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Republic of the Marshall Islands—Assessment Letter for the Asian Development Bank

September 23, 2020

This note provides the IMF staff's assessment of the Republic of Marshall Islands (RMI)'s macroeconomic conditions, prospects, and policies, based on available information as of September 23, 2020. The assessment has been requested in relation to the COVID-19 Pandemic Response Option program to the RMI to be considered by the Asian Development Bank in October 2020.

I. RECENT DEVELOPMENT, OUTLOOK, AND RISKS

Recent Developments

1. **Economic performance pre-COVID-19 was broadly strong, although there were signs of fiscal slippages.** Growth is estimated to have increased to 5.3 percent in FY2019, from 3.6 percent in 2018, supported by newly added fishing capacity. Inflation remained contained over the last two years, partly as a result of low U.S. inflation and low commodity prices. The current account surplus increased further to 8 percent of GDP, boosted by increases in fishing exports and grants. The fiscal position has weakened recently with higher expenditure (especially copra subsidies) have only be partially offset by higher revenue from fishing license.

2. **The government has taken swift precautionary measures in response to the COVID-19 pandemic**. There have been no confirmed cases of COVID-19 in RMI as of September 23, 2020. Travel bans on visitors from affected countries were imposed as of January 24. President David Kabua declared a State of Health Emergency because COVID-19 on February 7, 2020. A general ban on incoming travelers established on March 8 has been extended to October 5, with the possibility of extensions towards the end of the year. To ensure continuity of services, a limited number of carriers and fishing vessels can enter RMI for the purpose of transshipment, after spending 14 days at sea and obtaining clearance from the relevant agencies. On August 26, the government approved a temporary suspension of non-essential international departures of RMI citizens, given a surge in COVID-19 cases in key transit points overseas.

Outlook and Risks

3. **The near-term economic outlook has significantly deteriorated with the drag from the COVID-19 pandemic.** The RMI economy is heavily dependent on fisheries activities and fishing license receipts while relying relatively less on tourism. The COVID-19 pandemic is expected to impose large negative consequences in the economy, with real GDP contracting by 4.5 percent in FY2020. Fisheries and port-related activities are already experiencing significant losses due to lower global demand and travel restrictions. Slow business activities and job loss, including in the hotel and tourism sectors, are expected to weigh on domestic demand, despite support from the booming construction sector. Growth is projected to be negative also in FY2021. A gradual recovery is expected starting in the second half of 2021 as the pandemic subsides and economic activity resumes. Inflation is projected to stay subdued for FY2020, reflecting the decline of international

commodity prices and US inflation. RMI's current account surplus is projected to narrow to 1.6 percent of GDP in FY2020, as increases in primary income flows and grants is offset by a large negative goods balance.[1] Over the medium term, the economy is projected to grow around 2 percent on the back of increasing infrastructure spending, while inflation is expected to rise gradually to 2 percent, converging to U.S. inflation rates. A current account deficit of around 2.3 percent of GDP is expected by 2025, as grants and fishing license fees (as a proportion of GDP) are expected to decline significantly, while Compact Trust Fund (CTF) disbursements will only provide for a partial offset.

4. Risks to the outlook are tilted to the downside. The uncertainty around the near-term outlook is larger than usual. The external risks include a more prolonged COVID-19 outbreak and global slowdown further hampering demand for RMI exports and lowering growth. Despite the travel ban, a domestic virus outbreak remains a risk, which would add fiscal costs and lead to an economic downturn if it materialized. In the medium and long term, inadequate access to financing for the government is a key risk, given emerging fiscal deficits from rising spending pressures amid weak revenue receipts, a lack of fiscal consolidation plans, a possible fiscal cliff associated with the expiration of US Compact grants, and stagnant fishing license receipts. Risks from climate change, the potential issuance of the SOV, and a weak AML/CFT framework also loom large. Climate change could impact productive capacity, fiscal costs, and private investors' decisions. The issuance of a decentralized digital currency, the SOV, as a second legal tender would elevate risks to macroeconomic stability and financial integrity. The potential loss of the last USD corresponding banking relationship (CBR) if AML/CFT risks, including those related with the SOV, were not addressed would disrupt external aid and other important flows producing a significant drag on the economy. On the upside, agreement on a new Compact of Free Association (COFA) (negotiations are on-going) with favorable terms could significantly mitigate the risks of a fiscal cliff (see below) and preserve the provision of key federal services. In addition, revenues from fishing licenses could continue to grow on the back of higher global demand for fish, and public investment financed by much larger donor assistance envelopes could provide a significant stimulus to the economy.

II. POLICY FRAMEWORK AND SETTING

Fiscal Policy

5. The government has taken comprehensive measures to mitigate the impacts of the COVID-19 pandemic. The national COVID-19 plan was recently increased to $59 million (around 26percent of GDP), from an initial cost of $42 million, to boost the immediate COVID-19 response and help the economic recovery. Development partners have committed to cover most of the costs with grants and will address the urgent needs for RMI's Ministry of Health and Human Services (including infrastructure, medical supplies and equipment, and support in case of a domestic outbreak). To date, approximately $10 million has been spent on procuring medical equipment and

[1] The external position in 2019 was assessed as stronger than the level warranted by fundamentals and desirable policies, although the external position is subject to long-standing structural vulnerabilities given the reliance on grants and fishing license fees.

supplies, enabling surge capacity, and upgrading the infrastructure, including new isolation and quarantine buildings. Other major spending has included building hand-washing stations, assisting expatriate Marshallese impacted by COVID-19, and economic relief payouts to local companies currently affected by COVID-19.

6. The fiscal position is expected to weaken in the near term and is at risk of deteriorating significantly if the current COFA expires without new agreement or fiscal adjustment. Reflecting revenue shortfalls from weaker economic activity and expected fiscal measures, the fiscal balance is projected to change from a surplus of 0.3 percent of GDP in FY2019 to a deficit of 3.5 percent of GDP in FY2020. The deficit is expected to be mostly financed by drawing down government deposits, and possible additional grants from development partners. The fiscal balance is expected to return to a surplus in FY 2021, but, in the absence of a new COFA, RMI could face a fiscal cliff after FY2023 when the annual U.S. Compact grants amounting to around 12 percent of GDP are set to expire. Fiscal adjustment to prepare for the expiration would reduce the risk of a fiscal cliff, as would a new COFA.

7. Avoiding a fiscal cliff and protecting the real value of the CTF income stream should be fiscal policy priorities. Once the fallout from the pandemic fades, the authorities would need to undertake a combination of expenditure rationalization and revenue measures to achieve significant fiscal adjustment of around 4 percent of GDP over five years to maintain fiscal sustainability under the baseline outlook, which assumes expiration of the current COFA without renewal. On average, this would allow the country to complement the proceeds from the CTF yield with additional resources in order to compensate for the expected expiration of grants in 2023 under the Compact Agreement with the US. Reducing other fiscal risks, such as pension system shortfalls, further state-owned enterprises (SOE) losses, periods of below-average CTF yields, or risks from natural disasters, would require additional fiscal adjustment. Should the COFA agreement be extended, depending on the specifics, the needed fiscal adjustment could be smaller.

8. Sizeable fiscal adjustment should be accompanied by ambitious fiscal structural reforms. A good part of the adjustment could be achieved by reversing recent increases in central government recurrent spending (around 3.5 ppt of GDP between 2015 and 2018) while preserving spending on health and education. Social security benefits could be adjusted through improved targeting to contain the need for government transfers over time. Improvements in revenue administration could also contribute, including through a tax-compliance strategy, improvement in return and payment collection processes, strengthening of tax audits, and enhanced taxpayer services. On the revenue side, implementing growth-friendly tax reforms could also contribute to sustained revenue increases. Specifically, the following reforms could be considered: reforming the personal income tax system; introducing a net profits tax and a consumption tax, with the latter replacing the gross revenue tax; replacing import duties with excise taxes; and enhancing the taxation of shipping and corporate registries.

Debt Sustainability

9. Preliminary analysis suggests RMI is assessed to remain at high risk of external and overall debt distress. The DSA's mechanical ratings remain at high risk, with two out of four external public and publicly guaranteed (PPG) debt thresholds and the threshold for total public debt breached towards the end of the 10-year forecast horizon. In the near term, the public debt-to-GDP ratio is expected to rise first, because of the economic fallout of the COVID-19 pandemic, and then to decline gradually, as the economy recovers. However, the PV of external PPG debt-to- GDP ratio is projected to continue to rise from 2024, on a path similar to that expected before the pandemic, which reflects the fact that the same three factors remain the main drivers of the higher external financing needs: the expected expiry of the U.S. Compact base grants in 2023, the technical assumption that assistance by the World Bank and Asian Development Bank shifts from grants-only financing to concessional loans[2], and the leveling-off of fishing license revenues. Accordingly, the standardized stress tests highlight a high vulnerability resulting from shocks to exports, current transfers, and/or the occurrence of natural disasters. In practice, debt sustainability will importantly hinge on continued donor grant inflows, including, possibly, a new COFA. Even so, some fiscal adjustment would likely still be needed to contain the risk of debt distress beyond 2025 and maintain external stability.

Financial Stability

10. The authorities should seriously reconsider the issuance of a digital currency (the SOV). An enabling law to introduce the SOV as a second legal tender in addition to the US dollar was introduced in February 2018. Work to address the risks associated with SOV issuance continued in 2020 and the authorities are considering a phased approach to the issuance of the SOV. Such an approach would enable to evaluate the risks at every stage before deciding whether to continue with the full issuance. While acknowledging on-going efforts to assess the SOV-related risks and to identify possible measures to mitigate some of them, additional measures will be needed to finalize the governance framework and to upgrade the domestic AML/CFT regime, including for AML/CFT supervision of the virtual asset service providers, including for the potential pre-sale of the SOV before the full launch. The IMF remains of the view that the potential benefits from issuing the SOV are likely to be smaller than expected and far smaller than the potential costs resulting from the significant economic, reputational, financial integrity, SOV-governance, and legal risks, some of which are beyond the control of the government.

11. Before the COVID-19 pandemic, the financial sector appeared sound, but with some vulnerabilities. With capital at over 15 percent of the risk-weighted assets, commercial banks were well-capitalized and profitable. Household debt, however, was high, with debt service taking up a

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[2] While the RMI is expected to continue to benefit from its grant-only status for the prospective financial assistance from the International Development Agencies and other Multilateral Development Banks, the Debt Sustainability Analysis assumes regular credit terms for small economies for all the years of which grant finance has not been committed yet.

significant share of the income of many public employees. Analysis of the COVID impact on the financial sector is prevented by the absence of high-frequency financial sector data.

Climate Change

12. Investment in climate change adaption and preparedness are critical. RMI is highly vulnerable to climate change. Vulnerability stems from (i) rising sea level (given low elevation) and associated risk of flooding, destruction of infrastructure and crops, and contamination of fresh water sources; (ii) droughts (rain is key source of fresh water); and (iii) storms and cyclones and their impact on infrastructure and crops. These natural disasters have an immediate impact on current and long-term growth and impact fiscal sustainability. Under the COFA, RMI has access to the Disaster Assistance Emergency Fund (DAEF) and the United States Disaster Preparedness and Response Services and Related Programs, but access to the latter is expected to expire by FY 2023. Government efforts in response to climate change risks are ongoing, supported by development partners. RMI could enhance its disaster risk management approach by developing a National Disaster Risk Financing Strategy to guide policy making about risk retention and transfer and seek support from development partners to bridge the financial gap stemming from the risk of natural disasters.

Sustainable Growth

13. Key structural reforms are needed to promote sustainable growth. Improving the business environment for sustainable private sector development remains key to promoting sustainable growth. Staff recommend land registration reforms which can help collateralize properties, which in turn improve access to credit and lower hurdles for long-term land leases by nonresidents, thereby facilitating foreign direct investment. Services provided by SOE in RMI are important, but costly. Staff recommend that the planned SOE reforms be fully implemented to reduce the cost of service delivery.

IMF Relations

14. Marshall Islands is on a 24-month Article IV consultation cycle. The 2018 Article IV consultation was concluded by the IMF's Executive Board on September 9, 2018. The originally planned 2020 Article IV consultation (in March 2020) is suspended due to the COVID-19 pandemic. The Fund provides technical assistance and training from headquarters and PFTAC.

Marshall Islands: Selected Economic Indicators, FY2015–2025 1/

Nominal GDP: US$ million 221(FY 2018) | GDP per capita: US$3,667 (FY 2018)

Population: 58,413 (FY 2018) | Quota: SDR 3.5 million

	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025
					Est.			Proj.			
Real sector											
Real GDP (percent change)	1.6	1.3	4.1	3.6	5.3	-4.5	-0.9	3.5	2.3	2.0	1.8
Consumer prices (percent change)	-2.2	-1.5	0.1	0.8	1.2	0.9	1.1	1.5	2.0	2.0	2.0
Central government finances (in percent of GDP)											
Revenue and grants	58.8	61.0	68.3	62.6	66.2	76.2	85.5	73.8	69.9	66.0	65.3
Total domestic revenue	27.0	31.6	37.7	32.2	33.0	32.8	32.1	32.2	31.6	41.1	40.9
Grants	31.8	29.5	30.7	30.4	33.2	43.4	53.4	41.6	38.3	24.9	24.4
Expenditure	56.0	57.1	64.0	60.1	66.0	79.7	83.2	74.8	71.6	70.8	70.0
Expense	52.2	54.0	57.9	55.6	60.8	66.3	67.2	61.0	59.2	58.9	58.4
Net acquisition of nonfinancial assets	3.8	3.1	6.1	4.6	5.1	13.4	15.9	13.8	12.4	12.0	11.7
Net lending/borrowing	2.8	3.9	4.4	2.5	0.3	-3.5	2.3	-1.0	-1.7	-4.8	-4.8
Compact Trust Fund (in millions of US$; end of period)	247.1	294.5	356.9	402.4	434.7	480.0	525.7	574.6	626.9	631.4	635.7
Balance of payments (in percent of GDP)											
Current account balance	17.2	16.1	7.5	6.5	8.0	1.6	1.2	0.2	4.0	1.0	-2.3
Goods and services balance	-46.7	-41.2	-44.6	-45.8	-43.0	-48.8	-51.7	-49.1	-38.4	-38.4	-38.5
Trade balance	-28.6	-24.6	-25.6	-28.6	-25.4	-29.6	-34.6	-31.9	-21.1	-21.1	-21.1
Net services	-18.0	-16.6	-19.0	-17.2	-17.6	-19.2	-17.1	-17.3	-17.3	-17.4	-17.4
Primary income	34.4	30.9	28.5	27.7	22.1	22.4	20.6	17.7	15.1	22.3	19.5
Of which : fishing license fee	13.9	12.6	12.4	11.9	11.1	11.7	11.6	10.9	10.4	10.0	10.0
Secondary income	29.5	26.4	23.6	24.6	28.9	28.0	32.3	31.6	27.3	17.1	16.8
Of which : compact current grants	17.9	16.1	14.6	14.4	16.1	14.9	14.7	13.8	13.2	3.6	3.5
Of which : other budget and off-budget grants	8.6	8.9	7.6	9.5	11.8	11.8	16.3	16.8	13.3	12.9	12.7
Current account excluding current grants	-9.4	-8.8	-14.7	-17.3	-19.9	-25.2	-29.8	-30.4	-22.5	-2.6	-5.8
External PPG debt (in millions of US$; end of period) 2/	89.0	83.5	77.9	72.6	66.6	66.0	64.5	63.8	64.2	70.2	76.7
(In percent of GDP)	48.2	41.6	36.6	32.8	28.1	29.3	28.3	26.4	25.4	26.6	27.9
Exchange rate											
Real effective exchange Rate (2010 =100)	117.6	120.3	120.7	121.5	97.2	…	…	…	…	…	…
Memorandum item:											
Nominal GDP (in millions of US$)	184.6	200.6	212.9	221.3	237.4	224.7	227.7	241.6	252.9	264.0	275.1

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 IDA financial assistance in the form of grants.