2018 Staff Report is due to the fact that the Supplementary Education Grants are also expected to expire, the worsening deficit path, and delayed adjustment due to the COVID-19 pandemic.

¹⁹ The 5-year adjustment is extended to 10 years (by keeping the same primary balance) to facilitate the comparison between the two scenarios. The second scenario results in a relatively lower value of the CTF but is less economically costly in terms of growth impact.

²⁰ Successful implementation of those measures would require strong commitment, leadership, and management in the key government institutions, prioritizing key components and activities, enhancing resourcing of reform efforts, and well targeted TA.



- Revenue mobilization.** While some progress has been made in improving revenue administration, there were no tax policy reforms²¹ in recent years. The fiscal cliff and the expected stagnation of some major revenue items calls for key reforms:
 - Enacting the long-awaited tax reform bill as an import first step.*²² While the tax bill is broadly revenue neutral, its growth friendly measures could bring additional revenue from efficiency improvement²³.
 - Reforming the taxation of offshore shipping and corporate registries.* Despite being the second largest shipping registry in the world, the sector's contribution to the budget has been just about 2 percent of GDP in the last decade. The authorities should consider a better way to tax the offshore registries to support the public finance and improve transparency.
 - Continuing improving the tax administration supported by ongoing TA from PFTAC.* A more effective tax administration would support future tax policy reforms²⁴.
- Enhance public financial management.** A medium-term fiscal framework (MTFF) and structural fiscal reforms would help managing both fiscal risks and the consolidation measures and reforms on the revenue and spending sides. The Reform Coordination Unit (set up with ADB support) is a welcome step to monitor PFM reform progress. The recent prepared Fiscal

²¹ Key revenue administration reforms in recent years include: (i) better managing filling and payment activities; (ii) improving arrear collections and (iii) improving internal process to better identify and manage risks.

²² The current tax system suffers from efficiency, fairness, and design issues. For example, firms pay turnover taxes instead of a net profit tax; the tax rate on high income earners (12 percent) remains low compared to regional (24 percent) and international standards (28 percent).

²³ The tax bill should allow to: (i) improve the personal income tax; (ii) introduce a net profit tax; (iii) introduce a consumption tax to replace the gross revenue tax; and (iv) replacing the existing import duties with excise taxes.

²⁴ Specifically: (i) develop and implement a tax compliance strategy; (ii) improve return and payment collection processes; (iii) strengthen taxpayer services to support voluntary compliance; and (iv) accelerate digitalization to improve data gathering and better manage compliance risks.

Responsibility and Debt Management Act (FRDMA)²⁵ is an important step to strengthen multiyear fiscal discipline and ensure debt sustainability. Enact the FRDMA would be an important first step toward establishing the MTFF. In addition, structural fiscal reforms would include:

- a. *Continue strengthening fiscal projections and budget presentation and transparency* to help guide policy goals, with the support of PFTAC²⁶;
- b. *Rolling out the new Financial Management Information System (FMIS)* with the support of the WB, to improve public resources management and enhance financial reporting.
- c. *Speeding up the reforms of state-owned enterprises (SOEs)* with the support of the ADB. Strong efforts are needed to improve SOEs' performance and reduce SOEs subsidies (particularly for copra). The authorities should consider developing, in the medium to long-term, direct and targeted cash transfers via a formal social protection mechanism to the poor with the support of the WB.²⁷
- d. *Continue implementing reform measures*²⁸ for the social security system (MISSA) and assess reform progress to ensure long term fiscal sustainability. While MISSA's financial position has improved significantly in recent years, steadfast implementation of the policy measures is crucial and updated assessment is required to decide whether further reforms are necessary to secure its financial sustainability.

²⁵ The FRDM Act aims to enhance public expenditure and financial accountability, improve economic and fiscal forecasts, and reduce fiscal risks. Once the FRDM Act is enacted, the government intends to develop a public debt management strategy to better monitor its future borrowing.

²⁶ For example: (i) continue using the Marshall Fiscal Model (MI-FI) that allows to medium term projections for government revenues, expenditure and financing needs; (ii) continue to develop a comprehensive budget documentation by for example preparing the annual budget in a GFS format and (iii) costing and publishing in the annual budget the various tax expenditures to enhance fiscal transparency.

²⁷ The World Bank is supporting the authorities to develop conditional cash transfers to incentivize health and education service utilization. The system could be extended to copra farmers by replacing the current subsidies to Tobolar which is required to pay above market copra prices to farmers.

²⁸ The 2017 MISSA reform measures include: (i) an increase in the retirement age; (ii) an increase in the contribution rates for both employees and employers, and (iii) a reduction in benefits.

Marshall Islands: Summary of Recommended Fiscal Response

	During Covid-19	Post-Covid-19 Short-Term	Medium to Long-Term
Fiscal Policy Objectives	<ul style="list-style-type: none"> - Strengthen health security; Provide lifelines for the vulnerable group; support for recovery 	<ul style="list-style-type: none"> - Gradual fiscal adjustment to reduce risks of a fiscal cliff for possible expirations of US grants 	<ul style="list-style-type: none"> - Continued fiscal adjustment to reduce financing risks, and protect long-term income. Modernize fiscal framework
Expenditure policy	<ul style="list-style-type: none"> - Better targeted Covid-related spending - Consult with donors to prioritize Covid-related spending; fix bottlenecks in the disbursement 	<ul style="list-style-type: none"> - Reduce expenditure on goods and services; introduce ministerial budgetary ceilings; - Reduce transfers other than subsidies to SOEs 	<ul style="list-style-type: none"> - Reform the SOEs to reduce subsidies with the support of the ADB - Develop direct and targeted conditional cash transfers with the support of the WB
Revenue administration		<ul style="list-style-type: none"> - Develop a tax compliance strategy - Improve tax audits and taxpayer services 	<ul style="list-style-type: none"> - Digitalize the tax administration - Improve return and payment collection processes
Tax policy		<ul style="list-style-type: none"> - Better tax shipping and corporate registries; enact the tax reform bill; Implement a VAT with the support of PFTAC; improving tax policy efficiency and fairness 	<ul style="list-style-type: none"> - Continue to modernize tax system by implementing other reforms (income taxes and exercise tax) in the tax bill.
Public Financial Management	<ul style="list-style-type: none"> - Address bottlenecks and improve capacity to implement COVID-response measures 	<ul style="list-style-type: none"> - Enact the Fiscal Responsibility and Debt Management Act - Improve macro-fiscal forecasts by using the tool developed by PFTAC - Roll out the Financial Management Information System (FMIS) with the support of the WB - Assess social security reform progress to ensure long term fiscal sustainability 	<ul style="list-style-type: none"> - Upgrade the PFM system to manage fiscal risks and ensure debt sustainability - Adopt a medium-term fiscal framework (MTFF); strengthen public investment framework to improve investment efficiency

Source: IMF staff.

Authorities' View

16. The authorities concurred with staff's fiscal outlook and the need to contain spending and build buffers. They acknowledged that rapid increase in current spending had in part been driven by the rising fishing license revenues. They expected that the WB's public expenditure review would help to strengthen expenditure control. They also saw a need to build buffers to cope with volatile fishing revenues and dependency on external grants. The authorities also noted they would reconsider the comprehensive tax reform bill prepared a few years ago and highlighted recent progress in PFM and SOE reforms, especially on improving SOEs' business planning. They are optimistic about prospects for renewing the COFA financial chapter to continue receiving compact grants and other services from the US. They also pointed out efforts of contributing to the CTF.

SAFEGUARD FINANCIAL STABILITY

17. The cautious approach to the SOV is welcome. The issuance of the SOV as currently envisioned in the SOV Act would introduce a dual currency system, which would pose significant

risks to macroeconomic and financial stability²⁹. Volatility in the value of the SOV against the U.S. dollar would raise risks to the overall balance sheets of the government and private RMI agents holding SOVs. In addition, the SOV presents financial integrity risks, which the RMI does not appear equipped to mitigate. The RMI's legal, regulatory, and institutional capacity are not yet sufficiently developed to accommodate crypto-assets and manage associated risks. Moreover, faced with frequent power and network outages, the country's infrastructure and could hamper the issuance and wide-spread use of the SOV potentially excluding remote and most vulnerable parts of the population. In this context, staff welcomes the government's decision to commission a comprehensive due diligence study that will serve as the basis for Parliament's decision to potentially repeal the 2018 SOV Act.

18. The new initiative for a Digital Economic Zone (DEZRA) poses potential financial integrity risks if executed. A bill to create a digital economic zone on Rongelap Atoll (a former nuclear test site) was introduced in Parliament, presented as an attempt to revive the atoll by providing economic opportunities and incentives for investment. DEZRA is envisioned to focus on virtual means of exchange, including virtual assets. The economic benefits to RMI are likely to be limited, as most of the economic activity in DEZRA is expected to occur offshore. On the other hand, DEZRA will generate a host of new risks. The planned combination of a tax-exempt zone targeting primarily (if not exclusively) non-resident entities with no physical presence in the jurisdiction, could prove highly susceptible to illicit financial flows and activity, while the proposed legislation – as currently stands – describes no mitigating solutions, such as preventive measures and meaningful oversight mechanisms. Moreover, the country's current laws, institutions, and human resource capacity are not in a position to monitor and supervise such a complex entity. Therefore, staff recommends to proceed cautiously with the DEZRA.

19. Pressures on correspondent banking relationships (CBRs) persist and would be exacerbated by the issuance of the SOV and/or the DEZRA initiative. The RMI has one remaining USD CBR, which at present remains stable. Efforts to enter into new CBRs have been unsuccessful. These difficulties are likely due to the low volume of business generated by the jurisdiction coupled with financial integrity risks stemming from the RMI's "offshore" sectors that do not appear to be adequately mitigated. A SOV issuance and/or the DEZRA launch would further elevate the RMI's risk profile and jeopardize the RMI's last USD CBR. The only domestic bank- Bank of Marshall Islands has applied for a clearing house in US, which – if granted – would greatly alleviate CBR pressures. Nevertheless, the authorities should seriously re-consider any policies that would add to the RMI's risk profile and potentially impact its ability to clear transactions denominated in USD.

20. The RMI's anti-money laundering and combating the financing of terrorism (AML/CFT) regime does not adequately address financial integrity risks. Although the AML/CFT

²⁹ See IMF 2018 RMI Article IV Staff Report and Selected Issues Paper for detailed discussions on the SOV.

legal framework is broadly in place, it contains critical shortcomings that may impede its effectiveness.³⁰

- **Beneficial ownership information.** Beneficial ownership is not mandated to be registered or held by entities registered in the RMI. In 2018, legislation was introduced to require only reasonable efforts to obtain such information; no penalties may be imposed on entities for failing to have such information as long as reasonable efforts are taken. Although beneficial ownership information is reported to have been submitted for all bearer shares and voluntarily provided for most entities, the quality of such information cannot be confirmed. As non-resident entities are prohibited from opening a bank account in the RMI, domestic financial institutions will hold information only on domestic entities. Understanding of the concept of beneficial ownership pursuant to the international standard by regulatory authorities and industry is sometimes lacking (e.g., in which instances senior management may be listed).
- **Customer due diligence.** Requirements in the Banking Law are insufficiently stringent in some areas. Notably, for instance, a bank is only required to take reasonable efforts to identify the individual on whose behalf a customer is acting.

21. Financial integrity risks in the RMI are concentrated in and primarily arise from the non-resident corporate and shipping sectors, as cited by domestic and international counterparts and the recently concluded national ML/TF risk assessment. The “offshore” sector operates largely free of government oversight and little information on entities registered in the RMI is held in the jurisdiction or attainable by the authorities. Non-resident entities and maritime vessels registered with the RMI have been the subject of both UN and United States Office of Foreign Asset Control (OFAC) sanctions.³¹

- **Non-resident corporate and shipping registries.** Through a long-standing and confidential arrangement, the operation of the non-resident corporate and maritime registries has been delegated to the Trust Company of Marshall Islands (TCMI), a private company. The TCMI’s system of verifying information received and ensuing compliance with legal requirements does not appear effective; a system of monitoring was initiated only recently and no more than 0.4 percent of entities have been examined. Even given the limited pool, 20 percent of examined “high risk” entities were found to have serious record-keeping deficiencies in 2020 (over 30 percent in 2018 and 14 percent in 2019). Although the non-resident corporate and shipping registries fall within the purview of the Ministry of Transport, no government body conducts any meaningful supervision over delegated public functions.

³⁰ The RMI’s AML/CFT regime is currently being assessed by the Asia Pacific Group on Money Laundering (APG), a regional assessor body of the Financial Action Task Force (FATF) – the international standard setting body for AML/CFT. The APG last conducted such an assessment in 2011.

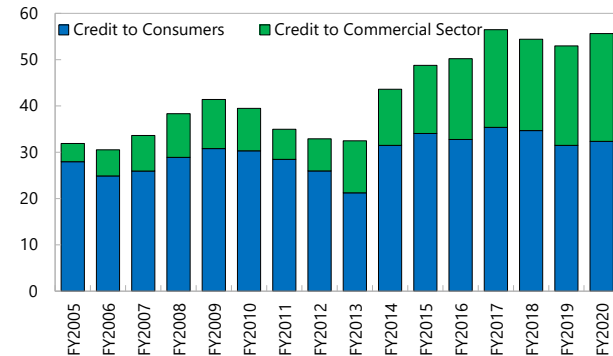
³¹ See <https://home.treasury.gov/policy-issues/office-of-foreign-assets-control-sanctions-programs-and-information> and <https://www.un.org/securitycouncil/sanctions/information>.

- **Corporate services sector.** The provision of corporate services to entities registered in the RMI is not adequately regulated. The RMI legal framework creates potential conflicts of interest by designating the TCMI (registrar of non-resident companies and maritime vessels) as the sole registered agent for all non-resident entities. More extensive corporate services are almost exclusively provided from abroad by TCMI's associated offices. Due to this arrangement and the limited range of services provided in the jurisdiction, corporate services provided to foreign entities registered in the RMI are not subject to the AML/CFT framework, undermining the authorities' ability to properly understand and oversee the sector, obtain accurate information, and combat criminal activity linked to "offshore" activities. Foreign companies and service providers³² registering entities in the RMI are not required to be licensed or subject to AML/CFT requirements or oversight in any jurisdiction.

22. Continue to improve financial sector oversight is needed to safeguard financial stability.

The financial sector of the RMI remains sound with sufficient capital and liquidity buffers. Banking Commission (BC) supported the COVID-19 mitigation responses with three-month interest payment moratorium which temporally affected the banks' profitability. Going forward, limited information on the corporate sector may prohibit a timely assessment of COVID impact and credit risks. Continued concentration in consumer loans, including by Marshall Islands Development Bank (MIDB), however, remains as a major vulnerability. Introducing a debt service to income ratio would help to lower risks in the sector. Amending relevant provisions in the banking act would provide further clarifications of BC's supervisory responsibilities and power with respect to MIDB.

Credit to Private Sector
(In percent of GDP)



Sources: Country authorities and IMF staff calculation.

Authorities' View

23. The authorities acknowledged the risks associated with the SOV issuance and DEZRA.

However, they remained open to the idea of issuing a digital currency at a later stage (after the establishment of a central bank). An update of the legal and regulatory frameworks that would allow for the proper regulation and oversight of activities (including for AML/CFT) relating to digital assets would be a key pre-requisite for the effective licensing and regulation of private virtual asset service providers. The authorities agreed that more time is needed to develop the DEZRA proposal more thoroughly and prepare for its implementation. The authorities also agreed that building institutional capacity is an important and necessary step should the government decide to pursue a digital economic zone and/or issue a digital currency and have requested related TA from the Fund.

³² The RMI's legal framework is silent on who may register entities in the RMI. As an internal policy, the TCMI accepts registration from "qualified intermediaries", although this term is not defined, nor are there clear qualification criteria.

Marshall Island: Financial Soundness Indicators, FY2019-FY2020					
(In Percent)					
	2019			2020	
	Sep.	Dec.	Mar.	Jun.	Sep.
Assets Quality					
Target ALLL to Gross Loans 1/	2.6	2.2	2.5	2.1	1.9
Actual ALLL to Gross Loans	6.9	7.0	5.7	5.6	5.3
ALLL to Non-performing Loans (NLPs)	288.2	321.8	201.1	351.0	503.5
NPLs to Gross Loans	2.4	2.2	2.8	1.6	1.1
Non - Current Loans to Gross Loans	2.5	3.5	3.3	5.9	2.2
Recoveries to Write-Offs	47.8	53.6	58.2	33.1	27.3
Net Loan Losses(Recoveries) to Average Gross Loans	0.3	0.4	0.4	0.3	0.7
Related Party Exposures to Gross Loans	0.5	0.5	0.5	0.4	0.4
Earnings					
Return on Asset(ROA)	3.3	3.5	3.9	3.3	1.9
Net Interest Income Average Earning Assets(NIM)	5.3	5.4	5.4	5.0	3.7
Total Overhead Expense to Average Assets	2.8	2.8	2.3	2.3	2.4
Net Operating Profit after Tax to Average Capital (ROE)	27.5	27.9	122.8	28.1	16.5
Non-Interest Income to Average Assets	1.1	1.2	1.3	0.3	1.0
Liquidity					
Liquid Asset Ratios(Statutory)	60	59	59	60	64
Statutory Requirement-Minimum Threshold 20%	20	20	20	20	20
Loans (Net) to Total Deposits	53	56	53	52	47
Loans (Gross) to Total Deposits	57	60	57	55	50
Top 20 Depositors to Total Deposits	70	68	70	71	70
Source: RMI authorities.					
1/ ALLL: allowance for loan losses.					

24. The authorities confirmed that insufficient information is available on the activities in the “offshore” sectors. The authorities noted that like all non-resident corporate programs, international business activities are vulnerable to being misused due to difficulties encountered in the regulation and supervision of entities not physically present in a jurisdiction. The authorities also agreed that continuing to bring the legal and regulatory framework consistent with international standards on AML/CFT, including those related to the “offshore” sectors, is critical. They have expressed interests to pursue related TA support from the Fund.

25. The authorities remained committed to improving the supervisory and regulatory framework. With the assistance from the Fund, they have completed a comprehensive review of supervisory framework to align with international standards and plans to submit proposed amendments for legislation in August 2021. BC has started supervision for MIDB and is seeking TA from the Fund to make additional formal legislative changes in the Banking Act to include clear statutory powers for the supervision of MIDB. As to the three-month interest moratorium, the authorities noted that most firms have already resumed debt servicing and consequently bank profitability has recovered. The authorities were keen to mobilize the excess liquidity in the system

for more commercial loans. BC is planning to introduce a ceiling on debt-service to income ratio to contain the potential risks from rising household debt and create room for additional corporate lending. They are considering establishing a monetary authority to support the payment system and have requested the Fund TA on this.

POST-COVID RECOVERY ACHIEVING A GREEN, SUSTAINABLE AND INCLUSIVE GROWTH

26. A green and sustainable recovery requires accelerating the preparation of national adaptation plan (NAP) to climate change and improving natural disaster management³³. RMI is one of the world's most climate-vulnerable nations. The vulnerabilities stem from rising sea level with risks including droughts and flooding. Despite pressing need on climate change adaptation measures, the NAP has been significantly delayed. The authorities, with financial support from the WB, are working on preparing the NAP framework and committed to finalize the NAP in 2021.

- **Careful considerations for adaptation strategy, cost estimation and financing preparation would be crucial.** Substantial international climate finance will be required to meet RMI's very large climate change adaptation costs.

Stronger PFM is a necessary precondition for enhancing RMI's ability to access international climate-related assistance (such as the Green Climate Fund) considering the limited room from domestic revenue sources.

Preparation of long-term financing strategy will help prioritize and target

funding applications in a strategic and coordinated way. Internal coordination and integration of climate change projects and financing to fiscal framework need to be clearly established.

Range of Adaptation Costs for Coastal Protection (Million USD per year at 2012 international prices)			
Country	2020s	2040s	2040s as percent of GDP
RMI	13~42	16~58	4~13
Fiji	71~230	86~329	1~3
Kiribati	13~42	16~58	4~11
Tonga	8~28	9~35	1~4

Source: World Bank (2016), Pacific Possible: Climate and Disaster Resilience.

- **The financial gap arising from the risk of natural disasters should be filled up.** Stabilized channels to ex-ante funding for natural disasters have been restricted to US Disaster Assistance Emergency Fund (DAEF) and RMI Contingency Fund. Relying on ex-post donor support for post-disaster expense could be lengthy. Additional donor funded ex-ante financing tools are therefore necessary to increase RMI's capacity to address economic and fiscal impacts of disasters. The authorities should seek additional ex-ante contingent financing from development partners, such as WB Catastrophe Differed Drawdown Option (CAT DDO), ADB Contingency

³³ While RMI's global greenhouse gas (GHG) emissions is negligible, it has made ambitious commitment to the reduction. In 2015 RMI became the first Small Island Developing State (SIDS) to table its post-2020 Nationally Determined Contribution (NDC). This committed the country to a 32percent reduction of GHG emissions by 2025, based on 2010 levels. It also made an indicative commitment to reduce GHG emissions by 45percent by 2030, based on 2010 levels, thereby setting a projected straight-line intended NDC trajectory to achieve RMI's stated aspiration of net zero GHG emissions by 2050.

Disaster Fund, to help strengthen capacity to respond to natural disasters adequately and rapidly. Better utilizing insurance market can also help³⁴.

Marshall Islands: Policy Recommendation on Climate Change		
	Short-term	Medium to Long term
Climate Change Adaptation	<ul style="list-style-type: none"> • Complete National Adaptation Plan • Strengthen internal coordination 	<ul style="list-style-type: none"> • Mainstream adaptation in fiscal framework • Establish long-term financing strategy
	<ul style="list-style-type: none"> • Build capacity and reform PFM reform for financing 	
Disaster Risk Management	<ul style="list-style-type: none"> • Secure resources for ex-ante resilience • Expand contingent financing from development partners 	<ul style="list-style-type: none"> • Prepare for potential DAEF closure • Utilize insurance market

Source: IMF Staff.

27. State-owned enterprises (SOEs) reform should move forward to mitigate fiscal burden and reduce economic distortion. A SOE act³⁵ was legislated to reform SOEs in 2015 and a SOE Monitoring Unit was created in 2018 with ADB assistance. So far, 9 out of 11 SOEs have submitted their business plan to the Ministry of Finance annually since 2019. These are important developments, but overall implementation of the act remains limited particularly in governance and community service obligations (CSOs). Furthermore, an amendment to the Act in 2020 allowing public officials in the responsible line ministry of an SOE to serve on its board reverses the previous efforts to protect independent SOEs operation. The financial viability of several SOEs are in question and corrective measures to put SOEs on a more commercial and sustainable footing will help strengthen public finances. Steps should be taken through:

- **Rationalizing subsidies to SOEs is crucial for fiscal sustainability³⁶.** In the absence of major reforms, subsidies will remain high and a burden on the budget, especially with respect to Tobolar. In the short term, authorities should start to examine the efficiency and effectiveness of the copra subsidies (including via the CSOs). In the medium to long term, the authorities should consider developing a social protection mechanism with direct and targeted fiscal transfers which would be more efficient in redistributing income to the poor and reduce economic distortion.

³⁴ RMI had used market-based disaster risk insurance through Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI) of the World Bank but withdrew from it in 2019, as they required more tailored insurance products to better suit RMI's risk profile (e.g. to include coverage of drought and flooding not from cyclones).

³⁵ Key items in the SOE act: (i) professionalize the board of directors of SOEs to their governance; (ii) generalize the community service obligations (CSOs) agreements to all SOEs, and (iii) encourage SOEs to submit their business plan and yearly report according to the Act.

³⁶ See Annex V for more background.

- **Speeding up the reform momentum and reversing the 2020 amendment.** Steadfast implementation of the SOE Act requires further strengthening SOEs' commercial mandate. To improve the efficiency of SOEs, CSOs for the four key SOEs should be finalized and implemented in the short term. CSOs should be extended to other SOEs in the medium to long term, along with close monitoring and adjustments to CSOs as required. Integration of SOE reforms into fiscal framework and initiation of privatization and public private partnership on areas appropriate for private firms such as communication and resort could be medium and long-term policy options. Moreover, a level playing field with the private sector would help improve business environment³⁷.

Marshall Islands: Policy Recommendation on SOEs Reform		
	Short-Term	Medium to Long term
SOEs Reform	<ul style="list-style-type: none"> • Continue to enforce the business plan submission • Generate CSOs for the four key SOEs as planned 1/ • Reverse the amendment in 2020 on appointing public officials to SOEs board 	<ul style="list-style-type: none"> • Implement CSOs for the rest of the SOEs • Professionalize the board directors • Integrate reform into fiscal framework • Initiate Public Private Partnership and Privatization • Ensure fair competition with private sector
Copra Subsidies (Tobolar)	<ul style="list-style-type: none"> • Examine the subsidy 	<ul style="list-style-type: none"> • Transform subsidies to direct fiscal transfer for the vulnerable

Source: IMF staff

1/ AMI (Air Marshall Islands), MEC (Marshall's Energy Company), MISC (Marshall Islands Shipping Corporation), Tobolar (Tobolar Copra Processing Authority)

28. Improving the enabling business environment to foster a more dynamic private sector.

Private sector development remains sluggish due to long standing structural challenges.³⁸ The authorities are considering to leverage the Vessel Day Scheme to develop domestic tuna value chains. Progress is also made in establishing a Competent Authority to facilitate access to the EU markets. Enhanced mobile banking is helping to facilitate credit access. Those are all welcome steps. However, a more dynamic private sector development will only be possible through improved business environment. Land issue remains the biggest obstacle for doing business in RMI for both land access and credit access. Improving land registration procedures and disputed resolution mechanisms can help collateralize properties -thereby improving access to credit- and to lower hurdles for long-term land leases by nonresidents-thereby facilitating foreign investment. Filling the

³⁷ SOEs only pay import duty and are exempted from other taxes.

³⁸ RMI faces similar challenges as many other remote island economies, small with limited natural resources, narrow-based economy, large distances from major markets, poor/inadequate infrastructure, low capacity, and vulnerable to external shocks. All of which affect economic growth and have often led to a high degree of economic volatility. These structural factors weigh on the country's external competitiveness as well as on its ability to innovate, diversify, and grow.

infrastructure gaps, including digital connection, to reduce cost of doing business, building human capital by enhancing skills training and quality education, and removing market distortions, including through copra subsidy and unfair SOE competition, would mitigate structural bottlenecks and promote private sector development .

Authorities' View

29. The authorities agreed on the need to facilitate climate change adaptation and SOEs reform. The NAP has completed 60~70 percent and is expected to be finalized in 2021. While costing and financing included in the NAP are discussed among related ministries, authorities noted need for additional support from development partners. They have created a master database of climate change projects to improve the internal coordination and the Ministry of Finance is in the process of applying for Accredited Entity from GCF. Also, the authorities recognized the natural disaster financing gap and have tried to expand financing sources including WB CAT DDO. The authorities recognized the necessity to accelerate SOEs reform and emphasized the progress in setting up business plan annually. However, the amendment of SOE act in 2020 was claimed to have no effect on the reform process. The authorities have lowered subsidies to Tobolar in FY2021 budget but have difficulty in making drastic changes on the subsidies due to Tobolar's function of social safety net to farmers.

30. The authorities agreed that accelerating business environment is key for private sector development. They acknowledged the need to focus on new approaches in land registration reform and the skilled labor shortage partly arising from ongoing migration of workers to the U.S. They noted TA needs to address those constraints. The authorities also noted the efforts to improve structure competitiveness measures to reduce the cost of doing business and plan to focus on expanding on tuna value chains to increase value added activities and onshore processing.

STAFF APPRAISAL

31. Swift and strong containment measures on the COVID-19 pandemic successfully prevented the risk of domestic outbreak but also imposed severe strains on economic activities. The government's policies helped to mitigate the economic impact of the pandemic. While the real GDP is expected to continue to decline in FY2021 before rebounding in FY2022, the outlook is subject to heightened uncertainty and risks are tilted to the downside. The authorities' plan for full vaccination for adult population is welcome and will help support the recovery.

32. Supportive fiscal measures should remain in place until the recovery is firmly underway, but measures should be well targeted and reprioritized as needed. Given the large size of the fiscal package, the uncertainty about COVID-19 developments, and limited implementation capacity, the supportive measures should be targeted to the most affected sectors and groups while balancing the needs between safeguarding healthy security, protecting the vulnerable, and supporting economic recovery. To maximize the efficiency of public spending, all COVID-19-related spending should follow strict guidelines for fiscal transparency and accountability.

33. After the recovery from the pandemic, a gradual fiscal consolidation is necessary to prepare the possible reduction of the U.S. Compact grants and reduce risks of a fiscal cliff.

Even if the expiring Compact grants are renewed, some adjustment will likely still be needed to preserve the real value of the Compact Trust Fund for future generations and reduce reliance on external financing. To reduce fiscal risks, the authorities should consider a combination of rationalizing spending, especially on recently rapid rising goods and service spending and SOE subsidies, implementing the long-awaiting tax policy reforms, and strengthening PFM. The recent preparation of the Fiscal Responsibility and Debt Management Act is a welcome step, but timely enactment and effective implementation will be critical for success.

34. The authorities should proceed with caution on the SOV and DEZRA. The SOV would pose significant risks to macroeconomic and financial stability and financial integrity. The RMI's laws and institutions are not yet ready to accommodate the SOV issuance and manage associated risks. The potential costs of the SOV issuance will likely outweigh the benefits by a large margin. Similarly, DEZRA would potentially pose significant financial integrity risks that would not be easily managed in light of the current legal and regulatory framework and institutional capacity.

35. Financial integrity risks in the non-resident corporate and shipping (offshore) sectors should be mitigated. Progress has been made to strengthen the RMI's AML/CFT regime, but weaknesses in the legal framework and capacity constraints among regulatory authorities might not allow for the AML/CFT regime to effectively mitigate financial integrity risks. Further, there is a lack of meaningful oversight of the offshore sectors – including relating to delegated public functions – and insufficient AML/CFT regulation of offshore activities associated with ML/TF risks (e.g., provision of corporate services). The foregoing may contribute to pressures on correspondent banking relationships (CBRs). The authorities should strengthen the AML/CFT legal and regulatory framework and the capacity of relevant agencies to ensure timely access to accurate and up-to-date ownership information, proper regulation of offshore sectors, oversight of delegated public functions, and effective mitigation of financial integrity risks. Finally, the authorities should carefully consider whether delegating public functions to an entity that also performs commercial activities creates potential for conflicts of interest; as a result, these two roles should be separated, or potential conflicts otherwise mitigated.

36. A green and sustainable recovery requires accelerating the preparation of a national adaptation plan (NAP) to climate change. Climate change and natural hazards pose a serious threat to achieving RMI's development goals. The authorities need to address both immediate disaster risks alongside planning for longer term adaptation needs. A NAP is critical to address the challenges in climate change to prioritize key adaptation investments and integrate resilience and disaster risk costs in the budget. Long-term predictable and adequate financing pose significant challenge for developing and delivering the NAP and requires careful considerations. The authorities' commitment to finalize the NAP in 2021 is encouraging and calls for steadfast actions.

37. Strong commitment to SOEs commercialization and accelerating the momentum of SOE reforms is critical to reduce fiscal pressures and improve economic efficiency. Steadfast implementation of the SOE Act to strengthen SOEs' commercial mandate and financial viability

requires timely finalizing and implementing the CSOs. The efficiency of the copra subsidy should be carefully evaluated in the short term. In the medium to long term, the government may consider to develop direct and targeted fiscal transfers via a social protection system, which are more efficient in redistributing income to the poor than paying subsidies to SOEs while helping fiscal consolidation and improving efficiency.

38. Enabling the private sector to grow and become more dynamic requires strong structural reforms. The authorities' plan to leverage RMI's participation in PNA to broaden onshore processing potential is promising and establishing a Competent Authority is a welcome step to expand fish exports to EU. Land registration reforms would be critical step for the promotion of business investment in the RMI. Building skilled and qualified workforce, closing infrastructure gaps, and enhancing access to finance would expand export capacity while enhancing efficiency.

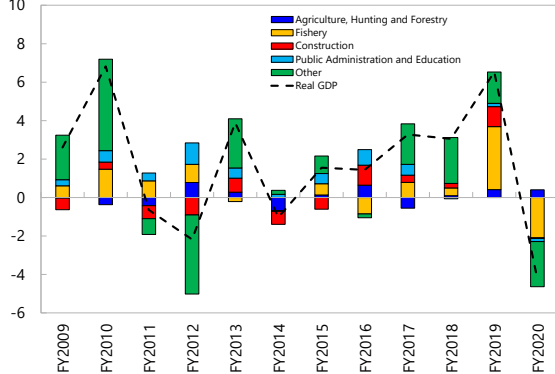
39. It is recommended that the next Article IV consultation will take place on the current 24-month cycle.

Figure 1. Marshall Islands: Real Sector Development

Real GDP in FY 2020 contracted resulting from negative impacts from the COVID-19 pandemic...

Real GDP Growth Contribution

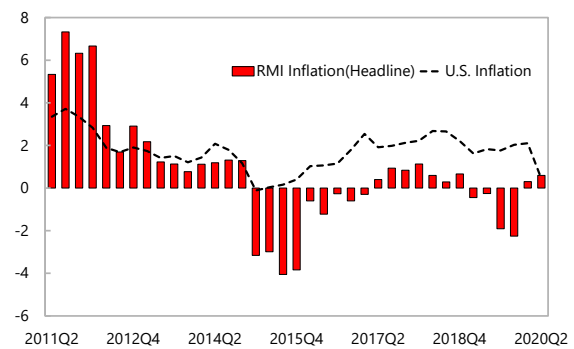
(In percent)



Inflation remains low due to lower commodity prices

CPI Inflation

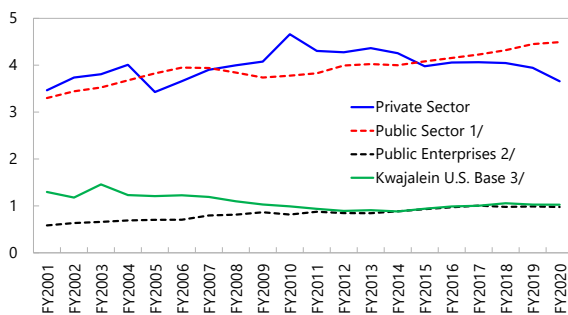
(In percent, year-on-year change, quarterly)



The public sector has recently taken over the private sector and become the primary employer...

Employment

(Workers, in thousand)

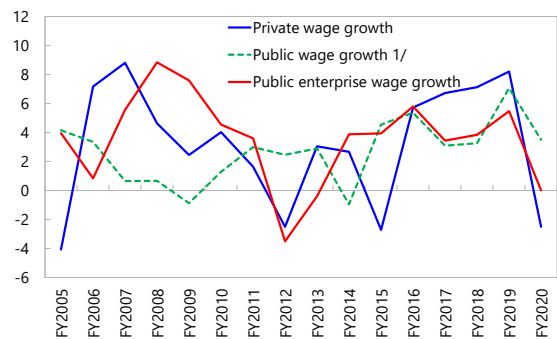


1/ Central and local government.
2/ State-Owned Enterprises
3/ U.S. military base hired workers

...while wage growth dropped sharply from 2019.

Average Public and Private Sector Wages

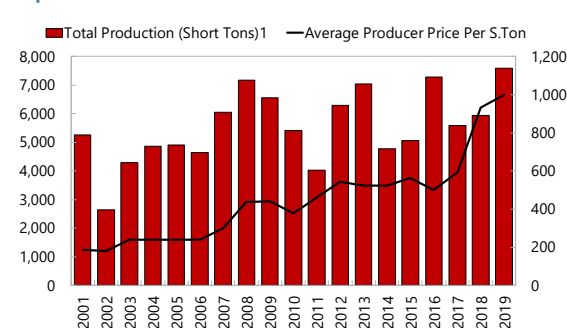
(In percentage point)



1/ Average wage growth of central, local and government agencies.

The copra production picked up due to higher purchase price

Copra Production and Producer Price

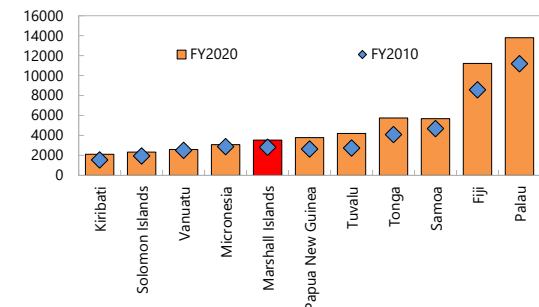


1/Short Ton=0.984, Metric Ton=907.2 Kgs.
Source: Tobolar Processing Plant and EPPSO.

RMI continues to lag peers in terms of income level

Pacific Island Countries: GDP per Capita

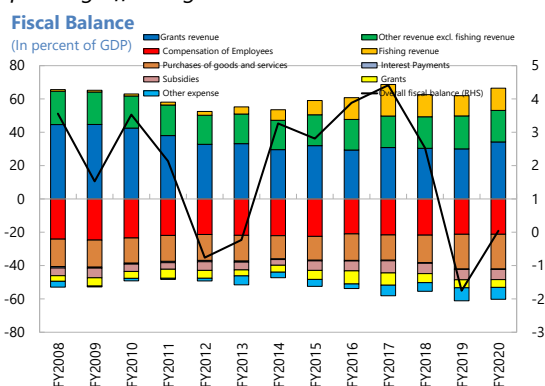
(Purchasing power parity; international dollars)



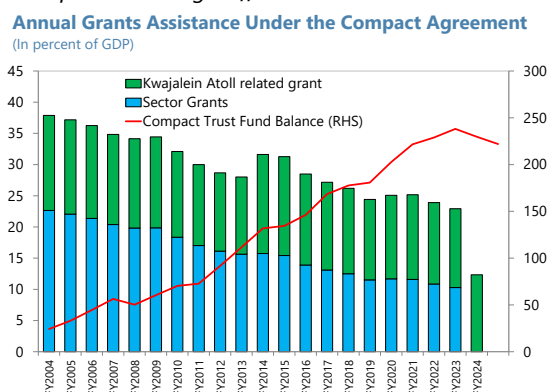
Sources: IMF, World Economic Outlook; and World Bank, World Development Indicators.

Figure 2. Marshall Islands: Fiscal Sector Development

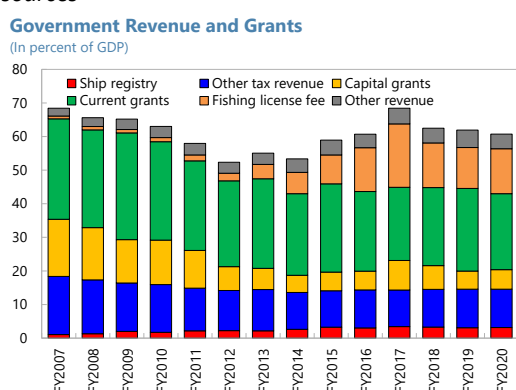
Fiscal surpluses narrowed because rising current spending offset higher revenues...



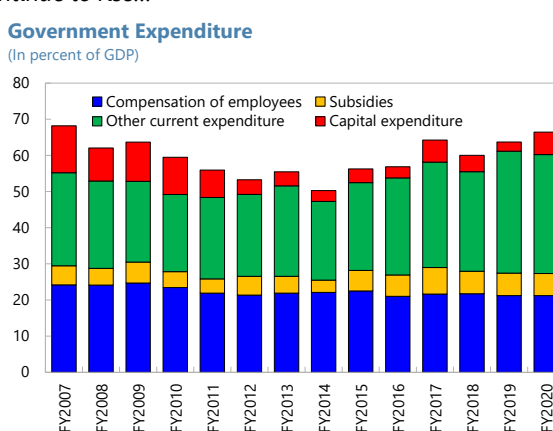
...while the expected expiration of COFA sector grants in 2023 requires building buffers...



Grants and fishing revenue remain the key revenue sources

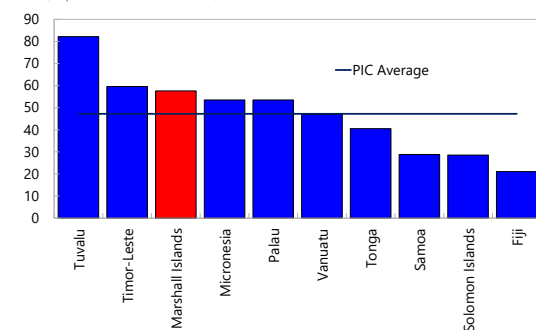


Subsidies remain substantial and other current expenditures continue to rise...



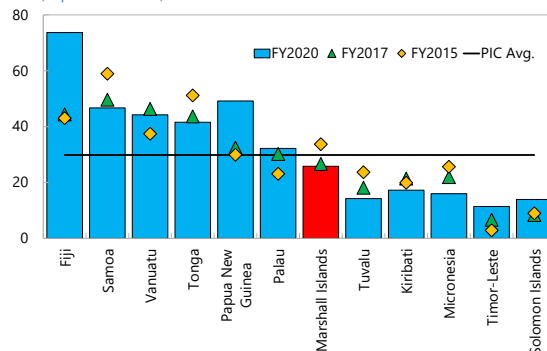
...with current expenditures the third highest among the peers

Current Government Expenditure
(In percent of GDP, FY2020)



But public debt is so far lower than the regional average.

Pacific Islands: Total Public Debt
(In percent of GDP)



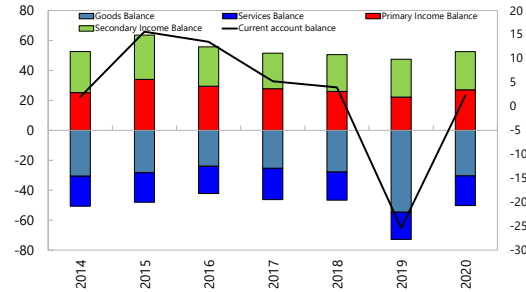
Sources: Country authorities; WEEI, and IMF staff estimates.

Figure 3. Marshall Islands: External Sector Development

The current account balance has moved from a temporary large deficit in 2019 to a small surplus....

Current Account Balance

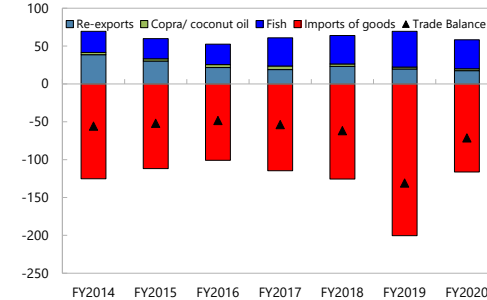
(In percent of GDP)



driven by lower trade deficit

Total Exports and Imports of Goods

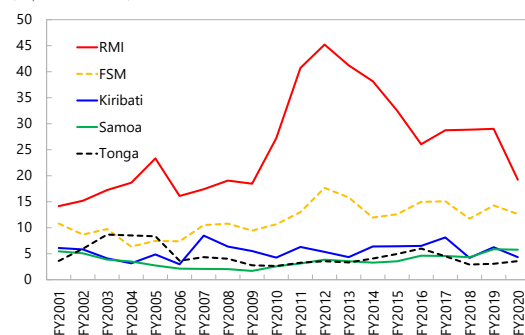
(in millions of USD)



Exports of goods decreased sharply due to the COVID-19 pandemic...

Total Merchandise Exports

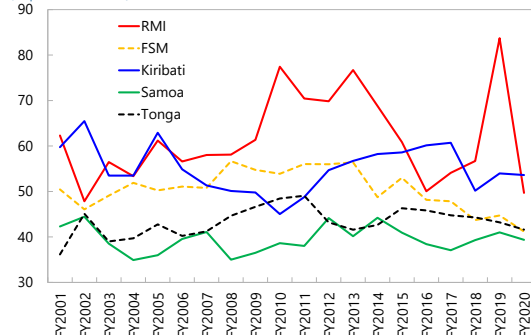
(In percent of GDP)



...while the decline in imports is mostly driven by a one-off imports of three fishing boats in FY2019

Total Merchandise Imports

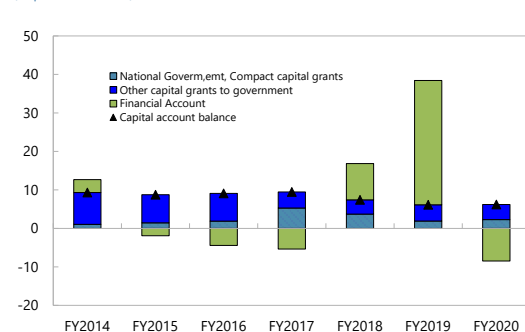
(In percent of GDP)



The capital accounts balance remained stable while financial account moved to deficit...

Capital and Finance Account Balance

(In percent of GDP)



Subdued inflation contributed to the moderation of the real exchange rate.

Real Effective Exchange Rates

(Index 2010=100)

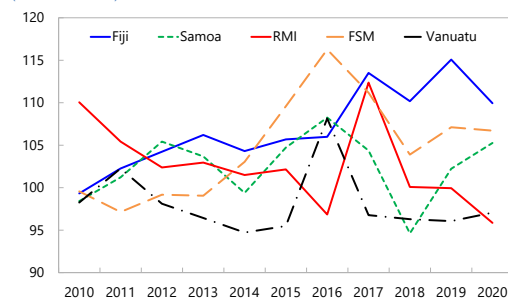


Table 1. Marshall Islands: Selected Economic Indicators, FY 2016-26 1/

Nominal GDP: US\$ million 239(FY 2019)

GDP per capita: US\$4,073 (FY 2019)

Population: 58,791 (FY 2019)

Quota: SDR 3.36 million

	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY2026
							Proj.				
Real sector											
Real GDP (percent change)	1.4	3.3	3.1	6.5	-3.3	-1.5	3.5	2.5	2.0	1.8	1.6
Consumer prices (percent change)	-1.5	0.1	0.8	-0.5	0.6	1.1	1.5	2.0	2.0	2.0	2.0
Central government finances (in percent of GDP)											
Revenue and grants	60.7	68.7	62.6	62.0	66.5	85.7	71.0	70.2	66.9	63.0	64.5
Total domestic revenue	31.4	37.9	32.2	31.9	32.3	30.4	31.2	31.3	41.0	40.7	40.4
Grants	29.3	30.8	30.4	30.0	34.2	55.3	39.8	38.9	25.8	22.3	24.1
Expenditure	56.8	64.2	60.0	63.7	66.4	85.1	72.3	71.7	70.1	66.5	68.5
Expense	53.8	58.1	55.5	61.2	60.2	76.9	59.8	59.8	59.9	60.0	60.1
Net acquisition of nonfinancial assets	3.1	6.1	4.5	2.5	6.2	8.2	12.4	11.9	10.2	6.5	8.4
Net lending/borrowing	3.9	4.4	2.5	-1.8	0.0	0.6	-1.3	-1.5	-3.3	-3.5	-3.9
Compact Trust Fund (in millions of US\$; end of period)	294.5	356.9	402.4	434.7	480.0	525.7	574.5	626.7	631.4	635.7	620.8
Balance of payments (in percent of GDP)											
Current account balance	13.5	5.2	4.0	-25.4	2.2	2.6	0.4	-0.2	-0.5	-1.7	-2.7
Goods and services balance	-42.2	-46.3	-46.6	-72.9	-50.3	-57.0	-60.0	-57.8	-56.0	-56.7	-57.2
Primary income	29.4	27.8	26.0	22.2	27.1	27.9	29.0	29.0	38.5	38.0	37.6
Of which : fishing license fee	12.5	12.5	11.9	10.5	11.5	9.5	10.0	10.2	10.1	10.0	9.9
Secondary income	26.3	23.7	24.6	25.3	25.5	31.7	31.4	28.5	17.0	17.1	16.9
Of which : compact current grants	16.0	14.7	14.3	15.4	14.3	14.3	13.5	12.8	3.5	3.4	3.4
Of which : other budget and off-budget grants	8.8	7.6	9.5	9.7	10.2	16.4	17.1	15.1	13.0	13.2	13.2
Current account excluding current grants	-11.4	-17.1	-19.8	-50.5	-22.3	-28.1	-30.2	-28.1	-4.0	-5.1	-6.0
External PPG debt (Percent of GDP; end of period) 2/	41.4	36.8	32.7	27.8	27.5	26.2	25.3	25.1	26.7	28.8	31.3
Exchange rate											
Real effective exchange Rate (2010 = 100)	120.3	120.7	121.5	97.2
Memorandum item:											
Nominal GDP (in millions of US\$)	201.5	211.9	221.6	239.5	234.1	234.1	247.1	258.3	268.8	279.1	289.2

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

1/ Fiscal year ending September 30.

2/ Assumption is that RMI will continue to receive 100 percent of its MDBs financial assistance in the form of grants.

Table 2. Marshall Islands: Statement of Government Operations, FY 2016-26 1/

	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026
							Proj.				
	(In millions of U.S. dollars)										
Revenue	122.4	145.5	138.6	148.4	155.6	200.6	175.4	181.3	179.7	175.8	186.7
Taxes	28.9	30.4	32.1	34.9	34.1	33.2	36.0	37.4	38.9	40.4	41.8
Taxes on income, profits, and capital gains	13.8	14.8	15.1	16.3	16.6	16.1	16.8	17.5	18.2	18.9	19.6
Taxes on goods and services	5.8	5.7	7.3	7.8	7.0	6.5	8.0	8.4	8.7	9.1	9.4
Taxes on international trade and transactions	8.2	8.5	8.4	9.4	9.3	9.1	9.7	9.8	10.2	10.6	11.0
Other taxes	1.2	1.4	1.4	1.5	1.3	1.6	1.6	1.6	1.7	1.8	1.8
Grants 2/	59.1	65.3	67.3	71.9	80.0	129.4	98.3	100.4	69.4	62.2	69.7
<i>Of which : Covid-related grants</i>					8.0	44.3					
<i>Of which: U.S. Compact Sector Grants</i>	23.4	29.8	27.6	27.4	27.0	26.7	26.4	26.2	0.0	0.0	0.0
<i>Of which: U.S. Supplemental Education Grant</i>	5.6	5.3	4.8	5.6	5.6	5.6	5.6	5.6	0.0	0.0	0.0
Other revenue	34.4	49.9	39.2	41.5	41.5	38.0	41.0	43.5	71.4	73.2	75.1
<i>Of which : drawdown of the Compact Trust Fund</i>	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	26.7	27.2	27.7
<i>Of which : fishing license fee</i>	26.3	40.0	29.4	29.1	31.3	26.0	28.6	30.7	31.6	32.5	33.4
Expenditure	114.5	136.1	133.0	152.6	155.5	199.2	178.6	185.3	188.5	185.7	198.0
Expense	108.4	123.2	122.9	146.5	141.0	180.1	147.8	154.6	161.0	167.4	173.8
Compensation of employees	42.4	45.9	48.2	50.8	49.7	49.7	52.6	55.0	57.2	59.4	61.5
Use of goods and services 3/	32.0	32.2	36.8	50.0	48.9	66.5	51.2	53.5	55.7	57.8	59.9
Interest	0.8	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.7	0.8	0.9
Subsidies	11.9	15.5	13.7	14.9	14.2	17.2	18.1	18.9	19.9	20.9	21.8
Grants	15.8	15.6	12.1	11.5	10.9	15.1	12.5	13.1	13.6	14.1	14.6
Other expense 4/	5.5	13.4	11.5	18.7	16.7	38.5	12.9	13.5	14.0	14.5	15.1
Net acquisition of nonfinancial assets	6.2	12.9	10.1	6.1	14.5	19.1	30.7	30.7	27.5	18.2	24.2
Net operating balance 5/	14.0	22.3	15.7	1.9	14.6	20.5	27.5	26.7	18.7	8.3	12.9
Net lending/borrowing	7.8	9.4	5.6	-4.2	0.1	1.4	-3.2	-4.0	-8.8	-9.9	-11.3
	(In percent of GDP)										
Revenue	60.7	68.7	62.6	62.0	66.5	85.7	71.0	70.2	66.9	63.0	64.5
Taxes	14.3	14.3	14.5	14.6	14.6	14.2	14.6	14.5	14.5	14.5	14.5
Taxes on income, profits, and capital gains	6.8	7.0	6.8	6.8	7.1	6.9	6.8	6.8	6.8	6.8	6.8
Taxes on goods and services	2.9	2.7	3.3	3.2	3.0	2.8	3.3	3.3	3.3	3.3	3.3
Taxes on international trade and transactions	4.0	4.0	3.8	3.9	4.0	3.9	3.9	3.8	3.8	3.8	3.8
Other taxes	0.6	0.6	0.6	0.6	0.5	0.7	0.6	0.6	0.6	0.6	0.6
Grants	29.3	30.8	30.4	30.0	34.2	55.3	39.8	38.9	25.8	22.3	24.1
<i>Of which : Covid-related grants</i>					3.4	18.9					
<i>Of which: U.S. Compact Sector Grants</i>	11.6	14.1	12.5	11.4	11.5	11.4	10.7	10.1	0.0	0.0	0.0
<i>Of which: U.S. Supplemental Education Grant</i>	2.8	2.5	2.2	2.3	2.4	2.4	2.3	2.2	0.0	0.0	0.0
Other revenue	17.1	23.5	17.7	17.3	17.7	16.2	16.6	16.8	26.6	26.2	26.0
<i>Of which : drawdown of the Compact Trust Fund</i>	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	9.9	9.7	9.6
<i>Of which : fishing license fee</i>	13.0	18.9	13.3	12.2	13.4	11.1	11.6	11.9	11.8	11.6	11.6
Expenditure	56.8	64.2	60.0	63.7	66.4	85.1	72.3	71.7	70.1	66.5	68.5
Expense	53.8	58.1	55.5	61.2	60.2	76.9	59.8	59.8	59.9	60.0	60.1
Compensation of employees	21.0	21.6	21.7	21.2	21.2	21.3	21.3	21.3	21.3	21.3	21.3
Goods and Services	15.9	15.2	16.6	20.9	20.9	28.4	20.7	20.7	20.7	20.7	20.7
Interest	0.4	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.3	0.3
Subsidies	5.9	7.3	6.2	6.2	6.1	7.3	7.3	7.3	7.4	7.5	7.5
Grants	7.9	7.4	5.4	4.8	4.7	6.4	5.1	5.1	5.1	5.1	5.0
Other expense	2.7	6.3	5.2	7.8	7.1	16.5	5.2	5.2	5.2	5.2	5.2
Net acquisition of nonfinancial assets	3.1	6.1	4.5	2.5	6.2	8.2	12.4	11.9	10.2	6.5	8.4
Net operating balance	6.9	10.5	7.1	0.8	6.3	8.8	11.1	10.4	7.0	3.0	4.4
Net lending/borrowing	3.9	4.4	2.5	-1.8	0.0	0.6	-1.3	-1.5	-3.3	-3.5	-3.9
Memorandum items:											
Compact Trust Fund (in millions of US\$)	294.5	356.9	402.4	434.7	480.0	525.7	574.5	626.7	631.4	635.7	639.8
Compact Trust Fund (in percent of GDP)	146.2	168.4	181.6	181.5	205.0	224.6	232.5	242.6	234.9	227.8	221.2
Outstanding central government debt (in percent of GDP)	29.3	25.6	23.3	21.5	21.9	21.4	21.5	22.1	24.5	27.2	30.1
Nominal GDP (in millions of US\$)	201.5	211.9	221.6	239.5	234.1	234.1	247.1	258.3	268.8	279.1	289.2

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. Assume that RMI will continue to receive 100 percent of its MBDs financial assistance in the form of grants.

3/ Include some Covid-19 related expenditure

4/ Include other Covid-19 related expenditure

5/ Net operating balance is the difference between revenue and expense.

Table 3. Marshall Islands: Balance of Payments, FY 2016-26 1/

	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026
	Proj.										
	(In millions of U.S. dollars)										
Current account balance	27.1	11.1	8.8	-60.8	5.3	6.2	1.0	-0.6	-1.4	-4.8	-7.7
Goods Balance	-48.4	-53.7	-61.7	-131.0	-71.3	-91.6	-104.0	-103.0	-102.4	-108.18	-113.45
Exports, f.o.b.	52.5	60.9	63.9	69.5	45.0	55.9	54.0	55.7	58.0	60.2	62.5
Imports, f.o.b. 2/	-100.9	-114.6	-125.6	-200.5	-116.3	-147.5	-158.0	-158.7	-160.3	-168.4	-176.0
Services Balance	-36.8	-44.3	-41.6	-43.5	-46.4	-41.7	-44.2	-46.3	-48.2	-50.16	-51.98
Exports of Services	19.8	20.6	22.3	21.6	17.4	22.1	22.6	23.0	23.5	23.9	24.8
Imports of Services	-56.6	-65.0	-63.8	-65.1	-63.8	-63.8	-66.8	-69.3	-71.7	-74.1	-76.8
Primary Income Balance	59.3	58.9	57.5	53.2	63.4	65.2	71.7	75.0	103.5	106.0	108.7
Of which : Kwajalein atoll related inflows	41.6	42.8	44.0	45.6	46.0	46.7	47.3	48.0	48.7	49.4	26.3
Of which : fishing licence fees inflows	25.3	26.4	26.3	25.0	26.9	22.3	24.6	26.4	27.2	27.9	28.7
Secondary Income Balance	52.9	50.3	54.5	60.5	59.6	74.3	77.5	73.7	45.7	47.6	49.0
Of which : compact current grants	32.2	31.2	31.8	37.0	33.5	33.4	33.3	33.2	9.4	9.6	9.7
Of which : other budget and off-budget grants	17.8	16.1	21.0	23.2	23.9	38.5	42.2	38.9	34.9	36.8	38.2
Capital account balance	18.3	20.1	16.5	14.7	14.5	25.1	38.7	33.2	30.0	20.7	26.7
Of which : compact capital grants	3.8	11.2	8.2	4.6	5.4	6.6	10.7	10.6	2.9	2.9	5.5
Of which : other capital grants to government	14.5	8.8	8.2	10.1	9.2	18.5	28.1	22.6	27.1	17.8	21.2
Financial account balance 3/	-8.9	-11.4	20.8	46.1	-19.8	-31.3	-39.7	-32.7	-28.6	-16.0	-18.9
Errors and omissions	-36.6	-19.8	-46.1	0	0	0	0	0	0	0	0
	(In percent of GDP)										
Current account balance	13.5	5.2	4.0	-25.4	2.2	2.6	0.4	-0.2	-0.5	-1.7	-2.7
Goods Balance	-24.0	-25.4	-27.9	-54.7	-30.5	-39.1	-42.1	-39.9	-38.1	-38.8	-39.2
Exports, f.o.b.	26.1	28.7	28.8	29.0	19.2	23.9	21.9	21.6	21.6	21.6	21.6
Imports, f.o.b.	-50.1	-54.1	-56.7	-83.7	-49.7	-63.0	-63.9	-61.4	-59.7	-60.3	-60.9
Services Balance	-18.3	-20.9	-18.8	-18.2	-19.8	-17.8	-17.9	-17.9	-18.0	-18.0	-18.0
Exports of Services	9.8	9.7	10.1	9.0	7.4	9.4	9.1	8.9	8.7	8.6	8.6
Imports of Services	-28.1	-30.7	-28.8	-27.2	-27.3	-27.3	-27.0	-26.8	-26.7	-26.6	-26.6
Primary Income Balance	29.4	27.8	26.0	22.2	27.1	27.9	29.0	29.0	38.5	38.0	37.6
Of which : Kwajalein atoll related	20.6	20.2	19.8	19.1	19.7	19.9	19.2	18.6	18.1	17.7	9.1
Of which : fishing licence fees	12.5	12.5	11.9	10.5	11.5	9.5	10.0	10.2	10.1	10.0	9.9
Secondary Income Balance	26.3	23.7	24.6	25.3	25.5	31.7	31.4	28.5	17.0	17.1	16.9
Of which : compact current grants	16.0	14.7	14.3	15.4	14.3	14.3	13.5	12.8	3.5	3.4	3.4
Of which : other budget and off-budget grants	8.8	7.6	9.5	9.7	10.2	16.4	17.1	15.1	13.0	13.2	13.2
Capital account balance	9.1	9.5	7.4	6.1	6.2	10.7	15.7	12.9	11.2	7.4	9.2
Of which : compact capital grants	1.9	5.3	3.7	1.9	2.3	2.8	4.3	4.1	1.1	1.0	1.9
Of which : other capital grants to government	7.2	4.2	3.7	4.2	3.9	7.9	11.4	8.8	10.1	6.4	7.3
Financial account balance	-4.4	-5.4	9.4	19.3	-8.5	-13.4	-16.1	-12.7	-10.6	-5.7	-6.5
Errors and omissions	-18.2	-9.3	-20.8	0.0	0.0	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.

2/ Imports of goods in FY2019 are inflated by the purchase of 3 boats that amount \$US 61.8 million.

3/ The purchase of boats in FY2019 are also recorded as FDI, therefore inflating the financial account balance.

Table 4. Marshall Islands: External Vulnerability Indicators, FY 2016-20 1/

	FY 2016	FY 2017	FY 2018	FY2019	FY2020
Financial indicators:					
Commercial bank deposits (12-month percent change)	19.9	23.9	-3.3	-4.9	21.8
Private sector credit (12-month percent change)	12.8	18.3	0.8	5.2	2.7
Foreign assets/total assets (percent)	52.3	51.8	50.3	46.2	52.9
Consumer loans (in percent of total private sector loans)	65.3	62.7	63.8	59.4	58.2
External indicators:					
Exports (percent change)	-12.2	16.0	4.9	8.7	-35.2
Imports (percent change)	-9.8	13.7	9.6	59.5	-42.0
Current account balance (percent of GDP)	13.5	5.2	4.0	-25.4	2.2
Capital and financial account balance (percent of GDP)	4.7	4.1	16.8	38.4	-2.2
<i>Of which:</i> FDI (percent of GDP)	3.0	3.3	3.7	29.5	3.5
Gross official reserves (in millions of U.S. dollars) 1/	9.1	13.6	11.8	9.1	18.6
Gross official reserves (in months of imports of goods and services)	0.7	0.9	0.7	0.4	1.2
Debt indicators:					
External debt service (in millions of US\$)	6.9	7.9	7.1	7.6	0.0
External debt service (In percent of exports of goods and services)	9.5	9.7	7.8	12.2	0.0
External PPG debt (percent of GDP) 2/	41.4	36.8	32.7	27.8	27.5
External PPG debt (in percent of exports of goods and services) 2/	115.4	95.6	84.2	73.0	103.1

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, FY 2016-20

	FY 2016	FY 2017	FY 2018	FY2019	FY2020
(In millions of U.S. dollars)					
Assets and Liabilities					
Assets	220.4	261.8	257.0	245.9	293.8
Foreign assets	115.4	135.7	129.2	113.6	155.3
Total Credit/loan	103.8	121.5	122.1	127.6	131.0
Claims on central and local governments	0.0	0.1	0.3	0.0	0.3
Claims on public enterprises	2.7	1.8	1.3	0.8	0.5
Claims on private sector	101.1	119.7	120.6	126.8	130.2
Consumer	66.0	75.0	76.9	75.4	75.7
Commercial	35.1	44.7	43.7	51.5	54.5
Unclassified assets	1.2	4.5	5.7	4.8	7.5
Liabilities	220.4	261.8	257.0	245.9	293.8
Deposits	183.3	227.2	219.7	208.9	254.4
Central government deposits 1/	9.1	13.6	11.8	9.1	18.6
Foreign liabilities	5.4	4.1	4.4	4.3	5.7
Capital accounts	30.5	29.1	30.3	31.5	32.3
Unclassified liabilities	1.2	1.3	2.6	1.3	1.4
<i>Memorandum items:</i>					
Loan/deposit ratio (in percent)	56.6	53.5	54.9	60.7	51.2
Deposits (percent change)	19.9	23.9	-3.3	-4.9	21.8
Loans (percent change)	8.4	17.1	0.8	5.2	2.7
Consumer loans (in percent of total loan)	63.6	61.7	63.6	62.9	62.7
Income and expense					
Interest Income	10.5	12.9	14.7	15.3	12.9
Interest and fees on loans	10.1	11.9	12.7	13.0	9.7
Deposits with banks	0.4	1.0	2.0	2.3	3.2
Interest Expense	1.6	1.3	1.1	1.3	1.3
Deposits	1.6	1.3	1.1	1.3	1.3
Net interest income	8.9	11.7	13.6	14.0	11.7
Provision for loan losses	0.2	0.5	0.2	1.1	-0.1
Net interest income after loan loss provisions	8.7	11.2	13.5	12.9	11.7
Net Income (Loss)	5.8	7.5	9.5	8.8	7.2
Interest rates (in percent) 2/					
Deposit rates					
Checkable savings	1.0	1.5	1.4	0.2	0.2
Savings deposits	0.2	0.2	0.2	0.2	0.2
Time deposits	2.7	3.0	2.6	2.1	2.1
All interest bearing deposits 3/	1.5	1.3	1.1	0.9	0.8
Loan rates					
Businesses	4.2	5.3	6.8	6.5	6.3
Individuals	12.3	12.7	12.7	12.8	8.3
All loans	10.1	10.7	12.1	12.0	9.9

Sources: RMI authorities; and IMF staff estimates.

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

2/ Yearly average.

3/ Actual interest divided by relevant deposit or loan balances

Annex I. External Sector Assessment¹

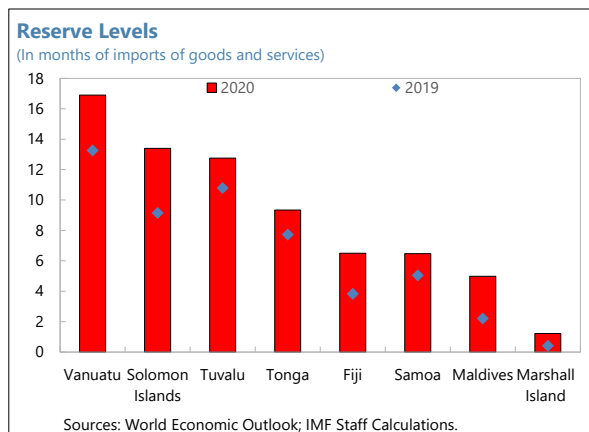
1. External balance assessment. The external position of the Republic of Marshall Islands in FY2020 was weaker than the level consistent with fundamentals and desirable policies. The external position remains vulnerable to uncertainties arising from the COVID-19 pandemic, ongoing negotiations on the Compact financial assistance with the United States, unresolved AML/CFT issues, and the possible issuance of a crypto currency. If the Compact financial assistance with the United States is not renewed after its expiration in FY2023, avoiding a further worsening of the current account (CA) balance will require a gradual fiscal consolidation, which will help preserve the real value of the Compact Trust Fund (CTF) and would lower the risks of unsustainable external position.

- **The External Sustainability approach²** estimates the CA norm to be a surplus of 0.6 percent of GDP, compared to the projected medium-term CA deficit of 2.7 percent. Hence, with a gap of 3.3 percent of GDP, the projected CA balance is assessed to be weaker with the level that would stabilize the net international asset position (as a percent of GDP) over the medium term.
- The CA and REER approaches seem less relevant due to data limitations that result in large margins of statistical variation around the estimates. Moreover, unlike the external sustainability approach, these backward-looking approaches cannot take into account the structural break in FY2024 arising from the reduction of the U.S. Compact grants.

Marshall Islands: External Balance Assessment, 2020	
Percent of GDP, unless otherwise indicated	
Actual Current Account (CA) Balance, 2020 (=a)	2.2
Cyclically Adjusted CA (=b)	2.8
Cyclically Adjusted CA norm from EBA Lite Model (=c)	-1.0
CA Gap (=b-c, p.p. of GDP)	3.8
of which: policy gap	-6.0
CA norm from External Sustainability Approach (=d)	0.6
Current Account Gap (=a-d, p.p. of GDP)	1.6
Projected medium-term CA balance, 2026 (e)	-2.7
Medium-term CA Gap (e-d, p.p. of GDP)	-3.3

Source: IMF staff estimates.

2. Reserves. The government's 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 legal tender. Since FY2019, government deposits have increased, by 4.1 percentage points to 7.9 percent of GDP, around 1.2 months of imports of goods and services in FY2020. Despite the moderate improvement, reserves remain under the Pacific

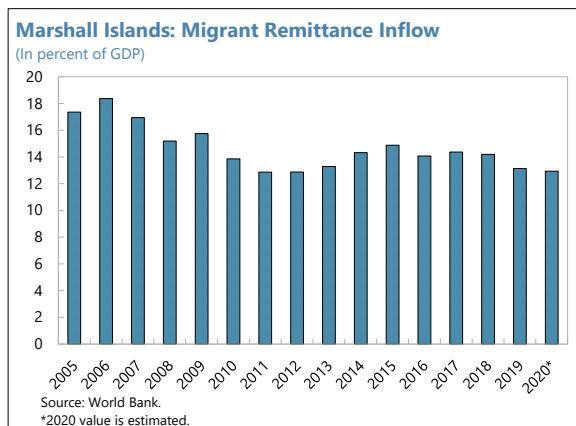


¹ Prepared by Biying Zhu.

² The EBA-lite method generates a lower CA norm compared to the external sustainability approach. However, it does not adequately incorporate the constraints from current CTF rules and on intergenerational equity considerations—the latter would argue argument-to preserve the value of the CTF after FY23. The possible margin of error in this assessment is large, given data limitations and special circumstances for small island economies.

Island countries' average of 8 months, but the stable foreign grants inflows help shield the country from liquidity squeezes.

3. Competitiveness. Under the U.S. Compact Agreement, people from RMI can work in the U.S. without separate permit, which has resulting in increasing migration of skilled workers to the United States, motivated by higher wages and better access to health care and education systems. Local labor costs in manufacturing have increased in the past few years due to domestic labor shortage, especially skilled labor. However, this potentially negative impact on external competitiveness is partially offset by relatively stable and large migrant remittance inflows, about 13.3 percent of GDP in FY2019. The remittance inflow in FY 2020 is estimated to be 12.9 percent of GDP.



4. External Financing. The long-standing trade deficit is offset by fishing license income and official transfers. Fishing license fee income is expected to stabilize in nominal terms over the medium-term, and grants from other donors are expected to continue after the Compact grant agreement expires. Most of public investment would continue to be financed by capital grants.

Annex II. Risk Assessment Matrix¹

Source of Risks	Relative Likelihood/ Time Horizon	Excepted Impact if Realized	Recommended Policy Response
Upside Risk			
Renewal of the Compact Financial Assistance	Medium	High	<ul style="list-style-type: none">Adjust the strategy to secure long-term fiscal self-reliance.
	Medium Term	Agreement on a new Compact financial chapter between the RMI and U.S. governments with favorable terms will help relieve the pressure of fiscal adjustment and result in better economic outcome.	
Downside External Risks			
Asynchronous progress and prolonged Covid-19 pandemic	Medium	High	<ul style="list-style-type: none">Strengthen health policiesContinue targeted support to the most affected sector and groupsContinued vaccine roll-out to a large percentage of populationMobilize more donors' grants if needed.
	Short to Medium Term	Containment efforts that extending border closure could limit fishing-related revenue and negatively impact the domestic economy and worsen external and fiscal positions.	
Downside Domestic Risks			
High frequency and severity of natural disasters related to climate change	Medium	High	<ul style="list-style-type: none">Strengthen the early disaster warning systemSeeking cost-effective insuranceEstablish contingent financing plans with donors.
	Short to Medium Term	Adversely affect production, water resources, health, infrastructure and current and long-term growth.	
Delayed fiscal adjustment	Medium/High	High	Multi-pronged efforts for fiscal consolidation, including reversing the recent increase in recurrent spending, improving revenue administration, and implementing tax policy reforms.
	Short to Medium Term	As investment earnings from the CTF would not be enough to replace the expiring portion of the US Compact grants after FY2023, the government could be forced to lower expenditures in the absence of other external financing, which would negatively affect the economy.	
Issuance of the SOV or pre-sale	Medium	High	<ul style="list-style-type: none">Seriously reconsider the issuance of the SOV including the pre-sale.
	Short to Medium Term	The issuance would elevate macroeconomic and financial stability risks as wells as risks of losing the last USD CBR	
Establishment of a digital economic zone (DEZRA)	High	Medium to High	<ul style="list-style-type: none">A more cautious approach on establishing the DEZRA.
	Short to Medium Term	Such an economic zone will generate significant financial integrity risks in the absence of effective regulation and supervision.	
Withdrawal of CBR	Medium	High	<ul style="list-style-type: none">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.
	Short to Medium Term	The termination of the last USD CBR would have significant repercussions to the economy with USD as legal tender owing to the lack of access to USD clearing services and potential disruptions to the flows of external aid.	

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 (ST)" and "medium term (MT)" are meant to indicate that the risk could materialize within 1 and 3 years, respectively

Annex III. The Compact Trust Fund and Fiscal Adjustment¹

Sizable budgetary grants under the Compact Agreement of the Republic of Marshall Islands (RMI) with the United States will be lost with the expiration of the agreement in 2023. The loss would be only partially compensated by disbursements from a Compact Trust Fund (CTF) set up for this purpose. The U.S. and RMI government are currently negotiating a new agreement, but the terms have yet to be specified. This note analyzes the size and pace of fiscal adjustment needed to avoid a fiscal cliff if the Compact Agreement were not renewed. In long term, fiscal policy should strive to lower RMI's reliance on external financial assistance and achieve real value preservation of the CTF, a key source of income for future generations.

Context

- 1. The fiscal situation in the Republic of the Marshall Islands (RMI) has weakened.** The fiscal surplus has declined from 3.6 percent of GDP on average in FY 2016-18 to a deficit of 1.8 percent of GDP in FY 2019, as rising revenue from fishing license fees were more than offset by higher recurrent spending. Some major revenue sources have already or are expected to decrease relative to GDP, notably as fishing license fees and U.S. Compact grants. At the same time, there are persistent pressures on the expenditure side, including from rising SOE subsidies, especially for copra production, adaption cost to climate changes, and the underfinanced social security funds. As a result, the government's fiscal position is expected to deteriorate significantly without adjustment.
- 2. The scheduled termination of the U.S. Compact grants is expected to compound the fiscal challenges.** The U.S. Compact Trust Fund (CTF) was established in 2004 to compensate for the significant reduction in U.S. grants and support the self-reliance of the RMI after the expiration of major U.S. financial assistance under the Compact Agreement at end-FY2023. However, the grants set to expire are likely to exceed the expected drawdown from the CTF.
- 3. The Compact Trust Fund plays a critical role in RMI's fiscal outlook.** After 2023, government revenue are expected to rely heavily on CTF disbursements. Staff estimates suggest that the outstanding CTF balance would reach around 243 percent of GDP at end-FY2023 and that the prospective CTF disbursements to the government could account for 10 percent of GDP. This sizable scale underscores CTF's critical role in securing the country's long-term fiscal sustainability.

Sustainability of the Compact Trust Fund and Required Fiscal Adjustment

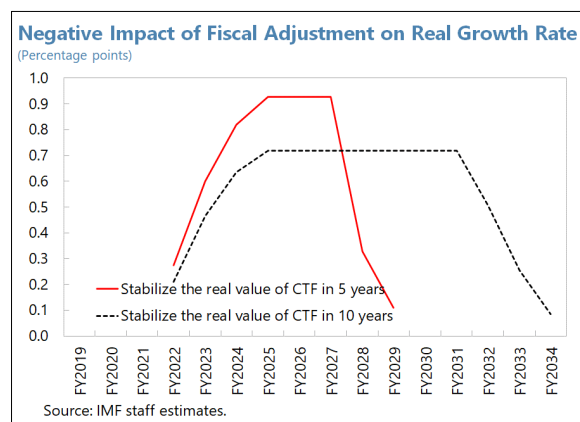
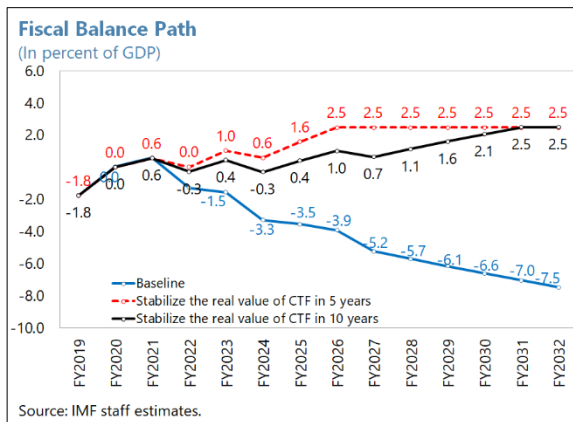
- 4. Past staff recommendations on fiscal adjustment focused on preserving the real value of the CTF.** The current distribution rule of the CTF stipulates that, from FY2024 onwards, CTF investment earnings of the previous year are allowed to be withdrawn to finance budget

¹ Prepared by Mouhamadou Sy and Kenji Kitano.

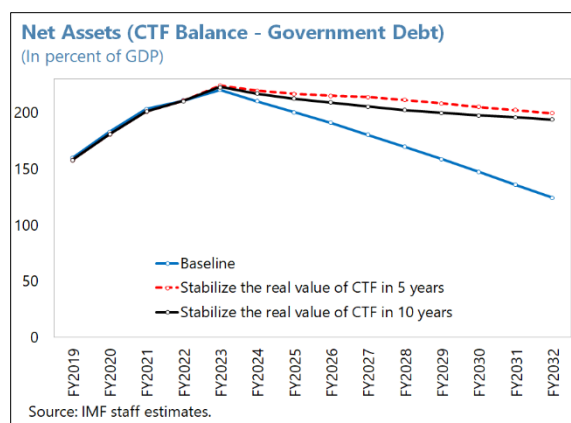
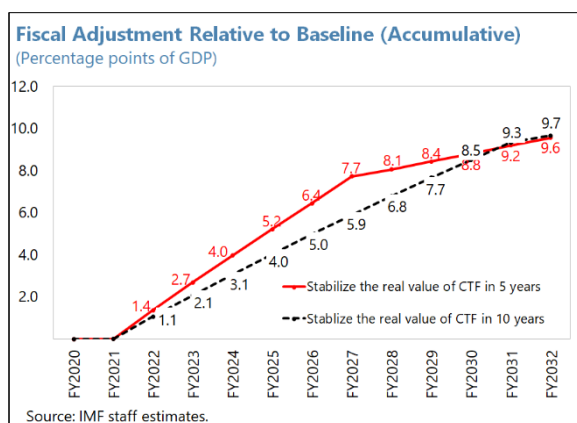
needs up to a certain limit.² While this rule serves as protection for the nominal value of the CTF, the real value of the CTF will erode if the government does not replenish the fund. In previous AIV consultations, staff proposed the size of fiscal adjustment that would preserve the real value of the CTF.

5. With larger than anticipated grant revenue losses, which will be compounded by impact of the COVID-19 pandemic on the fiscal position, the fiscal adjustment proposal in the last Article IV requires recalibration. The 2018 Article IV proposed fiscal adjustment of 4 percentage points of GDP over 5 years until FY2023. However, in addition to the Sectoral Grants under the Compact agreement, a Supplementary Education Grant from the U.S. is also likely to expire at end-FY2023. Furthermore, after FY2023, the fiscal balance as a percent of GDP is expected to continue to deteriorate, partly because the remaining U.S. grants and the maximum amount of disbursement from the CTF are kept constant in real terms by the relevant agreements with U.S.. As ratios to nominal GDP, they will, therefore, decline over time.

6. Staff analysis suggests that when designing fiscal adjustment strategies, authorities could face a trade-off between feasibility and real value preservation over the traditional 5-year horizon. Based on the updated baseline projection in the 2021 AIV, two adjustment scenarios are considered to achieve 2.5 percent of GDP primary surpluses to keep the real value of CTF after 5 years and after 10 years



² Annual disbursement from the CTF is funded by retained investment earnings of the previous year, up to a maximum limit equivalent to expired grant assistance amount as of 2023, fully adjusted for inflation. If the investment earning of the previous year falls short of the maximum annual limit, drawdown from the buffer account ("C account") covers the shortfall if C account has a positive balance.



7. Staff recommends a gradual fiscal adjustment. A 9.3 percentage point adjustment over 10 years from FY2022 would avoid a fiscal deficit and reduce the dependence on external financing and preserve the real value of the CTF. The rationale for recommending a adjustment over a longer period is twofold: (i) While that the U.S. and RMI governments have already started negotiating the renewal of the Compact financial assistance agreement, there is uncertainty around the renewal and the size of the needed adjustment. In the event that the expiring Compact grants are continued after 2023, some adjustment would still be needed to mitigate the erosion in revenues and in keeping the real value of the CTF. An early start of the adjustment would reduce risks that more abrupt adjustment might be needed later. (ii) A more gradual adjustment would smooth out the drag on real activity, especially given the considerable uncertainty about the path of the COVID-19 pandemic.

Liquidity Issues Associated with Disbursement Rule of the Compact Trust Fund

8. In addition to the fiscal sustainability risks, the CTF has a liquidity issue associated with its current rule of distribution. Under the current rule, the annual disbursement from the CTF is funded by retained investment earnings of the previous year, up to a maximum equivalent to the expired grant assistance amount as of FY2023, adjusted by inflation. This structure is vulnerable to volatile investment return on the CTF.³ At the same time, this structure also highlights that the CTF was not set up to play a buffer stock. If RMI faces unexpectedly large financing needs, for example, because of a natural disaster, the CTF cannot be used to accommodate the financing needs more than the CTF earnings, even if the fund has enough large value of outstanding assets. Given the RMI's inability to access market for borrowing, the rule is not flexible enough to allow for an optimal policy response to possible shocks to the economy.

9. CTF has a mechanism to mitigate the risks from lower-than-expected CTF returns, albeit to a limited extent. The CTF has a buffer account ("C account") that can be drawn on when the previous year's investment return is not adequate to fund the maximum annual limit of CTF disbursement (see footnote 2 and Box 2). However, this mechanism fails if C account is depleted due

³ The overall performance of the Trust Fund remains volatile. Its annual weighted investment return averaged 5.8 percent since the creation of the Fund in 2004 but fluctuated between -19 percent to 18.5 percent.

to prolonged underperformance of investment returns on the CTF. Under the current rule of CTF, C account balance is capped at three times the projected nominal amount of Compact grants in 2023, which is expected to erode over time in real terms or as ratio of GDP. Even with the C account, temporary shortage of transfers from the CTF would create a liquidity problem in RMI's fiscal situation with a high possibility in a long-term horizon.⁴

⁴ This issue is pointed out by several preceding studies by ADB (2015), Graduate School USA (2018), and U.S. Government Accountability Office (2018, 2019).

Box 1. Marshall Islands: Fiscal adjustment Scenarios for a sustainable CTF

Key assumptions

- The government draws the maximum annual amount allowed under the CTF rule. Any fiscal surplus is used to replenish the CTF balance. Fiscal deficits are financed by debt.
- Investment return on the CTF is 5 percent (the average return of the Fund) and interest rate on debt is 1.1 percent (the recent 5-year average of implicit interest rates on external debt).
- While the baseline scenario assumes no adjustment, adjustment scenarios assume annual fiscal adjustment at a constant ratio of GDP over a certain period. After the adjustment period, the achieved primary balance at a stabilization level in real terms is maintained.
- The impact of fiscal adjustment of real GDP depends on the fiscal multiplier assumption and the size of the additional fiscal adjustment. We assume a first-year multiplier of 0.2. This is the middle point for low multiplier country (See Batini et al, 2014¹). To determine the effect of fiscal adjustment on real GDP for subsequent years, the literature on persistence of shocks provides limited guidance. We therefore follow Batini et al, 2014 and assume that the size of the multiplier decreases over time with possibly a higher multiplier in the second year. Therefore, in the subsequent years, the following multipliers are applied: 0.2×1.2 (t+1), 0.2×0.8 (t+2), 0.2×0.4 (t+3), 0 (t+4). The resulting growth drag affects the primary balance through a tax buoyancy ratio of 0.14.

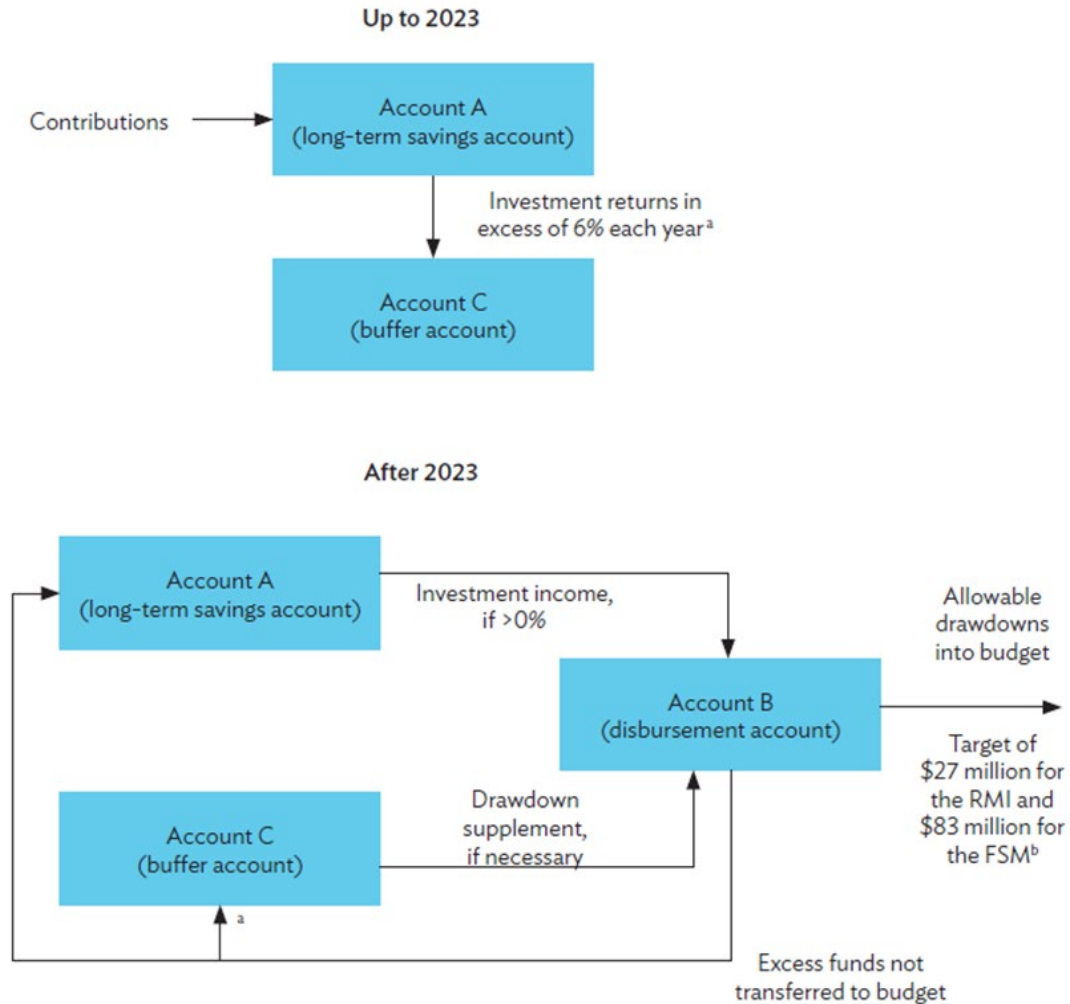
Scenarios

- **Baseline:** No fiscal adjustment.
Given the constant deterioration in fiscal balance, there would be no replenishment of the CTF balance by the government. The buffer account ("C account", see footnote 2) will start to be drawn on from 2024 because of the insufficient investment return and will be depleted in 2039. After the depletion, annual disbursement from the CTF will be limited to the retained investment earning of the previous year. The real value and value in percent of GDP of the CTF will erode in the medium-term with net assets deteriorating further due to debt accumulation.
- **Adjustment to achieve primary surplus to keep the real value of CTF in 5 years:**
5-year fiscal adjustment to achieve the primary surplus that would keep the real value of CTF.
 - 1.4 percentage points of GDP adjustment per year
 - Accumulative 6.4 percentage points of GDP adjustment over 5 years
 This scenario is intended to achieve the real value preservation of CTF in a 5-year timeframe as in the 2018 AIV recommendation. However, this sharp fiscal adjustment has contraction effects on real growth, especially exceeding 0.9 percent of GDP in 2025 and 2026. This suggests trade-offs between feasibility and real value preservation over the traditional 5-year horizon.
- **Adjustment to achieve primary surplus to keep the real value of CTF in 10 years:**
10-year fiscal adjustment to achieve the primary surplus that would keep the real value of CTF.
 - 1.1 percentage points of GDP adjustment per year
 - Accumulative 9.3 percentage points of GDP adjustment over 10 years
 The real value of CTF balance and net assets will be stabilized in the medium term, albeit at a lower value compared to the 5-years adjustment. The impact of the fiscal adjustment on growth is smoothed and relatively contained around 0.7 percent point during the most affected years.

¹ Batini N., Eyraud L., Forni L. and Weber A. (2014), "Fiscal Multipliers: Size, Determinants, and Use in Macroeconomics Projections", Fiscal Affairs Department, Technical Notes and Manuals, International Monetary Fund.

Box 2. Distribution Rule of CTF and the Role of C Account

Marshall Islands' and Federated States of Micronesia's Compact Trust Fund Account Structure and Drawdown Rules



FSM = Federated States of Micronesia, RMI = Republic of the Marshall Islands.

^a Subject to account C's cap of 3 times the projected FY2023 Compact grant.

^b Targets will reflect the amount required to replace the amount of US Compact grants provided in FY2023. The model assumes this to be \$27 million for the RMI and \$83 million for the FSM in 2023 dollars.

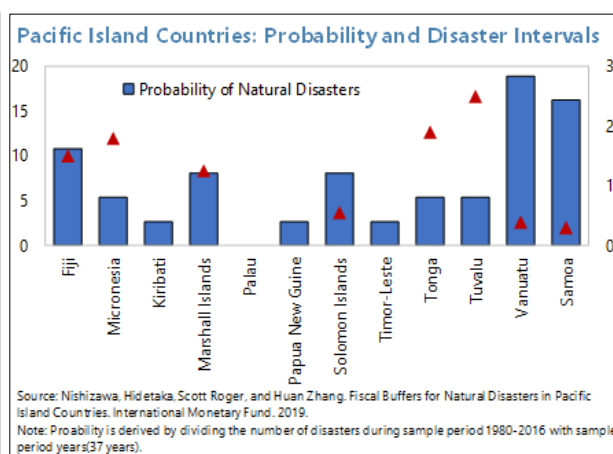
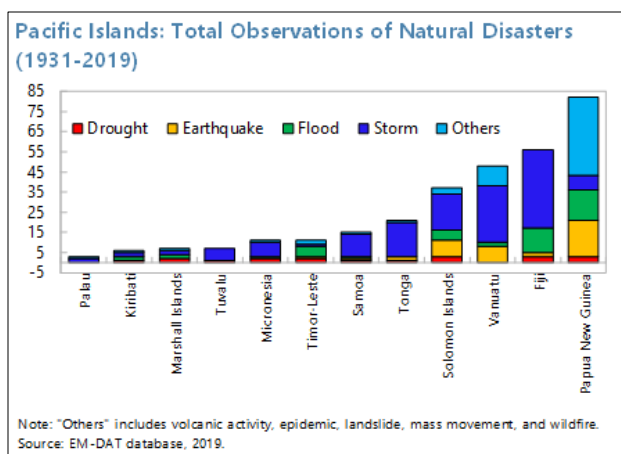
Source: Author.

Annex IV. Natural Disaster Risk Financing in Marshall Islands¹

The Republic of Marshall Islands (RMI) has some elements of a disaster risk financing system in place but its capacity to cover the financial impact of disasters is weak and will weaken further. Securing additional ex-ante contingent financing from development partners, such as the World Bank's Development Policy Financing with a Catastrophe Deferred Drawdown Option (Cat-DDO) contingent financing instrument would help to strengthen RMI's capacity to respond adequately and rapidly to emergency events of various magnitudes. RMI could also enhance its disaster risk management to transfer risks by better using insurance instruments.

1. RMI is among the most vulnerable countries to the climate change impacts. Lee et al. (2018)² indicate a 16.2 percent likelihood of at least one natural disaster occurrence per year in RMI, which is higher than northern pacific peers like Palau (2.7 percent) and Kiribati (10.8 percent). The paper also estimates the macroeconomic impact of natural disasters using a panel regression for 12 Pacific Island Countries (PICs). The authors propose country-specific adjustments to the baseline projection of annual growth, trade balance, and fiscal balance equivalent to the product of the expected impact per disaster (PIC average) and the country-specific probability of a disaster per year. For RMI, the paper suggests a downward revision to the baseline projections of 0.1 percentage points to annual real GDP growth, of 0.23 percentage points of GDP to the trade balance, and of 0.1 percentage points to the fiscal balance (as a percent of GDP).

2. However, there is large financing gaps in managing natural disaster risks. The economic damage of the 2015-16 draught was estimated at USD 5 million for FY2015, but the total external support was only USD 1.5 million.³ In response to the 2013 drought, RMI received USD 3 million in external financing, of which USD 2.8 million was humanitarian aid and only USD 200,000 was grant from ADB⁴.



¹ Prepared by Albe Gjonbalaj and Sangmok Lee.

² 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.

³ UNOCHA Financial Tracking Service.

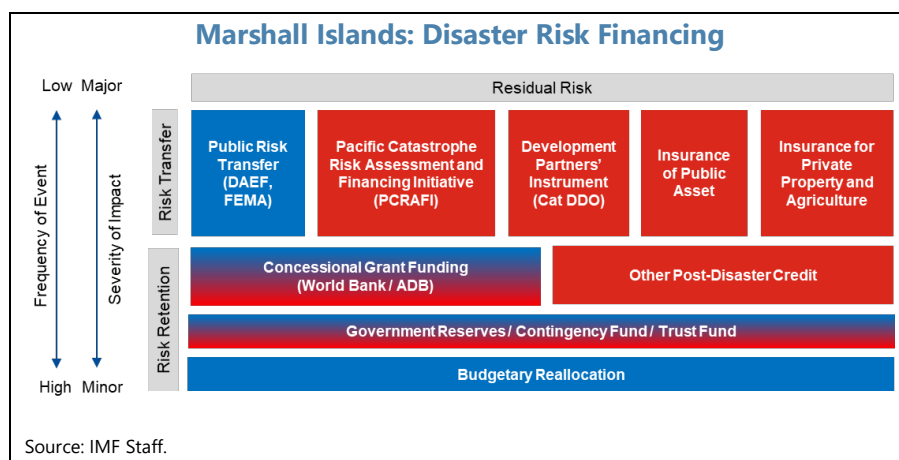
⁴ Nishizawa, H., Roger, S., and Zhang, H., 2019. Fiscal Buffers for Natural Disasters in Pacific Island Countries. International Monetary Fund.

3. **The Disaster Assistance Emergency Fund (DAEF) under the Compact of Free Association (COFA) is the main ex-ante disaster risk financing tool for RMI.** The U.S. government contributes USD 0.2 million per fiscal year to the DAEF between 2005-2023 to build a fund, which can be drawn down under the declaration of a state of emergency or disaster⁵. However, restriction of USD 50,000 per state of emergency per fiscal year can't adequately meet the reconstruction needs after a disaster.
4. The budget finances annual contributions to a Contingency Fund to reduce **the gap between disaster risk needs and DAEF disaster relief provisions**. RMI has established a Contingency Fund with USD 200,000 appropriated each fiscal year to meet disaster response needs beyond DAEF assistance for reconstruction. However, this funding has crowded out other development spending.
5. **RMI's disaster management efforts have also benefited from contingent financing and grants from development partners.** The government recently added World Bank and Asian Development Bank (ADB) contingent financing instruments to its ex-ante financing tools, which provided fast-disbursing support to respond to the COVID-19 crisis. However, contingent external assistance on an ad hoc basis might not always be forthcoming and usually insufficient to recovering the damage.
6. **RMI continues to rely heavily on donor support to fund post-disaster expenditure.** Ex-post, for major events, RMI has access to the US Federal Government disaster response instrument (as part of the Compact), including from the US Agency for International Development and the Federal Emergency Management Agency (FEMA). However, response times can be lengthy.
7. **The insurance market is underdeveloped and underutilized by the private and public sector.** The Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI) of the World bank provided market-based catastrophe risk insurance to RMI⁶ but was cancelled in 2019 by the government as they required more tailored insurance products to better suit RMI's risk profile (e.g. to include coverage of drought and flooding not from cyclones). The non-life insurance market premium in RMI is estimated at only USD 3 million, lower than the average for Pacific Island countries. Insurance for natural catastrophic events is not easily available and insurance rates are higher than the Pacific average.
8. **RMI's approach to disaster risk management could be improved through better risk transfer mechanisms and retention instruments.** The figure compares the RMI's approach against the World Bank's risk-layering framework. The disaster risk instruments used by RMI are shown in blue, while those not used are shown in red. This comparison shows that RMI retains much of the

⁵ It is expected that RMI will accumulate a balance of USD 4 million in the DAEF and the ownership of these funds will pass to the RMI Government at the end of FY 2023.

⁶ The PCRAFI between 2013 and 2015 provided USD 600,000 to RMI to purchase catastrophe risk insurance for 2013 and 2014, and additional financing of USD 250,000 for 2015.

disaster risk, except transfer through the DAEF and FEMA. The authorities should prepare for the expected expiration of the DAEF, secure fiscal buffer for disaster, expand development partners' support, and explore insurance market more.



9. Contingent financing could be improved as a vehicle of risk transfer by using tools such as the World Bank's Catastrophe Deferred Drawdown Option (Cat DDO). Cat DDO is a contingent financing line by IDA that provides liquidity immediately in the aftermath of a natural or health disaster and helps countries' efforts to plan and mitigate crises by securing access to financing before disaster strikes.

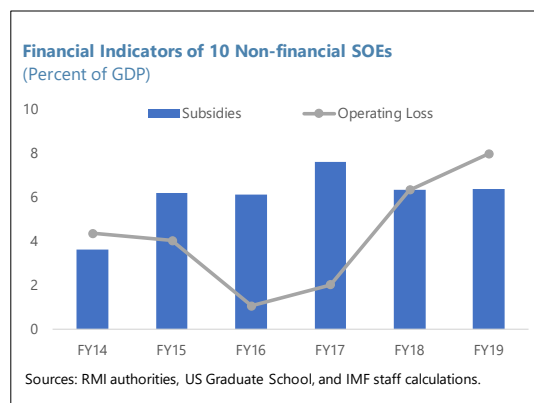
Key Features of Cat DDO Financing	
Approval for gaining access to Cat DDO	(i) The recipient has an adequate macroeconomic policy framework; (ii) Has a satisfactory disaster risk management program which the World Bank monitors periodically.
Funding the Cat DDO	A country can fund the Cat DDO through its concessional core IDA allocation envelope. Of the total Cat DDO funding requested, only 50 percent is funded by country's core IDA allocation, and 50 percent is financed by IDA's global resources.
Country borrowing limit	IDA borrower can secure immediate access to financing up to US\$20 million or 0.5 percent of GDP, whichever is higher.
Drawdown trigger	The member country needs to declare a state of emergency due to a natural disaster to access Cat DDO financing.
Drawdown period	It has a three-year drawdown period which may be renewed once for a maximum of years in total.

Source: IMF Staff.

Annex V. State Owned Enterprises (SOEs)¹

1. The continued weak performance of SOEs has put a significant burden on public finances.

SOEs play a significant role in the RMI economy, accounting for assets of about 80 percent of the GDP and 9 percent of total employment. However, SOEs continue to generate large losses which are covered through rising budgetary subsidies. During FY2014~2019, the total annual operating loss of SOEs averaged 4.3 percent of GDP, the average budgetary subsidy to SOEs amounted to 6.0 percent of the GDP. SOEs' weak performance is the result of small and dispersed markets, their insufficient management capacity, and their role as vehicles for providing public services to residents located in remote, dispersed atolls.



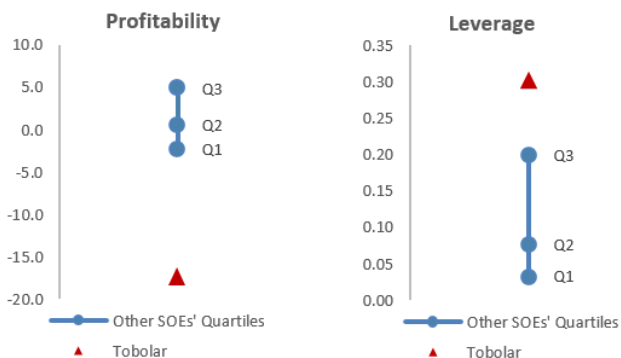
2. The authorities have made important efforts on SOEs reforms but progress remains limited. After the legislation of SOE act in 2015, a SOE monitoring unit (SOEMU) was set up in 2018. Good progress has been made only on the planning side. Business plans for 9 of the total of 11 SOEs have been submitted to the MOF in 2019 and to the Parliament in 2020. However, annual reports have been presented late due to delayed audits of the financial statements. There is no progress on the other two areas of the SOE Act: community services obligations (CSOs) and skill-based board selection². Poor compliance is resulted from SOEs' limited capacity and continued disregard of the commercial mandate. The new government taking office in January 2020 provided a momentum to strengthen the SOE reform, which was, however, hampered by the Covid-19 pandemic. SOEMU is currently preparing a roadmap for SOE reform implementation.

3. Weak financial performance is particularly problematic for Tobolar.² Subsidies to this SEO have approached 45 percent of its total income during 2014-19, nearly double the average subsidy to other SOEs. A benchmarking exercise shows that Tobolar's performance is substantially weaker, particularly in terms of profitability and leverage, than that SOEs in the same sector in 52 emerging market and developing countries. This is due to rising copra purchase prices set by the government, which exceed world market prices despite large fluctuations in production. An administered price guarantees a certain income to copra farmers and provides incentives to stay in rural areas rather than moving to two already over-crowded urban centers. However, redistributing income in this way is inefficient and distortive. Farmers are subsidized independently of their income level and high copra price reduces incentives for farmers to change to other, commercially more viable crops.

¹ Prepared by Sangmok Lee and Mouhamadou Sy.

² CSOs indicate an agreement between the government and the SOE to provide a specified quantity of goods and services for people with a specified price. Skill-based board selection means appointing board directors in a SOE based on experiences, qualifications or merit related to a SOE.

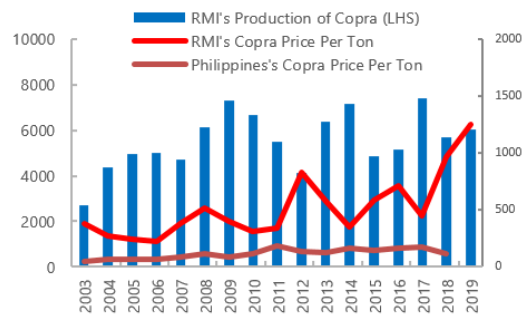
Benchmarking Tobolar with SOEs in the Same Sector in 52 EDMCs



Sources: Tobolar 2018 financial statement and IMF staff calculations using Baum, Medas, Soler and Sy (2020).

The Production and Price of Copra

(LHS: tons, RHS: USD thousands)



Sources: Tobolar, US Graduate School, FAO and IMF staff calculations.

Annex VI. Main Recommendations of the 2018 Article IV Consultation

	Fund Recommendations	Policy Actions
Fiscal Policy	<ul style="list-style-type: none"> Gradual adjustment of about 4 percentage points of GDP over the next five years. Reverse the recent increase in recurrent spending, improve revenue administration, and implement tax reform. 	<ul style="list-style-type: none"> Recurrent spending continues to increase, by 7.4 percentage points of GDP from FY2016 to FY2019, leading to a deficit of 1.8 percent in FY19 from a constant surplus position. There is no change on tax policy with the tax reform bill still yet to be enacted. Good progress has been made in revenue administration with improvements in taxpayer services, filing, compliance and audit functions.
Climate Change	<ul style="list-style-type: none"> Continue to adapt to climate change by strengthening early disaster warning system and improving coastal protection. Reflecting adaptation costs to budget explicitly to ensure continuity in project implementation. 	<ul style="list-style-type: none"> The authorities are working with World Bank on the Pacific Resilience Project II to strengthen early warning system and shoreline protection. Climate Change Directorate (CCD) has begun preparations of a National Adaptation Plan—with an assessment of climate change adaptation needs, cost, and financing options. A climate financing database is created to improve inter-department collaboration.
State-Owned Enterprises	<ul style="list-style-type: none"> Implement the planned SOEs reforms to reduce subsidies to SOEs that are not justified by the provision of the essential community services. 	<ul style="list-style-type: none"> progress has been made in submitting business planning annually but implementing reform measures on CSOs and the governance remains pending. Subsidies to SOEs remains high though moderating slightly from 7.5 percent in FY 2017 to 6.4 percent of the GDP in FY 2019.
Financial sector	<ul style="list-style-type: none"> Further strengthen the AML/CFT framework. Enhance financial sector supervision to lower the risk of losing the last U.S. dollar corresponding banking relationship. 	<ul style="list-style-type: none"> The authorities have concluded the national risk assessment of ML/TF risks. However, the AML/CFT framework has not yet been amended to be in line with international standards and to cover the non-resident corporate and maritime sectors. Efforts to strengthen financial sector supervision, including for AML/CFT, continue with the support of technical assistance providers.
Digital Currency	<ul style="list-style-type: none"> Seriously reconsider the issuance of digital currency as legal tender given that the potential benefits from revenue gains appears considerably smaller than the potential costs. 	<ul style="list-style-type: none"> The authorities concluded a due diligence study which is expected to serve as basis for parliament to repeal the 2018 SOV Act. The SOV issuance is on hold, but the authorities remain open to embracing digital currency projects in the future once risks have been sufficiently mitigated.

Annex VII. SDGs Identified in the 2020-30 National Strategic Plan (NSP)

Key development objectives identified by the NSP	Corresponding SDGs ^{1/}		Role of the IMF
Sustained and inclusive economic growth	1 No Poverty	8 Inclusive Economic Growth & Decent Work	✓ Surveillance and policy advice on macroeconomic policies ;
	2 Zero Hunger	10 Reduced Inequality	✓ Technical assistance on domestic revenue mobilization;
	5 Gender Equality		✓ Technical assistance on financial sector stability to support financial deepening and inclusion ; ✓ Technical assistance on developing a sound medium-term macroeconomic framework and improve macroeconomic analysis for policy making.
Infrastructure	6 Clean Water & Sanitation	9 Resilient Infrastructure & Innovation	✓ Surveillance and policy advice on public investment management
Access to quality social services and culture	3 Good Health and Well Being	4 Quality Education	✓ Coordination with ADB, World Bank and development partners
Resilient and environmental sustainable development	7 Affordable and Clean Energy	12 Responsible Consumption	✓ Surveillance and policy advice on climate change adaptation
	11 Sustainable Cities & Communities	13 Climate Action	✓ Capacity development
	14 Sustainable Use of Oceans	15 Life on Land	
Governance	16 Peace, Justice, and Strong Institution	17 Partnerships for the Goals	✓ Technical assistance on revenue administration, focusing on compliance improvement; ✓ Technical assistance on PFM with a focus on improving the budget document and developing a medium term fiscal framework; ✓ Surveillance, policy advice and technical assistance on improving AML/CTF
1/ Staff compilation.			