August 5, 2008
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 08/50-1

10:00 a.m., June 4, 2008

1. Republic of the Marshall Islands—2008 Article IV Consultation

Documents: SM/08/147 and Supplement 1; SM/08/150; SUR/08/52

Staff: Edison, APD; Brown, PDR

Length: 25 minutes

Executive Board Attendance

T. Kato, Acting Chair

Executive Directors	**Alternate Executive Directors**
	L. Lephoto (AE), Temporary
	G. Mpatswe (AF), Temporary
	J. Maciel (AG), Temporary
R. Murray (AU)	W. Mañalac (AU)
	J. Prader (BE)
	A. Maciá (BR), Temporary
	R. Lin (CC), Temporary
	J. Pineda (CE), Temporary
	P. Jenkins (CO), Temporary
	A. Lahreche (FF), Temporary
	C. Denk (GR), Temporary
	K. Dheerasinghe (IN)
	F. Valeri (IT), Temporary
	H.Yamaoka (JA)
	K. Harada (JA), Temporary
	A. Monajemi (MD), Temporary
	H. Caracalla (MI), Temporary
	S. Cerovic (NE), Temporary
	B. Ólafsson (NO), Temporary
	A. Shabunina (RU), Temporary
	S. Alnefaee (SA), Temporary
	C. Sucharitakul (ST)
	S. Mathema (ST), Temporary
	M. Lanz (SZ), Temporary
	M. Kaplan (UA), Temporary
	H. Rab (UK), Temporary

S. J. Anjaria, Secretary
J. Hellström, Assistant

Also Present
IBRD: A. Ollero. Asia and Pacific Department: D. Burton, J. Carter, H Edison, J. Gordon, P. N'Diaye, D.. Rozhkov. Finance Department: R. Lam. Policy Development and Review Department: S. Brown. Secretary's Department: P. Cirillo, P. Martin. Advisors to Executive Directors: J. Luque (AG), S. Na (AU), D. Orynbayev (BE), F. Waqabaca (ST).

1. REPUBLIC OF THE MARSHALL ISLANDS—2008 ARTICLE IV CONSULTATION

Mr. Murray and Mr. Na submitted the following statement:

Introduction

The Republic of the Marshall Islands (RMI) wishes to express its appreciation to the Fund and its staff for the well-structured report which successfully highlights the country's current economic status and the challenges it faces. The selected issues paper appropriately addresses critically important issues related to long-term self-reliance.

The RMI's socio-economic environment, such as geographical detachment from major markets, narrow production and export base, and vulnerability to external shocks, has made it difficult to achieve a self-sustaining economy, resulting in heavy dependence on external grants. The authorities are deeply grateful for the continued support from the international community and, in particular, from the United States, which has provided financial support through the Compact of Free Association (Compact) as well as various capacity-building measures.

The new Government under President Litokwa Tomeing took office in January 2008, with a strong desire to improve the quality of life of its citizens and achieve long-term fiscal sustainability with the help of major donor countries. Although the current resource constraints and existing expenditure commitments limit the authorities' policy options, the authorities are well aware of the importance of recommended reform measures and are moving ahead with steadfast commitment.

Recent Economic Development

Despite seven years of continuous growth which was aided by increased financial resources from the Compact, recent economic performance has nonetheless slackened, as suggested by real GDP growth slowing from 4.3 percent on average in FY2001 to FY2004 to only 1.6 percent on average in FY2005 to FY2007. In FY2007 the economy evidenced some signs of improvement, but this seems to be more related to one-off events, such as the construction of the new convention center, the refurbishing of a fish processing plant, and tourism income from Japanese charter flights. Employment rates have been stagnant, with youth unemployment remaining high because of limited job opportunities and low levels of foreign direct investment.

Consumer price inflation has been reasonably contained, averaging about 4 percent in the last three years, despite high oil and food prices and subsequent high electricity costs. However, the RMI cannot be insulated against the recent global price hike. The Majuro consumer price index survey conducted by the RMI government shows a sharp increase in the CPI in Majuro Island at 7.7 percent (yoy) in March 2008, compared to 4.3 percent (yoy) in December 2007. Most increases in the CPI resulted from the increases in utility and transport costs—16.8 percent and 21.1 percent, respectively—reflecting rising oil prices.

Over the medium term, the staff projects that economic activity will likely remain subdued, with GDP growth of less than 2 percent a year because of: (i) rising food and energy costs; (ii) a large job loss in the Kwajalein military base; and (iii) the nascent tourist business. Furthermore, in the longer-term, there will likely be less room for the economy to improve, given the significant decline in external grants under the amended Compact as well as the steady increase in debt service payments which will peak in 2019.

Achieving Fiscal Sustainability

The new Government's overriding economic objective is to maintain a stable macroeconomic environment, with a focus on maintaining a prudent fiscal policy. To this end, the Government has so far committed to balanced budgets, as required under the Financial Management Act, as well as to a stable and efficient tax regime—both through a consistent tax structure and its predictable enforcement.

Overall, government deficits have been stable at around ½ percent of GDP for the past two years, having improved from 3.6 percent in FY2005. This is mainly due to the increased funds from the Compact and other grants, together with some improvements in tax collections. An overall deficit of 0.3 percent of GDP is projected for FY2008. It is also commendable that, in addition to significantly closing the fiscal deficit gap, the authorities have successfully met their mandatory contributions to the Compact Trust Fund.

As reflected in the improved fiscal position, the RMI authorities have made some progress in various areas since the last Article IV consultation in January 2006 in relation to budget formulation and implementation:

Rigorous achievements have been made in relation to tax collections. The authorities have strengthened the tax audit unit and taken aggressive measures against non-compliant entities, while working together with key stakeholders. In addition, discussions about longer-term revenue reform measures were undertaken during the recent Article IV mission, as well as with the Pacific Financial Technical Assistance Center (PFTAC) to address the narrow tax base and long-term sustainability.

The system for public financial management has been much improved with the help of the PFTAC. To help prevent cash flow problems, a cash management manual was developed by the PFTAC in 2007 and a series of training courses were held subsequently, while a commitment control manual is currently being developed, with a pilot program and associated training being scheduled for the near future.

Oversight of the budget has been enhanced with the help of the Medium-Term Budget and Investment Framework (MTBIF), the goal of which is to anticipate future issues and set out strategies for government expenditures over the medium term.

In setting FY2008 revenue forecasts, the authorities fully utilized a new model prepared by the Ministry of Finance in collaboration with the PFTAC, with further work to refine this model scheduled for later this year.

The authorities acknowledged the urgency of further fiscal consolidation, which would be very challenging, given the limited timeline and the heavy reliance on the public sector, and noted the warning that delaying the adjustment would only make it more difficult for the RMI to implement consolidation and achieve sustainable growth in the longer term. In this vein, the authorities welcome the staff's detailed analysis and their suggestions for long-term fiscal sustainability and comprehensive tax reform, and thus will take this timely advice into consideration in their own budget deliberations and future policy framework.

The authorities are considering drastic expenditure cuts. They are looking to implement freezing wages and recruitment and to further eliminate vacant positions—a measure which could yield savings of nearly ½ percent of GDP. More cuts in discretionary expenditure, particularly spending on travel, energy consumption, and use of government vehicles, are seriously being considered in setting the FY2009 budget.

In an effort to further strengthen tax enforcement, the Ministry of Finance issued a public notice in January 2008 on tax procedures and filing deadlines. The authorities recently advised that some cases have come to light which have the potential of bringing in significant additional revenues. With regard to tax policy, the authorities indicated that the adoption of a new customs program is imminent and, moving forward, the new government is considering the implementation of a comprehensive tax reform, following the case of the Federated States of Micronesia.

In terms of tax administration, the non-compliance rate is estimated at 25 to 50 percent. This estimate by the Fund staff has encouraged the authorities to take a more aggressive stance. In addition, the authorities will eliminate duplicate efforts by the national and local governments in revenue collection.

Boosting Private Sector Growth—Structural Reform

Another priority of the new government is to address structural reforms to boost private sector growth. The authorities intend to take tangible steps to decrease the administrative delays facing potential foreign investors and to streamline the process of business registration and licensing. One critical barrier for investment is access to land. Some progress has already been made in registering land, including the revision of the Land Registration Act and the establishment of the land authority. The authorities emphasize their strong desire to tackle further the land ownership issue in a consistent manner, while accepting that this issue will entail considerable time and effort in the future.

The authorities recognize that the current size of the public sector is not sustainable, and acknowledge the urgent need to narrow the wage gap to improve labor mobility and make full use of skilled workers.

In the area of public enterprise, significant progress has been achieved in reshaping the Social Security Administration and the Marshall Islands Shipping Corporation, such that the burden on the budget has eased considerably. The authorities also accept the staff's recommendation of extending the scope of this successful reform to other public enterprises. It is pleasing to note that the RMI national airline resumed commercial flights in April 2008 after being grounded for more than six months because of financial problems. This resumption will contribute to tourism in western Pacific nations.

Tourism is gaining some momentum particularly from Japan. There have been six chartered direct flights from Japan to the Marshall Islands since the initial flight in February 2007, with an average of 200 tourists per flight. The authorities are considering various measures to attract more tourists, such as upgrading airport facilities for frequent night flights and better marketing of their services and facilities. The authorities have initiated dialogue with relevant entities, including land owners, and expect positive results from these discussions.

Financial Sector

Most bank lending involves high-interest, short-term consumer loans rather than commercial loans because of the lack of adequate collateral. Thus, the recent adoption of the new legislation on secured lending, together with the establishment of a registry for collateral, is a significant improvement especially to small private businesses. Concurrently, the Banking Commission is well aware of the possible risk which could result from high-interest household loans, and stressed the need for vigilance in monitoring bank lending and strengthening the financial sector supervision. The imminent operation of the new third bank will function as a catalyst for increasing competition in the banking industry and further lowering high lending rate.

The Banking Commission has also expanded the scope of its on-site examinations of banks by focusing on operational and liquidity risk management. Looking forward, the Commission plans to strengthen off-site monitoring and loan management, centered on non-performing loans. The Commission reiterated the need for greater efforts to improve data collection, including loans and remittances, and to issue regular reports for better financial supervision. Anti-Money

Laundering/Combating Financing of Terrorism (AML/CFT) compliance is also being improved considerably.

Mr. Yamaoka and Mr. Harada submitted the following statement:

We thank the staff for their concise papers and Mr. Murray and Mr. Na for their helpful statement.

Issues Related to the Size of the Country

As is often the case with Pacific island countries, one of the continuous challenges to the Republic of the Marshall Islands (RMI) is its limited size as an economy, which reflects the country's geographical conditions. In this respect, we think the following considerations are important.

Harmonizing Administrative Frameworks and Sharing Social Infrastructure with Other Pacific Island Countries

It would be burdensome and sometimes inefficient for a small country to build all of its own administrative framework and social infrastructure. In this respect, it would be fruitful to consider how the authorities could cooperate with other Pacific islands to both harmonize the administrative framework and share social infrastructure. These efforts would also be necessary to reduce the size of the public sector while maintaining the quality of services for the people.

Buffers against External Shocks

Small-sized countries are especially likely to be vulnerable to external shocks, due to their difficulty in absorbing unexpected shocks by means of the "law of large numbers". Also in this respect, it would be productive to cooperate with other small-sized economies so as to create an insurance pool against adverse events.

Improvements in the Business Climate

Since there are inherent limits to diversifying the RMI's industrial base, it would be important to continuously foster its tourism sector. Although tourism development requires some expertise in terms of merchandising and advertising (not offered by the Fund, of course), the authorities are required to enhance the country's business environment, so that private entities can utilize their initiatives, to the maximum extent possible, within the RMI's beautiful natural landscapes.

Reducing Tax Administration Costs

There are many viewpoints in evaluating the tax administration system such as fairness, efficiency and the effects on resource allocation. In case of small-sized economies like the RMI, it is critical to reduce the costs of both tax administration and enforcement so as to make the taxation system sustainable over the long run.

Fiscal Policy

As we pointed out in the previous Board discussion on Palau, autonomous and self-reliant fiscal sustainability is indispensable in order to generate sound economic growth, over the long-run, as well as establish external credibility for the nation. In this regard, we welcome the government's commitment to maintaining a balanced budget, and encourage the authorities to rationalize public expenditures, including those for public sector wages, and to reduce the relative size of the public sector to an appropriate level.

With these remarks, we wish the authorities every success in their future endeavors.

Mr. Prader and Mr. Orynbayev submitted the following statement:

We thank the staff for the well-written report and Messrs. Murray and Na for the helpful buff statement.

The staff has rightly recommended that the authorities need to reduce the large public sector. However, it is unclear what opportunities would be available to the people who would have to leave the sector especially given the fact that the country's private sector is small and underdeveloped and will not be able to absorb these civil servants. In this case, the government will have to provide support to these people, which will increase the government's social expenditure. Boosting private sector development will also take time. In that case, will the downsizing of the public sector have an impact on the country's growth?

The enactment of the legislation on land registry could help in making it possible to pledge land as loan collateral. However, administrative delays and restrictions on foreign investment and on foreign workers could have a slowing down impact on the country's growth. Higher FDI would certainly strengthen private sector activity. Thus, we agree with the staff that structural reforms are necessary to stimulate private-sector development.

The authorities should enhance the transparency and efficiency of public spending. Therefore, the authorities' intention of raising additional revenues by improving tax administration and cutting expenditures by 5 percent in the FY2009 budget are steps in the right direction.

Since budgetary self-sufficiency of the RMI after 2023 is unclear, we see merit in the staff's recommendations that the authorities should try to achieve a fiscal surplus of 3 percent of GDP in the medium term. In this way, the authorities will add reserves to the Compact Trust Fund. We share the staff's caution regarding securitization of future trust fund contributions of the United States.

With these comments, we wish the authorities success in policy implementation.

Mr. Rutayisire submitted the following statement:

We thank Messrs. Murray and Na for their helpful buff statement, and the staff for their set of papers, which give a comprehensive account of the current status of the Marshall Islands' economy, and of the daunting development challenges it continues to face, due to the country's geographic remoteness, narrow production base, and increasing vulnerabilities to climate change and other external shocks.

We take note of the agreement between the government and the staff that, although economic activity picked up in early 2007, the overall outlook is on the downside, as reflected by the slowdown of real GDP growth (from 4.3 percent on average in FY2001-04 to 1.3 percent in FY2005-06), the growing inflation pressures following the recent global price hike for oil and food, and the increasing unemployment rate, particularly for youth, including as a consequence of the large job loss in the Kwajalein military base. There is also a same understanding that the underlying vulnerabilities are likely to harden in light of the expected significant decline in external grant financing under the amended Compact and the increasing debt service payments. This calls therefore for a substantial fiscal consolidation to achieve a budgetary self-sufficiency after 2023 when the compact grants will end, as well as a fresh impetus to push forward the much needed structural reforms aimed at promoting a less public sector-dominated economy.

We thank staff for the selected issues paper, which gives a thorough analysis of the different scenario to achieve the country's fiscal sustainability. We concur with the recommendations therein, which reiterate previous calls for maintaining adequate fiscal surplus over the medium-term, in order to avoid accumulation of debt and costly abrupt fiscal contraction when the compact grants will end. This is to be achieved through implementation of a comprehensive tax reform that further broaden the tax base, simplify the tax structure and improve the efficiency of the tax administration. It also calls for a prudent management of the intergenerational Compact Trust Fund (CTF), not only to ensure good returns, but also to secure the fund's future, and for measures to bring current expenditure at sustainable level, particularly the wage bill. We note that some progress have been made, though at slower path than desirable. We welcome the authorities' commitment, as assured by Messrs. Murray and Na, to take this timely advice into consideration during their budget deliberations and future policy, and give a new impetus to the suggested reforms.

Long-term development of the Marshall Islands (RMI) would principally depend on the path of the structural reforms to build a dynamic private-led economy. We take positive note of the progress also made in this area, particularly in strengthening the financial sector, in land legislation and administration, and in streamlining the process of business legislation and licensing. The authorities are urged to aggressively pursue these structural reforms, in addition to removing rigidities in the labor market, such as the public-private sector's wage gap, and scaling back the government involvement in commercial activities. Beyond these reforms, a more proactive development strategy would be required in order to package the RMI as a profitable investment destination. The nascent tourism, fishing, and shipping industries could provide opportunities to this end, particularly if they are promoted in regional context given the country's geographic remoteness and market size.

With these remarks, we wish the RMI authorities success in their future endeavors.

Mrs. Sucharitakul and Mr. Waqabaca submitted the following statement:

We thank the staff for a concise report and Messrs. Murray and Na for the useful buff statement. The economy of the Republic of the Marshall Islands (RMI) is virtually dependent on the donor grants including that from the United States under the Compact of Free Association. Given the country has a narrow production and export base and vulnerable to external shocks and climate change, the country is presently facing a challenging environment of low growth of 1.2 percent and high inflation at 5.5 percent in 2008. In an environment of volatile external grants, the difficult task is to strengthen the Compact Trust Fund (CFT), which was established to create an income stream to replace Compact grants after FY2023. As we are in broad agreement with the thrust of staff's appraisal we limit our comments to the following.

The pressing challenge is to achieve long-term sustainability, which is possible through strengthening fiscal consolidation. We share the view of the staff that fiscal objectives need to be more ambitious so as to achieve fiscal surplus through restraining the current expenditure and scaling back the subsidies. In this regard, we welcome the authorities' efforts to enhance revenue generation by strengthening the tax audit unit, taking aggressive measures against non-compliant entities, the imminent adoption of a new customs program and improving tax administration. On the expenditure side, we find reassuring the authorities' commitment to make drastic expenditure cuts including wage and recruitment freezes and traveling expenses. Releasing resources from the public sector should also provide impetus to foster the entrepreneurial spirit which is needed for private-sector led growth.

Moreover, structural reforms aimed at private sector led growth are a key step to anchor fiscal consolidation efforts thereby achieving long-term sustained growth. Expediting structural reforms such as resolving land issues, establishing a registry for collateral, privatizing the government entities including the energy company should assist in bringing down the pressure on fiscal consolidation efforts. We welcome the authorities' intention to press ahead with structural reforms to complement fiscal consolidation to boost private-sector growth. We also welcome the revision of the Land Registration Act and the establishment of the land authority, whilst fully conscious of the challenges posed given the sensitivities surrounding land issues. We commend the authorities for taking necessary actions for the energy company to adopt a template for tariff that automatically adjusts to changes in the world fuel prices.

As in other Pacific island countries, the country faces inflationary pressure due mainly to higher electricity costs and prices of food and oil. The authorities need to be vigilant on the second round effect of inflation expectations.

While the exports have been held back mainly by structural deficiencies, further deterioration in the performance of exports is inevitable to reduce given reliance on its major trading partner. Policy towards boosting tourism exports needs to be explored further to sustain the current account in the medium term as well as help bring down the high external debt which constitutes almost 70 percent of GDP as of FY2006.

On the financial sector front, as short-term consumer loans dominates commercial loans, the banking system is missing the opportunity to finance capital accumulation and commercial activities, while growth is sustained largely through private and public consumption. Banks also need to improve their operations to narrow the interest spread as large gap between bank deposits and bank lending has not been conducive to channeling deposits domestically. We commend the authorities for adopting new legislation on secured lending together with the establishment of a registry that will pave the way for greater financial access for small private businesses.

We welcome the authorities' efforts to establish Compact Trust Fund as the cornerstone of the RMI's future and encourage the authorities to diversify portfolios in order to boost returns. Nonetheless, like the staff, we also urge the authorities to weigh carefully the costs and benefits of securitizing future U.S. contributions as the benefits of such a scheme may not cover the additional risk posed in the process.

With the RMI ranking lower than all other Pacific island countries, except the Federated States of Micronesia in the World Bank's 2007 Ease of Doing Business, we are somewhat surprised that the staff urges the authorities to study the implementation of tax reform in the Federated States of Micronesia. We may be missing some of the important lessons learnt from this PFTAC assistance and invite the staff to further elaborate on this matter. We note that the new government intends to ensure policy continuity. Therefore, what are likely to be the areas of amendments to the Compact agreement being contemplated by the authorities and their possible impacts on the overall resources projections in the long-term?

With these remarks, we wish the authorities success in their endeavors.

Mr. Charleton and Mr. Jenkins submitted the following statement:

We thank the staff for an informative report, which clearly describes the significant economic challenges facing the authorities of the Republic of the Marshall Islands (RMI). As we noted in our statement for the recent Board discussion of Palau, the challenges facing the RMI—a small population, high fixed costs of providing public services, limited policy capacity, limited natural resources, dependence on tourism, and vulnerability to natural disasters and climate change—are familiar to us from the experience of members of our own constituency. Just as familiar to us is the constructive contribution that the IMF can make to improved policy-making through a productive surveillance dialogue and capacity building, drawing on the experience derived from its diverse membership and including valuable cross-regional perspectives.

The experience of our own constituency also points to the value of structuring the Board's consideration of Article IV reports for countries in the same region in a manner that enhances understanding of common economic structures and challenges. For the Caribbean, given the highly-developed nature of regional institutions and the extent of intra-regional economic linkages (although the latter are still less developed than one might wish), this takes the form of a structured program of regional surveillance. While the absence of common regional institutions, far wider geographic dispersion, and the correspondingly reduced intra-regional economic links mean that a formal program of regional surveillance may be much less useful in the case of the Pacific islands, the simple expedient of scheduling the Article IV Board discussions for several Pacific countries on the same day (as is done for some of the Caribbean islands) could be helpful in allowing the Board to draw out similarities and understand differences.

Turning from surveillance process to substance, we agree with the staff that placing fiscal policy on a sustainable footing, and enhancing long-term growth prospects, are critical, and complementary, economic policy priorities. The need for action is all the more compelling when it is recognized that the real GDP growth of less than 2 percent observed in recent years has occurred in an environment of substantial transfers from the United States, under the Compact of Free Association. There is a risk that growth out-turns could be far worse than this, and standards of living much lower, if Compact payments cease after 2023, when the current agreement expires.

We note from the staff's Policy Action Scenario that structural reforms and achievement of a moderately ambitious fiscal target (a surplus of 3 percent of GDP) will allow for the accumulation of a Compact Trust Fund large enough to serve as an endowment, replacing the real resource flows currently coming from the Compact grants after 2023. We urge the authorities to take maximum advantage of the 15 year window of opportunity that remains to put in place an economic program along the lines recommended by the staff. Given the high level of public sector wages in RMI, which the staff indicates are 50 percent higher than in the private sector, leading to a wage bill that is higher relative to GDP than in other comparable countries, public sector wage restraint and a more differentiated salary structure would represent an important starting point in a strategy to achieve fiscal consolidation.

We share the staff's reservations about the proposal, being considered by the authorities, to securitize Compact aid flows and thereby obtain a stock of funds for investment. One would presume that the interest rate paid on such securities would be no lower than the U.S. long-term bond yield, while the return, provided that the proceeds were invested in equities, would be higher but uncertain. While it is well-established that equity investments yield a premium over bonds in the long run, it is by no means certain that the 15-year horizon remaining until the cessation of the Compact grants would be sufficiently long to allow losses (relative to the cost of funds) in any sub-period to be recouped. It is also essential that the authorities carefully take account of the fees that might be levied by financial advisors and firms underwriting any securitization.

The staff report suggests the need for improvements in the business climate, with the RMI ranking second-lowest among the Pacific island countries according to the World Bank's Doing Business indicators. We welcome the authorities' recognition of and commitment to addressing weaknesses in the land registration system, and administrative impediments to foreign investment, including the granting of business licenses.

With these remarks, we wish the authorities well in their challenging endeavors.

Mr. Heath and Mr. Kaplan submitted the following statement:

We thank the staff for their informative report, and appreciate the focus of the selected issues report on relevant topics of fiscal sustainability and strengthening the tax regime. We commend the authorities for the recent steps to place the Republic of the Marshall Islands (RMI) on the path to sustainable development. Progress has been made in several areas, including the significant accomplishment of meeting the required contribution to the Compact Trust Fund. However, as noted in the staff report, progress has been slow on many significant structural issues, and economic performance is lackluster.

Exchange Rate Policy

We agree with the conclusion of the staff report that dollarization remains appropriate given the RMI's size, administrative capacity, and close ties with the U.S. economy. We take note that the authorities have underscored that they do not have the capacity to conduct independent monetary or exchange rate policy. This highlights the need for prudent fiscal and structural policies, however, which the authorities have not demonstrated. Threats to external stability in the long term could result from inappropriate management of the Compact Trust Fund during its capitalization period, but these issues can be addressed through prudent fiscal policy as the staff suggests.

Fiscal Policy

We commend the authorities for their recognition, as noted by Messrs. Murray and Na, that the current size of the public sector is not sustainable. We encourage the authorities to approach fiscal reforms with a sense of urgency, in view of the anticipated expiration of Compact grants and increasing external debt repayments. A sizable budgetary adjustment is needed to move the economy toward self-sufficiency and reduce vulnerabilities to external shocks. The staff sets out a reasonable path to fiscal consolidation, including fiscal management and governance that we can support.

In addition, care should be taken to ensure that the Compact Trust Fund is managed in line with international best practices. The IMF Guide on Resource Revenue Transparency provides an excellent resource. We welcome the resolution of the custodial disagreement between the trustee and investment advisors, and the subsequent appointment of an auditor. Disclosure by the CTF in areas such as purpose, investment objectives, institutional arrangements, and financial information—particularly asset allocation, benchmarks, and rates of return over appropriate historical periods—would be appropriate for the management of this public trust.

Structural Reforms

Lack of progress on structural reforms has been an unfortunate feature of staff reports on the RMI. The staff again highlights overdue reforms for the investment climate and land registration. We continue to emphasize the need for structural reforms in the areas of health, education, infrastructure, and private sector development.

We agree with the staff's assessment on steps needed to strengthen RMI's financial infrastructure. We welcome the accomplishment of some measures that were highlighted in the previous staff report, including the adoption of legislation on secured lending, and we now urge speedy implementation including the registry of collateral. A weak bank supervisory regime remains a major vulnerability.

Mr. Henriksson and Mr. Olafsson submitted the following statement:

We thank the staff for an interesting set of papers and Mr. Murray and Mr. Na for their helpful buff statement.

Economic growth has slowed down to 1.6 percent in FY2005 to FY2007 and the medium-term outlook is for a growth rate of less than 2 percent. This is coupled with high youth unemployment due to limited job opportunities and low levels of FDI. Despite this situation, we can be optimistic on the growth possibilities of the RMI given the potential of human resources. The exceptionally large Exclusive Economic Zone is an important asset with scope for much increased utilization. However, we agree with the staff that strengthening the private sector is a key to growth and economic progress in the RMI.

Fiscal Policies

Notwithstanding the progress made in several areas, we agree with the staff that a further fiscal improvement is essential including cuts in current expenditure and revenue raising measures or improvements in the tax system. Although sovereignty implies some indivisibility in public administration, the public sector employment must be reduced and the wage gap with the private sector narrowed. The staff recommends a fiscal surplus of three percent of GDP in the medium term with the aim to achieve budgetary self-sufficiency after 2023. An alternate strategy would be a more moderate fiscal surplus but to use all available means to increase economic growth by inter alia investment in human capital and incentives to strengthen the private sector.

Monetary Policies

Dollarization as a monetary framework has served well and there seems to be no need for a change. In the absence of “active” exchange rate and monetary policies, prices including wages must be flexible and market based. Dollarization also puts the onus on fiscal policies to provide a buffer against shocks and an anchor of stability and sustainable economic growth.

Climatic Change

We note the vulnerabilities of the RMI to climate change including rising sea levels from thermal expansion and the rapid melting of ice sheets at the poles. We welcome the regional and international efforts of the authorities to raise general awareness and assess the effects of climate change as well as implementing the UN Framework Convention on Climatic Change.

Mr. Lushin and Ms. Shabunina submitted the following statement:

We thank the staff for an informative report and Messrs. Murray and Na for their insightful buff statement. With GDP per capita at $ 2,735, the Republic of the Marshall Islands (RMI) gets 42.7 percent of GDP in the form of grants from the United States, which will cease in 2023. Economic transition of the RMI to self-reliance is pressing yet the progress in that direction remains limited. We broadly agree with the staff's appraisal and will limit our comments to several questions.

More than 60 percent of the budget is financed from the Compact grants, and though it is less than in the last year, this is still 6 percentage points higher than the 2004 level. It is vitally important that consistent downward dynamics of the grant share in revenue be implemented in the medium term fiscal framework. Deceptive remoteness of 2023 should not prevent the authorities from making fiscal adjustments now. Further delays in the fiscal reform implementation would make them even more painful in the future.

The authorities should exercise a very cautious approach to any new borrowing. The current level of external debt ($ 98.7 million) is higher than the size of the Compact Trust Fund ($ 88.5 million) and any further debt accumulation in the conditions of decreasing grant payments poses danger to debt sustainability.

If the RMI is to achieve self-reliance by 2023, the country needs to boost private sector development now. The authorities should put strong efforts in removing three major impediments to the private sector growth: poor infrastructure, poor investor protection and underdeveloped financial system.

Capital expenditure's share is very low especially compared to the government wage bill, which totals 22 percent of GDP. Development of tourism, one of the most promising directions for the RMI economy, requires large investment in infrastructure. In this regard we support the staff in their call to rebalance the priorities for budget expenditure and decrease the share of the wage bill.

According to the World Bank's "Doing Business" indicators, the RMI ranks high on the criteria of labor flexibility, but is dragged down by poor investor protection and contract enforcement. We support the staff's recommendations to foster structural reforms, speeding-up land legislation, and scaling back commercial activities of the government. We are also interested in the information on the character and scope of these activities and their influence on the private sector.

The financial system with prohibitively high loan rates, that are 4.5 times higher than deposit rates, is far from providing efficient financial intermediation. We welcome the authorities' intention to introduce collateral registry and encourage them to speed up the institutional reforms needed for the development of the financial system.

Taking into account the importance of the Compact Trust Fund for future economic welfare of the RMI, more transparency regarding its operations will be useful. We welcome the authorities' decision to disclose the information about the performance of the CTF. The staff mentions in the report that there was a "conflict between the trustee and the investment advisor" (SM/08/50 paragraph 6), which resulted in the temporary change in the investment strategy. Has this conflict been fully resolved by now and is there any room to improve CTF management? The staff's comments are welcome.

With the above remarks, we wish the Marshallese authorities every success.

Mr. Fayolle submitted the following statement:

We thank the staff for an interesting set of papers, as well as Messrs. Murray and Na for their useful buff statement.

Like most small Pacific islands, the Marshall Islands are very open to and highly reliant on the public sector. The staff has rightly pointed out that once the Compact grants are finished, the mix of limited external resources and large public expenditure will become increasingly unsustainable. An adjustment effort will therefore be necessary, which will be all the less painful that it is undertaken ahead of the time when financing needs will become constraining.

The scale of the needed adjustment is large, and will require both containing expenditure and increasing public revenue. Because of its large size, the public sector will be the main adjustment variable when it comes to reducing expenditure. However, like Messrs. Prader and Orynbayev, we have concerns about the underdevelopment of the private sector and wonder what the short-run effects of reducing its size will be on the growth of the country. We also note that fostering the development of the private sector would require important investments in infrastructure. How would these investments be financed?

Turning to public revenue, the efforts undertaken by the authorities to improve tax collection are welcome, but will need to be further strengthened. We note that total domestic revenues are expected to decline in proportion to GDP starting in 2008 and would appreciate the staff's comments on this evolution. In light of this evolution, we concur with the staff that there is a need to address tax noncompliance.

In the longer run, the private sector will have to become the main engine of growth. We note impediments to the development of this sector, due notably to land registration difficulties, as well as to a weak investment climate, and encourage the authorities to target inroads in these fields. The development of the banking sector will also be instrumental to ensure that private sector projects can be financed at a reasonable cost.

The staff representative from the Asia and Pacific Department (Ms. Edison), in response to questions and comments from Executive Directors, made the following statement:

Before answering the questions that Directors posed in their gray statements, I would like to update Directors on the current situation. Actually, the only new data available, because it is somewhat hard to obtain data from the Marshall Islands, is on inflation, and it does not paint a pretty story. The RMI has not been insulated against the recent global food and fuel price increases. The most recent CPI data released earlier this week shows an overall price increase of over 10 percent quarter on quarter, with food prices rising by the same magnitude and utility prices rising nearly 30 percent. This underlines the vulnerability of the RMI to global factors.

Let me turn to some of the questions that were posed by Directors in their gray statements. One Director asked about the potential revision to the compact agreement. There was a newly elected government and they underscored the need to review land use agreements regarding Kwajalein, where the United States operates a prime military base. So far, it is unclear what specific steps the government will undertake in negotiating with the United States, nor what impact this will have on long-term projections.

Let me turn to questions on fiscal policy. With respect to downsizing of public sector employment, the government's plans in the near term do not envisage a massive mandatory separation in the public sector. Rather, the authorities plan to impose a wage and hiring freeze and eliminate vacant positions. This could lead to savings of about half a percent in the next fiscal year without any substantial impact on employment and growth. I also want to mention that there is no unemployment insurance in the Marshall Islands.

It is also widely recognized that private sector employment will need to grow to offset any decline in the public sector. In this regard, it is encouraging that the RMI has recently seen significant new investment and growth in the fishing industry, including a refurbished fish processing plant, and increases in the number of fishing vessels. This fish processing plant opened in April 2008, and has increased employment by about 400 people.

Let me turn to the question about why domestic revenues are declining as a share of GDP as of 2008. The numbers reflect the government’s budget estimates. Most of the decline is related to lower gross tax revenues. On the nontax side, the decline stems from lower health care contributions, and some other minor nontax items.

In light of this evolution, we have urged the authorities to focus on tax reform. We also wrote a selected issues paper on tax reform, and we have also encouraged them to work on reducing noncompliance.

One Director asked whether the conflict between the trustee and the investment advisor of the Compact Trust Fund has been fully resolved, and if there is scope to improve CTF management. As has been noted, the CTF is a cornerstone of the Marshall Islands' future. From the start, there have been unexpected contractual delays, which led to accumulation of funds gathered for the CTF in a money market account. Slowly, the authorities were able to establish the main part of the CTF. However, there was a delay to invest the funds fully due to this disagreement between the trustee and the investment advisor over the assignment of custodial rights.

In February or March 2008, that dispute was resolved. As a result, the funds in the CTF can be invested not only in index stocks, but can also be managed by a money market manager and invested in individual equities, or however the committee decides to invest.

As a result of this conflict, there was also a delay in assigning an auditor, and hence no annual reports have been released. However, the RMI government has indicated its willingness to disclose information about the performance of the CTF. It has shown its willingness to describe how the money is being invested, and hopefully these reports will be issued shortly.

Currently, the government reports on its investment returns in the budget. In addition, the authorities have shared with us the reports on the investments. Therefore, we have all confidence that they manage the trust fund in a prudent way.

One Director asked about the character and the scope of commercial activities of the government and about their influence on the private sector. The government owns or heavily subsidized most, but not all, companies or enterprises. This includes industries, such as energy, shipping, hotels, and the airlines. The extensive government involvement hinders in some ways private development. However, there have been key examples of reform recently in the RMI. One of the nice success stories is the inter-island shipping corporation. Under new management—it is crucial to underscore new management—it has been able to increase inter-island shipping, make the boats run on time and has reduced, not eliminated, subsidies from the government. It also has enabled the outer islands to be able to ship back to Majuro all their copra production and has increased exports dramatically in this line. Another example of reform is the social security administration, which was a debacle in the 1990s, and has improved under new management.

Lastly, a Director asked about tax reform, and wanted some elaboration about the rationale to suggest the Marshall Islands to look at the implementation of tax reform in the Federated States of Micronesia (FSM). While the FSM and the RMI share quite a bit of common history, the FSM has embarked on a tax reform earlier than the RMI. PFTAC, our technical assistance group, has provided the FSM with plenty of assistance on how to plan these reforms. We thus urge the RMI to review what has been done for Micronesia, to take advantage of those things that have been successful, and to possibly use them as a starting point for their tax reform. PFTAC is engaged and communicates regularly with the RMI on planning this tax reform.

Those are my comments to answer the questions that I reviewed from the gray statements.

Mr. Murray made the following concluding statement:

The Board will be on a record time for looking at a particular country, unless of course I speak for three or four hours. However, this will not be a Fidel Castro speech. Firstly, on behalf of my Marshall Islands authorities, I would like to thank all Executive Directors who submitted gray statements for their excellent comments. I really enjoyed reading them last night. This is just a small country in the Pacific, but a very complex one. For those who do not know, the Pacific is cut up into Melanesia, Polynesia, and Micronesia, and this is one of the three compact countries, with very close ties with and strong support from the United States, and of course free entry of labor into the United States. We are thankful for the strong support from the United States for all the compact countries, including the Marshall Islands.

I would also like to express special thanks to Ms. Edison and her team. I am on very good terms with them, because they are also a team partly for Australia and New Zealand. Ms. Edison and I have walked the streets of Sydney, at a particular break in a hectic Australia schedule, and we were so exhausted that we just needed to try to reduce the Australian current account deficit by spending hard earned U.S. dollars on Australian consumption goods.

We are very much thankful to Ms. Edison whose leadership over Marshall Islands has certainly been important. There were two trips to Marshall Islands. The original trip was scheduled to coincide with the installation of the new government. However, the actual election process took forever; it was longer than an Obama and Hillary Clinton saga. The team had return and just organizing this was quite an effort on both the staff's part and my office's part.

However, the new government has new energy and direction. They have been spurred on by a lot of analysis by the Fund. This is a clear illustration of the core mandate of the Fund. If the Fund is not going to look at the specific issues about the compact countries, such as fiscal consolidation, then it is not going to be done by anybody. I can assure Executive Directors that the authorities are on track in terms of looking at long-term fiscal stability seriously.

I take this opportunity to deliver the new government's strong desire to improve not just living standards, but to seriously consider future directions in terms of fiscal sustainability. As I mentioned along with my advisor Mr. Na, the new government's overriding objective is to maintain a stable macroeconomic environment, and to focus on prudent fiscal policy. They know they have a big task ahead in doing that.

On fiscal consolidation, the authorities will continue to fully utilize every device available, particularly the tax audit unit, and the medium-term budget and investment framework. They are making aggressive efforts through the tax audit unit on tax collections, and they are particularly fortified, in this task, by the fact that there is a high noncompliance rate on tax.

Bearing in mind the staff's warnings that delaying this fiscal adjustment will lead to hardship, and certainly some great long-term expenses, and unsustainable positions, the authorities are considering implementation of a comprehensive tax reform. PFTAC will be vital in that process. Headquarters, through the Fiscal Affairs Department, has just done a major visit to the Pacific to design a simplified VAT system. That was led by a former official of the Australian Treasury who now works in FAD. Some of that has already been implemented in the Pacific, particularly in Samoa, but PFTAC will play a central role in taking this further and making the VAT work in the Pacific. I am hopeful that the new government of the RMI will engage seriously in the comprehensive tax reform, including by looking at the VAT.

Aggressive belt tightening measures will also be introduced; not only by cutting discretionary expenditure, but also by freezing wages and eliminating vacant positions.

In terms of the public sector, Marshall Islands is not different from most small island countries. The public sector dominates partly due to historic and economic reasons. However, the private sector and structural reform efforts still need to continue, and certainly, the RMI is trying to pursue that. Land ownership is a big issue across the Pacific, and the authorities are taking reform efforts, also in relation to public enterprises. Given the success they have had, particularly on the shipping industry, there is no reason why that could not spread to some other enterprises, particularly the main utilities.

Tourism is a potential new industry. Palau, which is now a middle income country with U.S. per capita income of 7,000 to 8,000, is a clear example of what the Pacific can do on tourism. There is certainly serious dialogue going on between the government and private sector on that new area.

We acknowledge the difficulty with the wage gap between the public and private sectors. However, recent private surveys indicate that in 2007 there was an increase of 17 percent in nominal wages in the private sector, whereas public wages fell by 6 percent. It is uncertain how robust the survey is, but it provides some indication about possible progress.

On the financial issues, there is a fairly inefficient banking sector, and, certainly, there are risks around the large number of high interest rate households loans. This is something that the banking commission is obviously monitoring quite closely.

Finally, without getting into too much detail, because Ms. Edison already gave a bit of detail, consumer price inflation is obviously now in double-digit zone. This results to a large extent from higher import prices, particularly utility costs from rising oil prices, and from rising food and housing prices. These are supply side factors. If there was a central bank, it would need to ascertain that this did not add to inflation expectations and to wages. There is no indication of that happening. My great fear for Marshall Islands, along with a lot of other countries in the Pacific, is that they have no specific monetary policy instruments. They are pegged to a particular currency and therefore depend, in this case, on U.S. monetary policy. It is an issue for the Fund, because this is an issue around the core workings of the economy in terms of inflation expectations. But it is also a major issue for the World Bank and for the Asian Development Bank, because there are significant issues involved in terms of income distribution and poverty reduction. The current focus is clearly on issues around rice, flour, fuel, and also housing.

I do not have any particular answers to this, but this is something both my office and the Fund staff will need to keep a very close watch on, and in close consultation with the Asian Development Bank and the World Bank.

I would like to reiterate my authorities' clear commitments and endeavors in terms of the central issue of fiscal consolidation, and, bearing in mind their close relationship with the United States, of the management of the CTF.

I do feel new energy from the new government, which is very pleasing, because I could not have said that six months ago. Therefore, in closing, I would like to finally inform the Board that the Marshall Islands government has consented again to publish the staff report. Mr. Kato, I thank you for your chairmanship and for your strong support for yet another country in my constituency. I thank Executive Directors, and Ms. Edison and her team for their efforts and particularly for the strong analysis on fiscal consolidation and sustainability.

The Acting Chair (Mr. Kato) made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the recent steps taken by the authorities to move the Marshall Islands toward lasting growth. At the same time, they underscored the substantial challenges facing the economy, owing to the country's geographical remoteness, narrow production base, and increasing vulnerabilities to climate change and rising food and oil prices. In addition, the country faces anticipated declines in Compact grants and increases in debt-service payments. Against this background, Directors encouraged the authorities to press ahead with critical fiscal and structural reforms, with a view to spurring private sector-led growth and economic self-reliance.

Looking ahead, Directors emphasized that fiscal consolidation will be essential to maintain external stability and achieve budgetary self-reliance, and called for more ambitious fiscal objectives than those stated in the most recent budget. In particular, the authorities should aim for achieving, and maintaining, a fiscal surplus of about 3 percent of GDP in the medium term, to build reserves in the Compact Trust Fund (CTF) and prepare for the elimination of Compact grants after 2023. Directors underlined that, as the level of current expenditure is not sustainable, steps to rationalize current expenditures, including for public sector wages and subsidies, will be essential, along with measures to raise tax and nontax revenue.

Directors stressed that the CTF is the cornerstone of the Marshall Islands' future. They urged the authorities to adopt prudent and transparent management of the CTF, in line with international best practices. Directors called on the authorities to weigh carefully the costs and benefits of securitizing future U.S. contributions before reaching a decision.

Directors underscored the importance of ambitious structural reforms to promote sustainable private sector growth and to complement fiscal consolidation, while reducing the dominant role of the public sector in the economy. These reforms should include shoring up infrastructure, resolving land issues, and scaling back the government's commercial activities. Directors encouraged the authorities to improve the country's business environment, in particular to spur nascent industries in the tourism, fishing, and shipping sectors.

Directors welcomed the progress that has been made in strengthening financial sector supervision. At the same time, they emphasized that further steps are needed to bolster the country's financial infrastructure and to ensure that the system performs its role in the development of the economy. Directors urged the authorities to introduce measures to reduce impediments to commercial lending. They also stressed the need to carefully monitor the widespread reliance on high-interest personal credit, and to safeguard against potential non-performing loans.

Directors encouraged the authorities to improve the coverage, reliability, and timeliness of key economic statistics, with the help of technical assistance from donors.

It is expected that the next Article IV consultation with the Marshall Islands will be held on the 24-month cycle.

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SHAILENDRA J. ANJARIA
Secretary