

**Statement by Chang Huh, Executive Director for Republic of the Marshall Islands
and Byung Hee Yoo, Senior Advisor to Executive Director
May 21, 2021**

On behalf of the authorities in the Republic of Marshall Islands (RMI), we thank Ms. Zhou and her team for their constructive engagement and candid dialogue on the country's economy and policies in unprecedented difficult circumstances.

Our authorities highly value the Fund's continuous engagement and broadly agree with staff's assessment on the economic outlook and policy recommendations. They also expressed their appreciation for the Fund's capacity development support and requested a set of technical assistances during the Article IV consultation.

RMI comprises small, sparsely-populated and low-lying atolls and islands spread across 750,000 square miles of the Pacific Ocean. Its extreme remoteness, low population, small private sector and narrow production base means the country is highly dependent on external aid, with grants making up around half of government revenue. RMI is one of the countries most vulnerable to climate change and natural disasters such as flooding, storms and drought due to its low elevation, with an average of only 2 meters.

The COVID impact, response, and outlook

RMI has encountered the COVID-19 pandemic when its fiscal and external positions weakened due to rising current expenditure despite solid economic growth driven by strong fishery and construction activities. Real GDP grew at 6.5 percent in FY2019.

At the outset of the pandemic, the authorities have taken swift and decisive containment measures, including border closure, travel restrictions, and mandatory quarantine at ports. These measures successfully prevented a domestic outbreak and as a result RMI has been COVID-free so far except for only four recovered cases imported from abroad. The authorities are taking a cautious approach to reopening borders as the global pandemic persists. They have secured a vaccination plan with the US support and about 47 percent of total adult (age 18+) population already completed inoculation as of May 11¹.

The pandemic and containment measures have constrained RMI's economy, significantly afflicting fishery, transportation, construction, and tourism sectors, though the lives of the Marshallese have been largely intact. The government's fiscal support measures to mitigate the economic impact of the pandemic amount to USD 63.1 million (around 27 percent of GDP) of which USD 50 million is provided in grant financing by development partners. Notwithstanding the government efforts, real GDP is estimated to have contracted by 3.3 percent in FY20 and expected to further decline by 1.5 percent in FY21. The authorities share staff's view that the economic growth would rebound in FY22 as containment measures are gradually eased. They note staff's medium-term growth projection of around 1.6 percent while considering ongoing pandemic and climate change to be one of the main risks to the outlook.

¹ The population of RMI is estimated at 58,000 people of which 50 percent is under 18. The vaccination rate of adults living in urban areas (19,750 people) is 68 percent while vaccination of rural adults on outer islands (9,250 people) is low (1.18 percent).

Fiscal policy

Despite higher expenditure for the pandemic responses, RMI's fiscal balance is estimated to be neutral in FY20 and a slight surplus in FY21 owing to sizable additional donor grants and limited capacity to execute the planned expenditure. The authorities agreed with staff's view that in the near term the COVID responses should be maintained, while properly targeted, until the recovery becomes firm and durable, and that pandemic-related governance safeguards should be strengthened to ensure spending transparency and accountability. The authorities plan to audit the COVID-19 related spending and publish a report by end-FY22.

In the medium term, RMI's fiscal challenges are shaped to a large extent by the impending expiry of substantial budgetary grants made under the Compact of Free Association (COFA) financial provisions with the United States. From FY24, the revenue loss will be partially compensated by ongoing distributions from the Compact Trust Fund (CTF) – which is currently being built up through contributions from the US, Taiwan POC and RMI itself. However, the current track for contributions, together with expected investment returns, is not enough to ensure that the CTF can replace the expiring grants each year and also maintain the Fund's real value over time.

The authorities agree that a gradual and significant fiscal adjustment is needed to build fiscal buffer amid volatile fishing revenue and stagnant tax revenue though they have relatively optimistic view on the renewal of the COFA financial chapter. The government is currently undertaking a review on public expenditure with the World Bank which will help identify unproductive spending and strengthen expenditure control. The authorities expressed renewed interests on the comprehensive tax reforms and highlighted recent progresses on the public financial management and state-owned enterprises (SOEs) reforms. The planned Fiscal Responsibility and Debt Management Act will contribute to establishing the medium-term fiscal management framework.

The authorities agree on the need to accelerate SOE reforms and reduce overall government subsidies. An important step has been the establishment of an SOE monitoring unit in the Ministry of Finance, which reviews annual business plan and budget of SOEs to help improve their performance. However, SOE reforms have been stalled due to the pandemic as well as capacity constraint.

Financial sector stability

Pressures on CBR remains a significant concern to the RMI authorities. The authorities recognize that “offshore” sectors have been a major source of financial integrity risks due to difficulties encountered in regulation and supervision of entities not physically present in a jurisdiction. They agree that it is critical to continue to develop the legal and regulatory framework for AML/CFT supervision in line with international standards.

The authorities remain committed to improving the supervisory and regulatory framework. With the assistance from the Fund, they have completed a comprehensive review of the bank supervisory framework to align with Basel Core Principles for Effective Banking Supervision. They plan to submit proposed legislative amendments to the Parliament in August 2021. The Banking Commission (BC) has started AML/CFT and prudential supervision on the Marshall Islands Development Bank (MIDB) and is seeking TA from the Fund for additional amendment to the Banking Act to include clear statutory powers for the supervision of MIDB. The authorities have also requested a Fund TA on establishing a monetary authority (MA) in their effort to address lingering

issues faced in the financial sector which relate to government banking services and deposits, domestic inter-bank clearing, the supply of US notes and coins and direct access to the US Federal Reserve payment and settlement services. The authorities are keen to mobilize the excess liquidity for more commercial loans. A ceiling on debt-service ratio to consumer credit would create room for additional corporate lending while containing the potential risks from rising household debt.

Cryptocurrency and DEZRA

RMI intends to issue a digital currency, the Sovereign (SOV), as a second legal tender in a partnership with a foreign private company which would share the first issuance of SOV with RMI, before an initial coin offering (ICO) was undertaken. The authorities' motivation is to take advantage of the growing enthusiasm for cryptocurrencies, together with the innovation of it being a national currency, to generate much-needed income for the government. This income would be obtained by selling half the RMI's initial allocation of SOV in the ICO and keeping around a quarter in SOV in its trust funds. The remainder would be distributed over time to RMI resident citizens. In parallel, a draft bill on establishing a digital economic zone on Rongelap Atoll (DEZRA) was recently submitted to the Parliament. This initiative aims to provide economic opportunities and incentives for investment focusing on virtual means of exchange.

The authorities are well aware of the risks involved in the issuance of the SOV and the creation of DEZRA, including reputational and CBR risks to RMI. The government conducted a comprehensive due diligence study on the SOV based on which the Parliament is considering repeal of the 2018 SOV Act. The authorities consider that the necessary developments in the legal and regulatory frameworks (including for AML/CFT) for the effective licensing and regulation of private virtual asset service providers are key pre-requisites for successful issuance and adoption of a digital currency. A more rigorous assessment and research is needed to develop the DEZRA proposal and prepare for its implementation. The authorities also agree that building institutional capacity and infrastructure is an important step to take before the government decides to issue a digital currency or pursue a digital economic zone and have requested related TA from the Fund.

Climate change

RMI authorities agreed on the need to facilitate climate change adaptation. They have been undertaking several projects for climate change adaption and disaster risk management and created a master database of climate change projects to improve internal coordination. The authorities expect country's national adaptation plan to be finalized this year but recognize the financing gap and the need for additional support from development partners.