IMF Country Report No. 17/280

FEDERATED STATES OF MICRONESIA

September 2017

2017 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE FEDERATED STATES OF MICRONESIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2017 Article IV consultation with the Federated States of Micronesia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its September 1, 2017 consideration of the staff report that concluded the Article IV consultation with the Federated States of Micronesia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 1, 2017, following discussions that ended on June 14, 2017, with the officials of the Federated States of Micronesia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 4, 2017.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Statement by the Executive Director** for the Federated States of Micronesia.

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

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Press Release No. 17/350
FOR IMMEDIATE RELEASE
September 15, 2017

International Monetary Fund
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Washington, D. C. 20431 USA

IMF Executive Board Concludes 2017 Article IV Consultation with the Federated States of Micronesia

On September 1, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation[1] with the Federated States of Micronesia (FSM).

FSM is a small and sparsely-populated state vulnerable to climate change. Over the medium term, the country needs to prepare for the expiration of grants under the Compact of Free Association with the U.S. from fiscal year 2024 onward, adapt to climate change, and promote sustainable private-sector growth and financial inclusion.

The Micronesian economy continued its gradual recovery in fiscal year 2016 (ending September 30), after three years of contraction during 2012–14. Real GDP is estimated to have grown by 3.0 percent in 2016 (after 3.7 percent in 2015), driven by increased construction activity related to infrastructure projects. Consumer prices remained broadly stable. The fiscal balance recorded an estimated surplus of 9 percent of GDP, after another year of strong revenues from fishing license fees. In 2017, growth is expected to moderate to 2 percent, as the recovery continues at a slower pace.

Despite the recovery, risks are tilted to the downside beyond the near term. Possible extreme weather events resulting from climate change, delays in infrastructure projects, and declining external grants could pose risks to growth. The current trajectory of the Compact Trust Fund is not on track to offset expiring U.S. grants after 2023. The FSM Trust Fund can only partially offset the shortfall. Without fiscal reforms, the fiscal surplus is therefore expected to turn into a deficit beyond 2023. Uncertainties surrounding the global economy could pose risks to trust fund returns and underscores the importance of strengthening fiscal buffers. On the upside, a decisive push for structural reforms could boost potential growth.

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

Executive Board Assessment[2]

Executive Directors welcomed the recent improvements in economic activity and the strengthened fiscal and external balances, but noted that Micronesia continues to face significant challenges arising from the scheduled expiration of U.S. Compact grants, vulnerability to natural disasters and climate change, and limited private sector activity. Against this backdrop, Directors underscored the importance of implementing sound fiscal policies and structural reforms to ensure long-term fiscal sustainability, reduce vulnerabilities to external shocks, and promote sustainable, private sector-led growth.

Directors stressed that gradual fiscal consolidation over the medium term is key to build adequate buffers and preserve fiscal sustainability in light of the scheduled decline in U.S. Compact grants and given vulnerabilities. They urged the authorities to work toward achieving the consensus needed to implement the adjustment efforts envisioned in the 2023 Action Plan. In particular, Directors recommended steps to enhance tax administration, contain current spending while avoiding delays in infrastructure investment, and further increasing budget contributions to trust funds. Accelerating the pace of public financial management reforms will also be critical to support the implementation of the fiscal adjustment and to address weaknesses in budget planning and execution.

Directors called for continued efforts to build resilience to natural disasters and climate change risks, including through explicit budget provisions for adaptation costs. They also encouraged the authorities to develop contingent financing plans for natural disasters from diverse sources.

Directors recommended reducing transportation costs, strengthening regulatory frameworks, and improving access to finance to facilitate private sector development. In this regard, they highlighted that efforts to streamline the investment application process would help attract foreign direct investment.

Directors emphasized the need to promote safe financial inclusion and ensure that the financial system plays its role in supporting growth. They recommended extending the oversight authority of the Banking Board to credit unions. Directors also supported efforts to facilitate more secured lending through developing the long-term lease market and the online secured transactions registry, while continuing to raise financial literacy and addressing skill gaps.

Directors welcomed the authorities' commitment to data transparency and the recent implementation of the enhanced General Data Dissemination System. They encouraged further improvements in the compilation of national accounts and external sector statistics to support economic analysis and policymaking.

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

Table 1. Federated States of Micronesia: Selected Economic Indicators, FY2012–2022 1/

Nominal GDP (FY2016): US$323 million
Population (FY2016): 102,249
GDP per capita (FY2016): US$3,157
IMF Quota: SDR 5.1 million

	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022
					Est.			Proj.			
Real sector (annual percent change)											
Real GDP	-1.7	-3.0	-2.4	3.7	3.0	2.0	1.4	0.9	0.7	0.7	0.6
Consumer prices	6.3	2.2	0.7	-0.2	0.5	0.9	2.0	2.0	2.0	2.0	2.0
Employment	-2.2	-2.0	-2.5	-0.3	2.4	1.4	0.8	0.3	0.1	0.1	0.0
Public (incl. public enterprises)	-0.9	-0.7	-1.3	-1.0	2.4	0.9	0.3	0.3	0.1	0.1	0.0
Private	-5.7	-4.0	-4.0	2.0	2.4	1.9	1.3	0.3	0.1	0.1	0.0
Nominal wages	3.5	1.0	0.8	3.6	2.5	2.0	2.4	1.9	1.7	1.7	1.4
public average wage/private average wage	2.0	2.1	2.2	2.2	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Consolidated government finance (in percent of GDP)											
Revenue and grants	65.9	62.0	64.8	66.0	70.2	68.9	68.4	68.4	67.9	67.4	67.2
Revenue	22.8	26.7	36.9	37.1	36.9	36.2	35.8	35.6	35.3	35.0	34.9
Tax revenue	11.6	12.1	19.0	12.4	13.2	13.3	13.3	13.3	13.3	13.3	13.3
Fishing license fees	8.1	11.1	14.9	20.7	19.6	19.0	18.5	18.2	17.9	17.6	17.3
Grants 2/	43.1	35.3	27.9	28.9	33.3	32.7	32.6	32.8	32.6	32.4	32.3
Expenditure	65.0	59.1	53.6	55.6	61.2	60.2	59.8	59.9	59.5	59.3	59.1
Current	43.6	44.8	46.5	48.7	49.0	47.8	47.1	46.8	46.4	46.1	45.8
Capital	21.5	14.3	7.1	6.9	12.1	12.5	12.7	13.1	13.2	13.2	13.3
Overall balance	0.9	2.9	11.2	10.4	9.0	8.7	8.6	8.5	8.3	8.1	8.0
Overall balance (excl. grants)	-42.2	-32.4	-16.7	-18.5	-24.3	-24.0	-24.0	-24.3	-24.3	-24.3	-24.2
Balance of trust funds (CTF and FSMTF)	82.3	106.5	126.8	145.5	170.0	188.5	206.9	226.9	248.3	270.4	294.4
Commercial banks (in percentage of GDP; end of period)											
Loans	11.6	11.0	11.7	13.2	15.1	15.5	15.8	16.2	16.5	16.8	17.1
Deposits	62.6	67.4	74.6	80.3	80.0	82.0	83.6	85.6	87.3	88.8	90.3
Interest rates (in percent, average for FY)											
Consumer loans	14.3	15.7	15.8	15.9	15.7	...	...	...	...	...	...
Commercial loans	6.4	7.1	6.8	6.8	7.8	...	...	...	...	...	...
Balance of payments (in millions of U.S. dollars)											
Trade balance	-125.4	-128.8	-117.5	-127.9	-142.8	-141.6	-145.1	-147.7	-150.1	-152.5	-154.7
Net services and income	-27.3	-11.6	-7.9	29.6	33.8	33.4	33.3	33.3	33.3	33.4	33.6
Private and official transfers	109.1	108.6	129.1	111.6	119.4	119.3	121.9	124.4	126.8	129.3	131.6
Current account	-43.7	-31.8	3.8	13.2	10.4	11.1	10.0	10.0	10.0	10.1	10.5
(in percent of GDP)	-13.4	-10.1	1.2	4.2	3.2	3.4	3.0	2.9	2.8	2.8	2.9
External debt (in millions of U.S. dollars; end of period)											
Outstanding stock	88.4	87.7	89.7	81.1	81.6	80.1	75.2	70.2	65.1	60.2	55.3
(in percent of GDP)	27.1	27.7	28.2	25.8	25.3	24.3	22.3	20.4	18.6	16.9	15.3
Exchange rate regime		U.S. dollar is the official currency									
Real effective exchange rate 3/	98.0	99.1	101.2	113.8	117.5	...	...	...	...	...	...

Sources: FSM authorities and IMF staff estimates.

1/ Fiscal year ends on September 30.

2/ Excludes grants to the Compact Trust Fund.

3/ Calendar year. 2010=100.

INTERNATIONAL MONETARY FUND

FEDERATED STATES OF MICRONESIA

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

August 4, 2017

KEY ISSUES

Context. Federated States of Micronesia (FSM) is a small and sparsely-populated state vulnerable to climate change. Over the medium term, the country needs to prepare for the expiration of U.S. Compact grants from FY2024 onward, adapt to climate change, facilitate sustainable private-sector growth, and promote safe financial inclusion. A new national government was formed in mid-2015.

Key Policy Recommendations.

- Ahead of FY2024, a gradual medium-term fiscal adjustment of 4 percent of GDP is needed to build adequate buffers, which can be achieved by domestic revenue mobilization, expenditure reforms, and higher trust fund savings.

- Continued efforts to adapt to climate change are needed, including explicit recognition of fiscal costs in the budget. Contingent financing plans for natural disasters should also be developed from diverse sources.

- To facilitate private sector development, reforms should focus on reducing transportation costs, strengthening regulatory frameworks, and improving access to finance.

- To promote safe financial inclusion and ensure the financial system plays its role in supporting growth, the oversight authority of the Banking Board should be extended to credit unions. Efforts to facilitate more secured lending should focus on developing the long-term lease market and the online secured transactions registry. Continuing to raise financial literacy and addressing skills gaps are also critical.

Approved By
Alison Stuart and Zuzana Murgasova

Discussions took place in Pohnpei during June 5–14, 2017. The mission comprised Mr. Arslanalp (head, STA), Mmes. Oeking and Le (both APD), joined by Mr. Kim (OED). Mr. Feridhanusetyawan (APD), Messrs. Usui and Rabanal (AsDB) participated in meetings. Mmes. Liu and Gamwalla-Khadivi (both APD) assisted from headquarters. The mission met with the Secretary of Finance, Governor of Pohnpei State, Speaker of Pohnpei Legislature, Banking Commissioner, Insurance Commissioner, and private sector representatives.

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APPENDICES

BACKGROUND

1. **Federated States of Micronesia (FSM) is a small and sparsely-populated state vulnerable to climate change.** Its economy is highly dependent on grants from the Unites States, as private sector activity is limited by a narrow production base, remoteness from major traffic routes, geographical dispersion, and weaknesses in regulatory frameworks. The FSM has a loosely federated structure making decision making at the national level difficult. Over the medium term, the country needs to adapt to rising fallouts from climate change, prepare for the expiration of U.S. Compact grants after FY2023, and enhance the platform for private-sector growth. To address these challenges, the last administration produced a plan ("2023 Action Plan"), which includes fiscal and structural reforms to secure fiscal sustainability and strengthen private sector growth.[1]

2. **Most grants provided under the Compact of Free Association with the United States (Compact grants) will expire after FY2023, posing a major medium-term fiscal challenge for the FSM.**[2] Under the agreement, the FSM is entitled to receive annual grants averaging US$80million over FY2004–23. Thereafter, investment earnings from the Compact Trust Fund (CTF) and the FSM Trust Fund—currently both in their accumulation phase—are intended to replace expiring Compact grants as a revenue source. While the projected balance of the two trust funds ($1.2 billion in FY2023) is likely to generate significant investment earnings, it will not be sufficient to replace the expiring grants. It will also not be sufficient to preserve the real value of the trust funds, which is needed to safeguard an important resource for future generations and to cope with the market volatility in investment returns (Appendix I).

3. **Progress has been made on past IMF recommendations in several areas** (Appendix II). The fiscal position improved due to higher fishing license fees, and to a lesser extent, improved tax compliance. The authorities have been contributing to the FSM Trust Fund beyond their initial commitment in the Action Plan—they have allocated about $60 million (20 percent of GDP) to the fund over the last three years (FY2014–16). The Infrastructure Development Plan was updated in FY2015, after which Compact infrastructure grants were made available again in January 2016.[3] However, in other areas, as building national consensus for decision making has been difficult, important pieces of legislation are delayed at various stages. These include amendments to the Foreign Investment Act and passage of the Debt Management and Credit Union bills. More progress is also needed toward Sustainable Development Goals (SDGs), particularly in the areas of domestic revenue mobilization, climate change preparedness, and financial inclusion, building on the progress with core Millennium Development Goals (MDGs) (Appendix III). FSM's progress with MDGs was

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[1] The "2023 Action Plan" was finalized in 2014 to prepare the FSM economy for the expiration of Compact grants after FY2023. The Action Plan envisages policy action in the following three areas: (i) growth through structural reforms; (ii) domestic revenue mobilization; and (iii) expenditure control.

[2] The Compact Agreement took effect in FY2004. The government's fiscal year ends on September 30 of each year.

[3] The Infrastructure Development Plan (IDP) for FY2016-25 was prepared by the national and state governments and identifies priority development projects in ten key sectors of the economy.

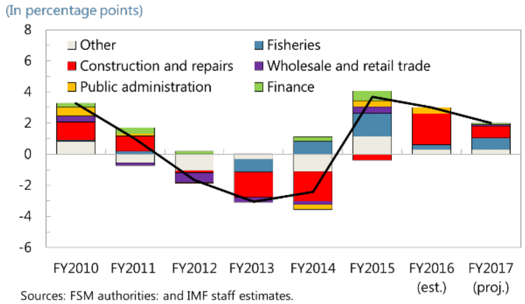
broadly in line with other Pacific islands, although only two goals—child mortality and environmental sustainability—were fully achieved.

DEVELOPMENTS, OUTLOOK AND RISKS

A. Recent Developments and Short-term Outlook

4. **The Micronesian economy continued its gradual recovery in FY2016, after a protracted contraction during FY2012–14.** The economy expanded by 3.7 percent in FY2015 and an estimated 3 percent in FY2016, driven by increased fishing and construction activity.[4] While two states (Chuuk and Yap) were severely hit by Typhoon Maysak in March 2015, the FSM benefited from extensive emergency relief and reconstruction assistance from the United States (FEMA/USAID). In FY2017, the growth momentum is expected to continue at 2 percent, supported by continued recovery in the construction sector. Consumer price inflation, broadly zero during FY2015-16, is expected to start converging back to the U.S. inflation rate of 2 percent, with the resumption of Compact-funded infrastructure spending.

FSM: Contribution to Real GDP Growth
(In percentage points)



Sources: FSM authorities: and IMF staff estimates.
Note: Other includes the remaining ten sectors, namely agriculture, mining and quarrying, manufacturing, utility, hotel and restaurants, real estate, transportation, education, health and social work, and other community social and personal services.

5. **The FSM has begun to run sizeable fiscal surpluses in recent years, although the fiscal position is likely to turn into a deficit in FY2024.** The fiscal balance has been in surplus since FY2012, mainly due to a surge in fishing license fees paid by foreign vessels. Fishing revenues increased from 6 percent of GDP in FY2010 to about 20 percent of GDP (on average) during FY2015–17, helped by the strong bargaining power obtained under the regional Nauru agreement.[5] Public investment is set to increase gradually with the authorities' new Infrastructure Development Plan (IDP). The fiscal

Federated States of Micronesia: Selected Economic Indicators, FY2013-17 1/

	FY2013	FY2014	FY2015	FY2016 Est.	FY2017 Proj.
	(year-on-year percent change)				
Real GDP	-3.0	-2.4	3.7	3.0	2.0
Consumer price index	2.2	0.7	-0.2	0.5	0.9
	(in percent of GDP)				
General government revenue	62.0	64.8	66.0	70.2	68.9
Tax revenues	12.1	19.0	12.4	13.2	13.3
Corporate tax	1.4	8.7	1.3	1.9	1.9
Foreign grants 2/	35.3	27.9	28.9	33.3	32.7
Current	25.4	24.7	25.1	26.6	25.5
Capital	9.9	3.2	3.8	6.7	7.1
Fishing license fees	11.1	14.9	20.7	19.6	19.0
General government expenditures	59.1	53.6	55.6	61.2	60.2
Current	44.8	46.5	48.7	49.0	47.8
Capital	14.3	7.1	6.9	12.1	12.5
General government balance	2.9	11.2	10.4	9.0	8.7
Balance of trust funds (CTF and FSMTF)	106.5	126.8	144.5	171.0	189.6
Current account balance	-10.1	1.2	4.2	3.2	3.4
Trade balance	-40.7	-36.9	-40.6	-44.2	-43.0
Net services and income	-3.7	-2.5	9.4	10.5	10.2
Transfers (private and official)	34.3	40.6	35.4	37.0	36.2

Sources: FSM authorities; and IMF staff estimates.
1/ Fiscal year ends on September 30.
2/ Does not include contributions to the Compact Trust Fund.

[4] In FY2015, the fishing sector expanded significantly with the main domestic fleet rising from five to seven vessels. In FY2016, the hold on Compact infrastructure grants, which pulled down GDP growth during FY2012–14, was lifted.

[5] This reflects the implementation of the Vessel Day Scheme (VDS) under the Parties to the Nauru Agreement (PNA). The cost of a day's fishing rose from a PNA minimum rate of US$5,000 introduced in 2012 to US$6,000 in 2014 and further to US$8,000 in 2015, although actual rates traded are currently in the US$10,000 to US$11,000 range. The PNA is not requiring further increases in the minimum rates, hence, fishing fees are projected to stabilize in nominal terms.

balance is projected to be around 9 percent of GDP in FY2017, with fishing license fees stabilizing in the range of US$60–65 million (in line with the levels achieved in FY2015-16).

6. The current account balance has improved substantially since FY2013 and turned into a surplus in FY2014. The current account improved from a deficit of 10.1 percent of GDP in FY2013 to a surplus of 3.2 percent of GDP in FY2016, as the large trade deficit was offset by official transfers and fishing license fees.

7. The banking system is well-capitalized and profitable, but provides limited credit despite ample deposits. The banking system's capitalization (Tier 1 capital) is high at 25 percent of risk-weighted assets. Interest rate spreads (between lending and deposit rates) are also high, keeping banks profitable. However, private sector credit has remained stagnant at around 20 percent of GDP in recent years. The loan-to-deposit ratio of the banking system is one of the lowest in the region, at around 20 percent. Corporate loans represent merely one-quarter of bank loans. Posting property as collateral is hindered by complex land ownership issues.

B. Medium-term Outlook

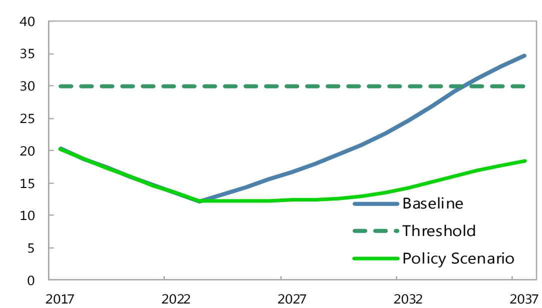
8. Beyond the near term, FSM's growth is projected to converge to the historical average of 0.6 percent, absent major reforms. Given FSM's population and labor force has remained broadly unchanged, the long-term growth outlook mainly reflects a continuation of the modest growth in labor productivity estimated at around 0.6 percent since FY2000. This long-term outlook also incorporates the likely impact of natural disasters.[6] Inflation is expected to rise to 2.0 percent, in line with U.S. inflation. Under the baseline scenario, without fiscal or structural reforms, the fiscal balance is projected to turn into a deficit of 4 percent of GDP in FY2024, after the expiration of Compact grants. Similarly, the current account surpluses are likely to decline over the medium-term.

FSM: Selected Economic Indicators, FY2017–23 1/
(In percent of GDP)

	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Baseline scenario							
Real GDP growth (%)	2.0	1.4	0.9	0.7	0.7	0.6	0.6
Fiscal balance	8.7	8.6	8.5	8.3	8.1	8.0	8.0
Current account balance	3.4	3.0	2.9	2.8	2.8	2.9	3.0
External debt	24.3	22.3	20.4	18.6	16.9	15.3	13.8
Policy scenario							
Real GDP growth (%)	2.0	1.1	0.7	0.5	0.6	0.7	1.0
Fiscal balance	8.7	9.1	9.5	9.8	10.2	10.6	11.0
Current account balance	3.4	3.4	3.8	4.4	5.0	5.5	6.0
External debt	24.3	22.4	20.5	18.8	17.1	15.5	13.8

Sources: FSM authorities and IMF staff estimates.
1/ Fiscal year ends on September 30.

FSM: PV of Debt-to-GDP Ratio
(In percent)



9. The Debt Sustainability Analysis (DSA) indicates that the FSM remains at a high risk of debt distress. Under the baseline scenario that does not assume major fiscal or structural reforms,

[6] Average GDP and GDP per capita growth between FY2000 and FY2015 were around 0.6 percent (excluding FY2013 when growth took a severe hit with the suspension of Compact infrastructure grants). The FSM experienced seven natural disasters during this period. Excluding disasters years, the historical growth average was 1.1 percent.

concessional external loans from FY2024 onward will be needed to safeguard priority infrastructure spending, leading to the breach of external debt thresholds (external debt-to-GDP, external debt-to-exports). With policy action that involves fiscal and structural reforms, however, the risk of debt distress could be greatly reduced.

C. Risks and Spillover

10. Risks are tilted to the downside, albeit with several mitigating factors (Appendix IV).

- *External risks* stem from extreme weather-related events and persistently low rates of return on financial assets in the Trust Funds. As an upside risk, lower-than-expected energy prices could improve the current account and stimulate growth moderately.
- *Domestic risks* include delays in infrastructure projects. On the upside, a decisive push for fiscal and structural reforms could boost potential growth. In the near-term, if downside risks were to materialize, the authorities could accelerate infrastructure spending, financed by unspent Compact infrastructure grants (US$160 million or 50 percent of GDP at end-FY2016).
- *The DSA analysis* indicates that the FSM continues to remain at a high risk of debt distress. Nonetheless, debt service ratios are low (below the DSA thresholds) due to concessional borrowing with long maturities. Income flows are positive with stable flow of funds from Compact grants until FY2023, which are projected to be replaced partly by investment income from the Trust Funds after FY2023.

The Authorities' Views

11. The authorities broadly agreed with the assessment on the economic outlook and risks. They shared the view that fiscal and structural reforms are needed to mitigate external and domestic risks, which could be achieved by implementing reforms envisaged in the "2023 Action Plan." In this regard, they noted a key risk factor on the reform agenda is achieving national consensus across states. At the same time, they noted that progress has already been made in several areas, including tourism, renewable energy, and climate change preparedness. They noted that they were looking for ways to accelerate Compact infrastructure projects, both in terms of their allocation and execution.

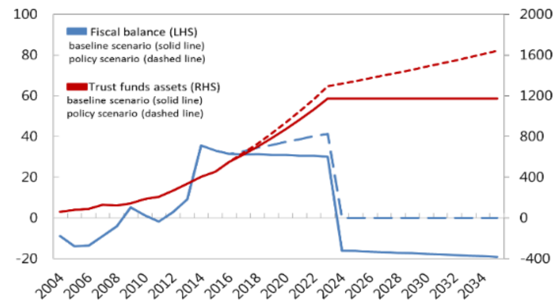
POLICIES FOR BUILDING RESILIENCE AND GROWTH

12. The key policy challenges for the FSM are to establish resilient policy frameworks and achieve sustained growth. In particular, four areas are both macro-critical and of high priority: (i) securing fiscal and external sustainability, (ii) adapting to climate change, (iii) facilitating private sector growth, and (iv) promoting safe financial inclusion.

SECURING FISCAL SUSTAINABILITY

13. A gradual medium-term fiscal adjustment of 4 percent of GDP is needed to achieve long-term sustainability and build buffers ahead of the FY2023 expiration of U.S. Compact grants. The projected investment earnings from the CTF and FSM Trust Fund are expected to fall short of expiring Compact grants by FY2024 (Appendix I). Staff analysis indicates that a cumulative fiscal adjustment of US$15 million (4 percentage points of GDP) over the next six years would be needed to finance the shortfall and preserve the projected value of trust funds in real terms over the long-run.

Fiscal balance and Trust Funds balance
(In millions of USD)



Sources: Country authorities and IMF staff calculations

14. The fiscal adjustment can be achieved through a combination of domestic revenue mobilization, expenditure reforms, and higher trust fund savings. Staff encourages the implementation of the "2023 Action Plan" prepared for the scheduled expiration of U.S. Compact grants. While the authorities have undertaken several measures envisaged under the Action Plan, staff urges additional steps to prepare for the post-FY2023 period.[7] These policy actions include:

- *Revenue mobilization (2 percent of GDP)*. Given the FSM has one of the lowest tax-to-GDP ratios in the Pacific, staff assesses that there is significant scope to raise domestic revenues. This can be achieved through tax administration and tax policy reforms. Reforms to strengthening core tax administration should include (i) implementing a Compliance Improvement Strategy; (ii) strengthening on-time filing and payment; and (iii) management of tax arrears and outstanding returns.[8] Tax policy reforms could include (i) reforming the personal income tax; (ii) introducing a net profits and value-added tax; and (iii) replacing the import duties on alcohol, tobacco, motor vehicles and fuels with excise taxes.

- *Expenditure reforms (1 percent of GDP)*. Staff supports the Action Plan's aim to rationalize current expenditures through efficiency improvements, including in health and education. Efficiency gains that lead to a 4 percent reduction in health and education spending, through curbing nonessential recurrent spending, would generate savings of 1 percent of GDP (Figure 2).

- *Increased Trust Fund contributions (1 percent of GDP)*. Staff encourages the government to save more into the trust funds, in particular by raising the annual budget contributions to the FSM Trust Fund by US$10 million (3 percent of GDP) from existing fiscal surpluses. Currently, these

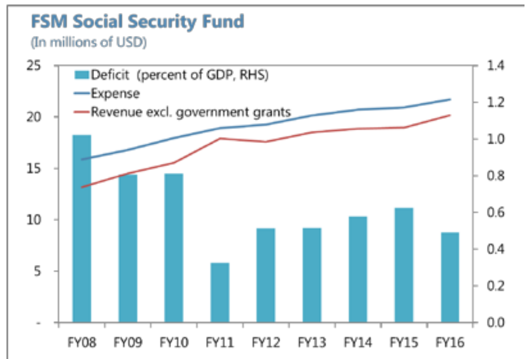
[7] Appendix II provides a summary of the recent action taken by the authorities on past IMF recommendations.

[8] A pilot program supported by PFTAC to improve tax compliance resulted in significant increase in tax collections in FY2015-16 with aggregate collection up US$2 million (0.5 percent of GDP) over that period.

surpluses are saved in low-yielding bank deposits. Staff estimates that saving them in the trust fund would generate additional investment income of 1 percent of GDP after FY2023.

15. Debt sustainability would be significantly improved with this adjustment. With these fiscal reforms, the debt level could remain at a manageable level below the DSA thresholds. Since delays could lead to a less gradual adjustment path with negative growth implications, staff highlights the importance of taking timely action. Also, if feasible, additional adjustment over the medium term would be helpful to build buffers against other fiscal risks, namely fishing revenue volatility and climate change costs.[9]

16. The financial position of the social security fund is relatively strong due to past reforms, but continued monitoring is needed. Major reforms took place during FY2011-13, which included raising the full retirement age from 60 to 65 and the payroll tax rate from 14 to 15 percent, to keep the social security fund on a sustainable basis. These have allowed the fund to accumulate reserves of US$50 million (16 percent of GDP) as of end-2016. The fund currently runs a small deficit of around 0.5 percent of GDP, financed by US$1 million annual budget transfers. Going forward, staff recommends the authorities to eliminate the deficit and budget transfer, which could be achieved by rationalizing dependency benefits.



Sources: FSM authorities; and IMF staff estimates

17. Improving public financial management (PFM) will play a critical role in implementing the Action Plan and reducing fiscal risks. Following the completion of the PFTAC-supported Public Expenditure and Financial Accountability (PEFA) self-assessment in November 2016, PFM reform is now directed towards implementing the resultant PFM roadmap. Staff supports the authorities' renewed focus on PFM reforms and, in line with the PEFA assessment, encourages them to (i) acquire a revenue management system, (ii) include annual spending projections of multi-year investment projects in the budget, and (iii) implement limited PEFA assessments for the four states. Staff also encourages the authorities to undertake a Public Investment Management Assessment (PIMA) to identify measures to strengthen the public investment process, particularly at the state level.

18. Staff encourages an external review of the FSM Trust Fund. An independent external evaluation of the CTF was conducted in FY2015. The review found the CTF to be generally well governed and its service provider performance in line with industry standards. It also suggested moving to a more conservative portfolio as FY2023 nears. Staff recommends a similar review and approach for the FSM Trust Fund to start preparing for the drawdown phase, and stresses the need of appointing a Board for the FSM Trust Fund (Appendix I). Staff also encourages the authorities to consider adopting the Santiago Principles for both trust funds—principles developed by sovereign

[9] For example, a 10 percent change in fishing license fees set by the PNA would swing the fiscal balance by 2 percentage points of GDP.

wealth funds all around the world to promote good governance, accountability, transparency and prudent investment practices.

The Authorities' Views

19. The authorities agreed with the staff on the size of the fiscal adjustment need. They noted that the states, particularly Pohnpei state, are revisiting the issue of tax reform. They appreciated PFTAC support on tax administration reforms, which has generated significant results. They agreed that modest improvements in efficiency of spending, particularly in education and health, may be feasible. They noted that raising the annual budget contributions to the FSM Trust Fund should be feasible, given existing fiscal surpluses, but the ultimate decision lies with the national Congress. The authorities also agreed with staff advice to take measures to eliminate the annual budget transfers to the social security fund, including by rationalizing dependent benefits. They expect that the PFM Roadmap (to be finalized later in 2017) will improve transparency in accounting for public funds and increase availability of information on annual budgets and financial statements.

MAINTAINING EXTERNAL STABILITY

20. The external sector position is currently comfortable, but a high buffer is needed to help manage the transition in FY2024. The FSM's external position is assessed to be weaker than underlying fundamentals and desirable policy settings based on the IMF's external balance assessment models (Appendix V). However, the methodology is not fully suitable for FSM given the special characteristics of the economy and the large structural change in FY2024 due to expiration of U.S. Compact grants, which is not fully captured in the model. Under a baseline scenario without major fiscal and structural reforms, the authorities would need to take on concessional external loans from FY2024 onwards to safeguard priority development spending which would lead to a breach of some of the debt sustainability thresholds. Thus, while in the near term, risks to external stability are limited, as previous current account deficits have mostly been financed by non-debt creating capital grants for infrastructure grants, it is desirable to strengthen buffers in preparation for the post-FY2023 period. The use of the U.S. dollar as the official currency is appropriate given the small size of the economy, close financial and trade linkages with the United States, and limited administrative capacity for independent monetary and exchange rate policies.

The Authorities' Views

21. The authorities broadly agreed with the external assessment and shared the view that an external sector buffer is needed to prepare for the post-FY2023 period. The authorities emphasized that the use of the U.S. dollar as the domestic currency remains appropriate for the FSM given the small scale of the economy and ease of administration.

ADAPTING TO CLIMATE CHANGE

22. The FSM is highly vulnerable to natural disasters and adverse effects of climate change. The authorities should plan for both *adaptation* and *contingent* fiscal costs. *Adaptation costs* are related to the cost of preparing for climate change, such as climate-proofing infrastructure, or building coastal protection, and could be around 1–3 percent of GDP every year and are built into the fiscal baseline (Box 1). *Contingent costs* are related to unavoidable losses and damages arising from natural disasters, which may intensify with climate change. These could be around 10 percent of GDP every 20 years, and present a large contingent liability that should be recognized as a fiscal risk, including for public debt management. Given the increasing importance of fishing revenues for the fiscal position, the impact of climate change on fish migration needs to be also carefully monitored.

23. Continued efforts to adapt to climate change are recommended, including explicit recognition of fiscal costs in the budget. Explicit budgeting of adaptation costs, particularly for infrastructure spending, would help ensure both sustainability and efficiency of such spending. This would also facilitate more sustainable donor funding, including from the Green Climate Fund. Similarly, it would be useful to develop diverse sources for contingent financing for natural disasters. The prioritization of climate-change related spending in the Infrastructure Development Plan and finalization of the Joint State Action Plans (JSAPs) for all states are welcome steps in this direction.

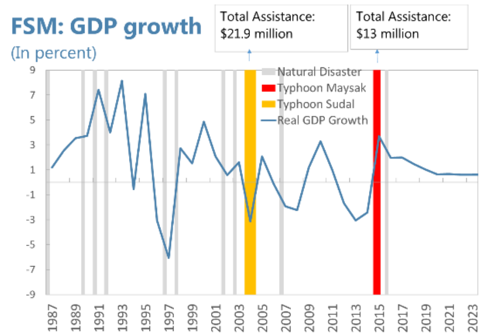
The Authorities' Views

24. The authorities continue to view climate change preparation as of high importance. In this regard, they noted significant milestones of securing US$10 million funding from the Adaptation Fund, and submitting proposals to the Green Climate Fund. The authorities shared the view that adaptation and contingent fiscal costs can be high, but are not currently recognized for budget planning. They noted that further climate change preparation is needed and may consider participating in the Pacific Catastrophe Risk Insurance (PCRAFI) Facility.

Box 1. Building Resilience to Disaster and Climate Risk[1]

The FSM is vulnerable to natural disasters and the adverse effects of climate change. The related fiscal costs can be large and are recognized in the macro-framework and the DSA. Recognizing this risk, the government is intensifying its focus on disaster risk management to build physical resilience and financial preparedness. These efforts can improve the business climate, encourage new investment, and boost medium-term growth.

As other Pacific islands, the FSM is vulnerable to natural disasters and adverse effect of climate change. In March 2015, Typhoon Maysak hit Chuuk and Yap resulting in 5 deaths. Under the Compact Agreement, FEMA/USAID provided relief and recovery assistance in the amount of US$13 million (4 percent of GDP), while the national government allocated US$6.4 million (2 percent of GDP) for relief. In early 2016, the FSM was hit again by severe drought conditions due to a protracted El Niño system.



Sources: FSM authorities; and IMF staff calculations.

Natural disasters and climate change imply both adaptation and contingent fiscal costs.

- The **adaptation** cost is related to the cost of adapting to climate change, including by improving critical infrastructure. Per the World Bank (2016), these costs could be 1–3 percent of GDP for the FSM.[2] FSM's Infrastructure Development Plan (IDP) includes public investment projects to adapt to climate change in the amount of US$31 million over a ten-year period. The macroeconomic framework incorporates these plans under the baseline scenario.
- The **contingent** cost is related to the fact that climate change is a contributing factor to extreme weather events. According to the Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI), the FSM can expect to incur losses and damages of 10 percent of GDP every 20 years due to typhoons.[3] This cost is incorporated in the DSA as a contingent liability shock.

FSM's resilience to disaster and climate risk can be enhanced through preparedness:

- **Identification of risks.** Steps are needed to identify and quantify the main disaster or climate change risks (i.e. likelihood of realization, potential impacts, infrastructures at risk, vulnerable communities). Toward this goal, the authorities have prepared Joint State Action Plans (JSAPs), finalized for Kosrae, Pohnpei, and Yap states.
- **Investing in risk reduction**. Resilience can be enhanced by making strategic infrastructure investments that help minimize damages.[4] Towards this goal, the IDP for FY2016-25 includes public projects in the order of 1 percent of GDP per year. The AsDB is supporting the preparation of a project proposal for each state to the Green Climate Fund.[5]
- **Developing contingency plans and financing**. These plans should include self-insurance (fiscal reserves), emergency support, and risk-transfer arrangements. A range of different sources of financing may be available such as the Green Climate Fund and the PCRAFI Facility. The IMF's Rapid Credit Facility (RCF) and Rapid Financing Instrument (RFI) could also help meet post-disaster financing needs.[6]

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[1]Prepared by Anh Van Le.

[2] World Bank, 2016. *Climate and Disaster Resilience*.

[3] PCRAFI, 2011. *Country Risk Profile: Federated States of Micronesia.*

[4] For example, in 2014, a 7-kilometer stretch of road in Kosrae state was climate-proofed under the AsDB's Pacific Adaptation to Climate Change Project.

[5] The 2017 report of the Pacific Islands Forum Secretariat on Climate Change Finance provides a comprehensive list of climate change related financing options. In March 2017, the Adaption Fund approved US$10 million project for FSM to help island communities reduce vulnerability to natural disaster and climate change risks.

[6]The PCRAFI is a risk insurance mechanism with financial support from Germany, Japan, the U.K, and the U.S. in the amount of more than US$40 million provided to Pacific islands under the G7 InsuResillience Initiative.

FACILITATING PRIVATE SECTOR GROWTH

25. Facilitating private sector development is necessary for sustainable growth, especially as external funding sources decline. The FSM has had significant challenges in boosting private sector growth and employment given its remoteness, geographical dispersion and weaknesses in regulatory frameworks. The public sector, which absorbs about half of total employment, remains the main source of economic activity. Going forward, the private sector needs to play a more prominent role in driving growth and employment. Fostering private sector growth requires addressing long-standing weaknesses in infrastructure, access to finance, and the business environment.

26. To promote private sector growth, reforms should focus on reducing transportation costs, strengthening regulatory frameworks, and improving access to finance (Box 2). The environment for private investment could be improved further by reducing impediments to doing business.[10] In line with the Action Plan, staff encourages the authorities to enact the amended Foreign Direct Investment (FDI) Act, currently with Congress, to streamline the FDI process and establish a national Investment Promotion Agency. Investments to upgrade ports and ports services, and building new transit routes could reduce transportation costs. Advancing reforms in the energy sector, including further investments in renewable energy, could help to improve energy efficiency and reduce high energy costs. With Nan Madol having become a World Heritage Site in 2016, staff encourages the authorities to further promote sustainable tourism, and to create stronger links with target markets in Asia. Targeted financial sector reforms could also help improve access to finance.

The Authorities' Views

27. The authorities broadly agreed that high transportation costs, regulatory burdens, and access to finance are the main constraints for private sector development. They noted that the amend FDI Act, if passed by Congress, would simplify the FDI process. To expand the tourism sector, a National Tourism Policy for sustainable tourism has been prepared and State Tourism Investment Plans developed. Since FY2016, the Congress has been appropriating annual budget allocations of US$2 million (0.6 percent of GDP) for these plans. The authorities also noted their efforts to reduce transportation costs through two new international airline routes, arrival of mid-size planes donated by China for domestic air service, and new marine links to outer islands. To promote agriculture and fishing, progress is being made to rehabilitate the coconut industry, and setting up a "competent authority" to facilitate fish exports to the European Union. A World Bank project is expected to provide all four states with access to broadband internet. Broader access to internet is expected to facilitate private sector development, promote financial inclusion possibly through mobile banking, and provide options for remote education and healthcare, especially to remote communities.

[10] Based on the World Bank's doing business survey, registering property and investor protection are two major concerns. Land registration reforms can help collateralize properties—thereby improving access to credit—and resolve hurdles for long-term land leases by nonresidents—thereby facilitating foreign direct investment (FDI).

Box 2. Private Sector Development[1]

Private sector activity in the FSM is hampered by high transportation costs, regulatory burdens, and limited access to finance. Reducing these constraints could help FSM specialize in niche products, foster high-value tourism, and ultimately boost private sector activity.

Background. The FSM is generally open to international trade—with low tariff and non-tariff barriers—and has preferential access to large markets including the U.S., EU, and Australia. Distortions from state-owned enterprises are also limited, allowing space for businesses to potentially leverage natural endowments (e.g., fisheries and aquaculture). However, broad-based private sector development remains elusive. The economy has stagnated over the past two decades, with FY2015 real GDP at about the same level as in FY1995. Private sector performance has been especially weak with output lower by more than 25 percent, and employment staying broadly unchanged as the public–private wage gap had widened.

Constraints. Private sector development in the FSM is constrained by:

- **High transportation costs.** Like other Pacific Islands, the FSM faces the twin challenges of smallness and remoteness that constrain domestic production and export opportunities.
- **Regulatory burdens.** Complex decision-making processes—rooted in a loose political federation and geographical distance between states—leads to higher regulatory burdens.
- **Limited access to finance.** Access to finance is constrained by structural hurdles as discussed in Box 3, including land tenure and property right issues.

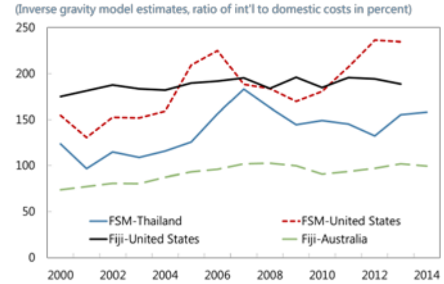
Policy advice. To strengthen private sector growth, the authorities could consider:

- **Reducing transportation costs**. Investments to upgrade ports and port services could help improve integration into global shipping networks and drive down freight costs. Further investment in renewable energy could improve energy efficiency and reduce reliance on imported fossil fuels.
- **Reducing regulatory burdens.** Transaction costs can be reduced by streamlining steps for government permits, and standardizing these across the four states, including through a pending FDI legislation.
- **Improving access to finance**. Support for small business development, expanding lenders' utilization of the secured transactions framework, and other measures could help mobilize credit to SMEs (Box 3).

Specific areas of growth could include:

- **Niche products**. Product differentiation allows niche exports to fetch high prices in the global market, effectively overcoming the inherent high cost structure stemming from the distance and size handicaps and potential high mark-ups by distributors. Such premium pricing for Fiji Water and Pure Fiji cosmetics has allowed Fiji to tap the U.S. as its biggest export market, despite similarly high bilateral trade costs (text figure). For the FSM, marketable niche export products may include coffee, pepper, traditional clothing, and handicrafts. Recent Pacific experience suggests that: (i) value-addition through certification and quality standards (particularly for agricultural products); (ii) responsiveness to buyers; (iii) and community-based business models are crucial for developing niche exports.
- **High-value tourism.** Sustainable niche tourism can be anchored on unique attractions such as the Nan Madol UN World Heritage site in Pohnpei; the Lelu ruins in Kosrae; the Chuuk lagoon (one of the world's leading wreck dive sites); and Rai (stone money) sites in Yap. Recent research suggests that increased number of flights can support sustained tourism growth, which could be encouraged through strategic air services agreements. The recently introduced direct flights from South Pacific—operated by Nauru Airlines and Air Niugini—can create stronger links with target markets in Asia.

Bilateral Trade Costs
(Inverse gravity model estimates, ratio of int'l to domestic costs in percent)



Sources: UN ESCAP-World Bank International Trade Costs database

[1]Prepared by Rommel Rabanal (AsDB).

PROMOTING SAFE FINANCIAL INCLUSION

28. The FSM banking system is well capitalized and profitable, but provides limited credit despite ample deposits. The FSM banking system is co-supervised by the Banking Board and the Federal Deposit Insurance Corporation (FDIC). This system has avoided the risk of a loss of correspondent banking relationship, as faced in the Marshall Islands. It has also ensured a sound and stable banking system. The banking system's capitalization (Tier 1 capital) is high at 25 percent of risk-weighted assets. Interest rate spreads (between lending and deposit rates) are also high at around 7 percent for corporate loans and 15 percent for consumer loans, partly reflecting credit risk. At the same time, the loan-to-deposit ratio of the banking system has remained exceptionally low at around 20 percent, one of the lowest in the region. The banks have generally preferred to extend credit to consumers with secure public sector jobs and an identified repayment stream. Commercial credit, on the other hand, has been stagnant.

29. The financial system should play a more prominent role in supporting growth (Box 3). Credit unions could help foster financial inclusion, but need to be put under the oversight of the Banking Board. In this context, staff urges the authorities to enact the draft Credit Union Act.[11] To facilitate more lending, reforms should focus on promoting long-term leases and the online secured transactions registry. The FSM Development Bank should continue to refocus its lending to small and medium enterprises (SMEs), while maintaining its status as a profitable and independent bank that operates without interest rate caps or budget transfers. The bank's Development and Finance Training Institute (DFI) is a welcome step to promote financial literacy and business development.

The Authorities' Views

30. The authorities agreed the financial sector should play a more prominent role in supporting growth, particularly by providing more access to finance for small and medium enterprises (SMEs). They emphasized that a key constraint to bank lending is the land tenure system, which prohibits use of land as collateral. The Banking Board shared staff's view that credit unions should be brought under its oversight and noted it has worked closely with PFTAC to prepare a Credit Union bill, which is now with the Attorney General's office. Finally, the authorities agreed that the FSM Development Bank should maintain its status as a profitable and independent bank that operates without interest rate caps or budget transfers.

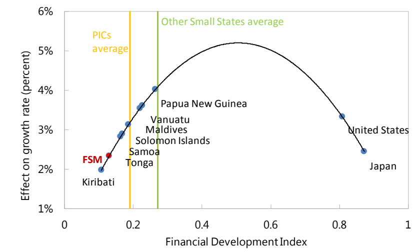
[11] Credit unions are currently small, with assets less than 1 percent of GDP.

Box 3. Promoting Financial Inclusion[1]

The FSM could promote financial access and inclusion, especially for small and medium enterprises (SMEs).

Background. There is growing empirical evidence that suggests that financial inclusion—defined as access to and use of financial services by households and firms—can enhance growth prospects. Recent work by Sahay and others (2015) has identified a positive link (up to a threshold) between growth and various aspects of financial inclusion, including better access to credit for small- and medium-sized firms; access to banking services for a wider number of households, including use of credit cards; and the use of bank accounts to receive wages.

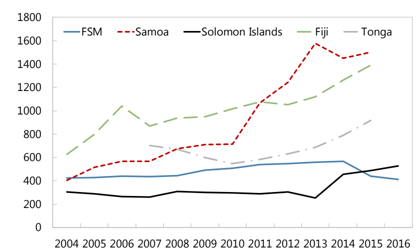
Financial Development Effect on Growth (2014)



Source: IMF Staff estimates, based on the methodology in SDN 15/08 and Cihak and others (2012).

Recent developments. The FSM lags regional peers in terms of financial access and inclusion. Only about half of the population has deposit accounts. The number of deposit accounts dropped in the past two years after the implementation of a minimum balance requirement of US$100 on savings accounts. Two commercial banks serve mainly urban areas, with eight branches and ten ATMs. There is no mobile banking that could facilitate banking for those living in the outer islands. Given long-standing issues, there has been little progress with land reform (Appendix II), hindering use of land as collateral and development of bankable projects. This is reflected in the fact that FSM has one of the lowest loan-to-deposit ratios in the region. Only one-quarter of bank loans are for firms (the rest for households).

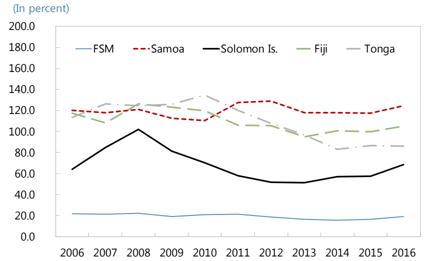
Deposit accounts with commercial banks per 1,000 adults



Source: IMF FAS Database.

Policy advice. Coordinated efforts are needed to advance financial inclusion in the FSM, especially for SMEs. These could include:

Loan-to-Deposit Ratio
(In percent)



- Promoting contracting of secure long-term land leases to generate more collateral for bank lending;
- Expanding the utilization of the online secured transactions registry to facilitate more secured lending.[2]
- Strengthening small business development training programs. The FSM Development Bank's new Development and Finance Training Institute (DFI) is a welcome step to promote financial literacy and business development;
- Addressing skills gaps in preparation of business plans and financial statements that hinder potentially bankable investments by outsourcing basic functions such as bookkeeping and accounting, through ICT.
- Enacting the draft Credit Union Act to put credit unions under the supervision of the Banking Board.

[1] Prepared by Yihan Liu.

[2] The secured transactions regime in the FSM is the longest running in the Pacific. It was established through the Secured Transactions Act of 2006 and the creation of an online registry, with AsDB assistance.

STATISTICS

31. Data dissemination has improved significantly, but data shortcomings in the areas of real and external sector statistics continue to hamper surveillance. The FSM is the second Pacific island to implement the Fund's enhanced General Data Dissemination System (e-GDDS), which represents a structural reform in statistical development. Implementation of the e-GDDS will promote data transparency and public access to macroeconomic data through a National Summary Data Page (NSDP) built on a global standard format.[12] Going forward, the authorities are encouraged to rebase the GDP and complete the ongoing rebasing of CPI (expected in 2018). For external sector statistics, they are encouraged to improve the coverage and timeliness of merchandise trade data (Statistical Issues Annex). The authorities could also adapt an Advance Release Calendar (ARC) for data dissemination to make further progress under the e-GDDS.

STAFF APPRAISAL

32. The Micronesian economy faces the medium-term challenge of coping with the reduction in Compact grants from the United States after FY2023, climate change, limited private sector growth, and weak access to finance. The fiscal balance is likely to fall into deficit after FY2023 without a sustained fiscal adjustment, undermining long-term self-sufficiency. Implementation of the Action Plan 2023 could help improve the outlook, but building national consensus for decision making has been difficult and has held up several important pieces of legislation (e.g., on tax reform and foreign direct investment).

33. Ensuring fiscal sustainability calls for gradual medium-term fiscal adjustment. The FSM is currently at a high risk of debt distress. An adjustment plan comprised of domestic revenue mobilization, expenditure reforms, and savings surpluses in trust funds (rather than in low-yielding bank deposits) is encouraged to prepare for the scheduled decline in Compact grants after FY2023. The implementation of such a medium-term plan can ensure that debt indicators remain well below the DSA threshold and trust fund balances are maintained in real terms beyond FY2023. Staff supports the renewed focus on public financial management and looks forward to further progress.

34. Continued vigilance is needed to prepare for both adaptation and contingent fiscal costs stemming from climate change. The authorities' intensified efforts to mitigate natural disaster risk and build resilience, including through the Joint State Action Plans (JSAPs), are welcome steps. Explicit budgeting of adaptation costs in the budget would help improve efficiency of spending and sustainability of donor funding.

35. A vibrant private sector is vital for sustainable growth and should be further promoted. Staff encourages improving access to finance, reducting transportation costs through port upgrades and renewable energy, and strengthening regulatory frameworks, including through streamlining the foreign direct investment process.

[12] The FSM's National Summary Data Page was launched in July 2017 and is available at: http://www.fsmstats.fm/?page_id=605

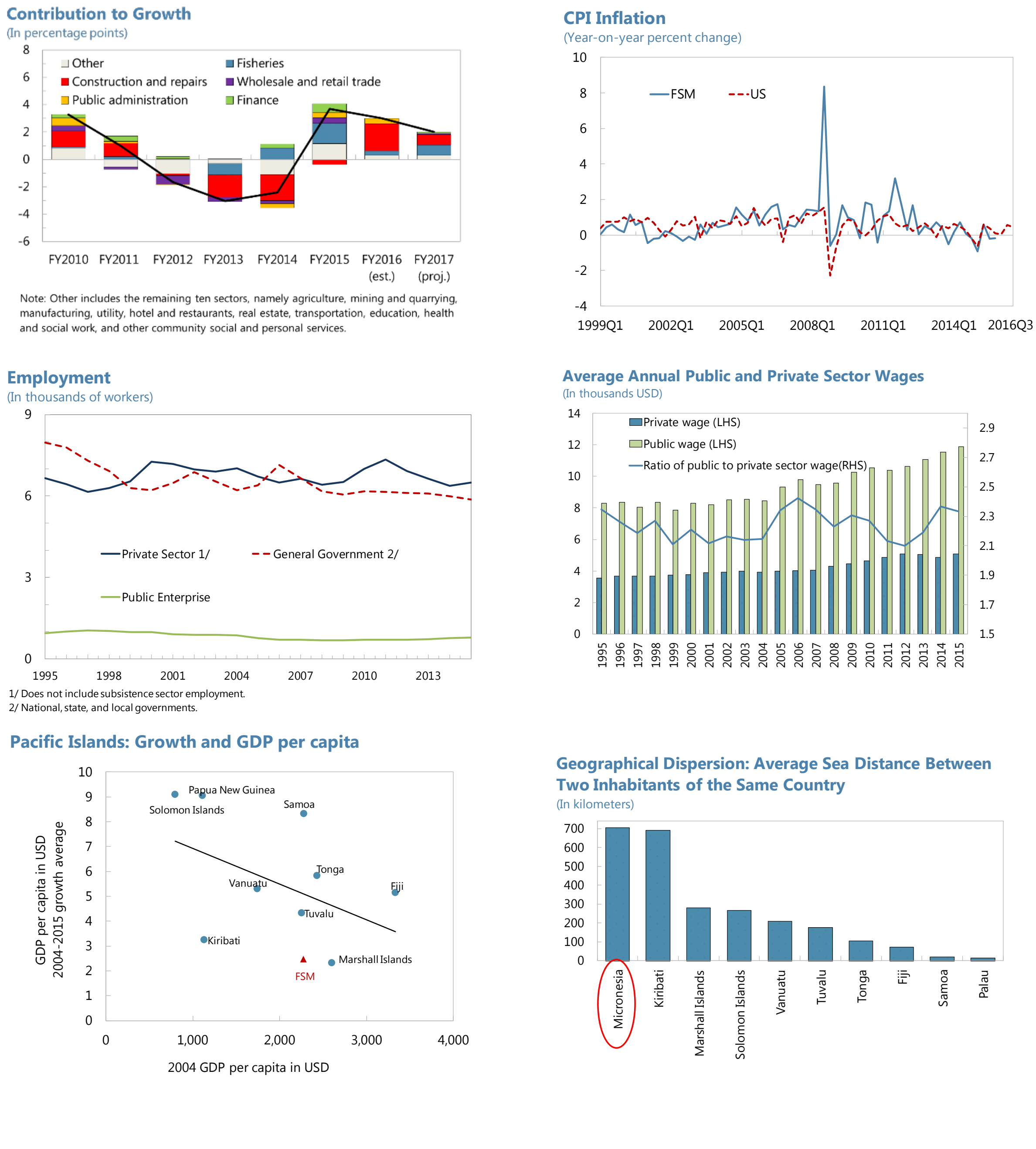
36. The financial system should play a more prominent role in supporting growth. Private sector development could further be promoted by improving access to finance. Oversight of credit unions by the Banking Board is necessary to promote safe financial inclusion. Further focus on SME lending, including by an independent FSM Development Bank, would also help to support financial inclusion and growth.

37. The external position is weaker than underlying fundamentals and desirable policies, but risks to external stability remain limited. The estimated current account gap is negative, but with relatively stable external funding available for financing trade deficits at least until FY2023. High buffers are needed to manage the post FY2023 period. External stability can be enhanced by saving more in the trust funds. The use of the U.S. dollar as the official currency remains appropriate given the small size of the economy and its close financial and trade linkages with the United States.

38. Staff welcomes the authorities' commitment to data transparency and encourages further improvements in national accounts and external sector statistics to help economic analysis and policymaking. The implementation of the e-GDDS in July 2017 represents a structural reform in statistical development and promotes data transparency. Building on this good progress, improvements in national accounts and external sector statistics can be made, with a view to improve their coverage and timeliness. Staff looks forward to continuing to work with the authorities, and other donors, on statistical capacity development.

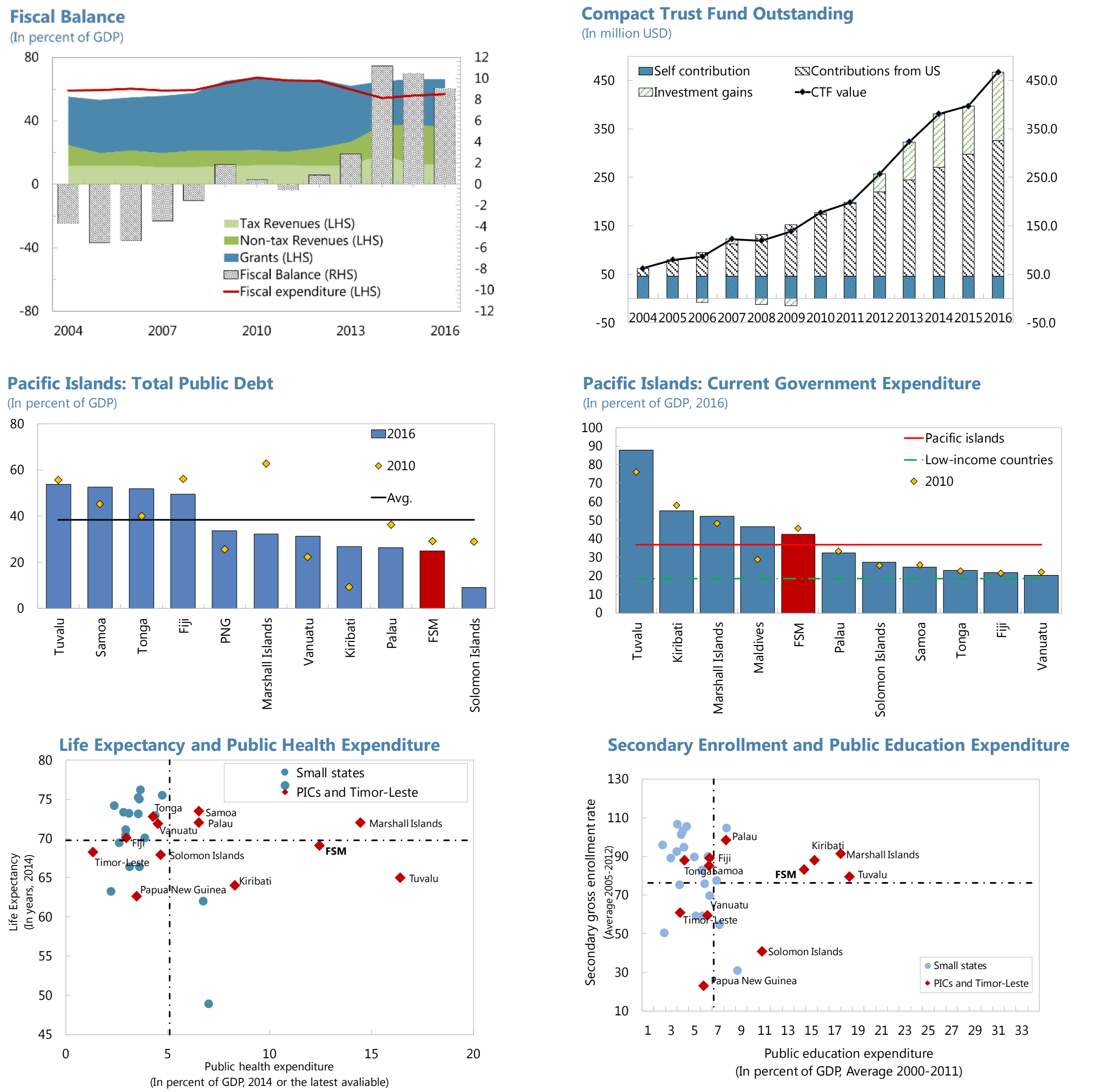
39. It is recommended that the next Article IV consultation take place on the current 24-month cycle.

Figure 1. Federated States of Micronesia: Real Sector Developments



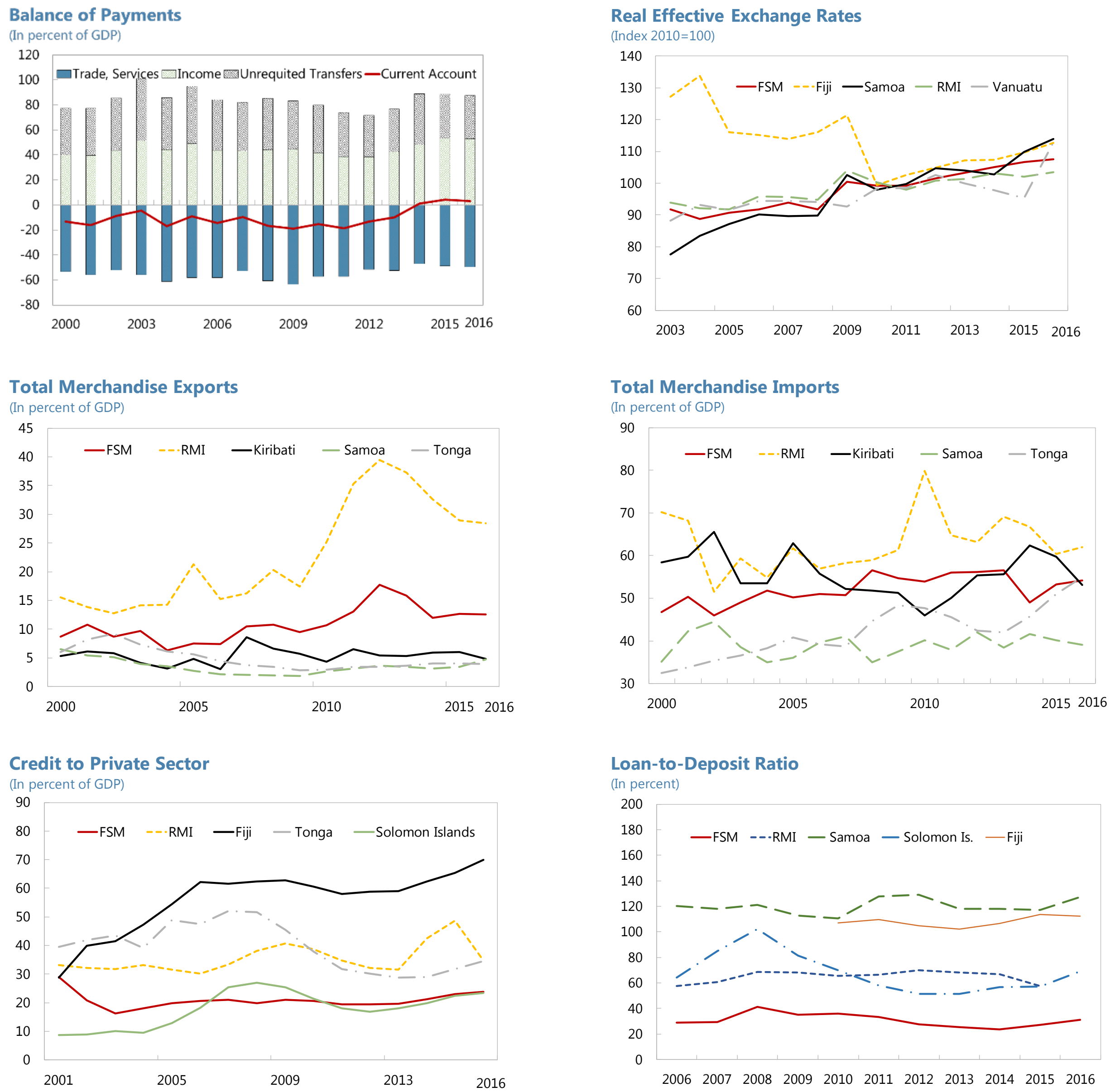
Sources: FSM authorities, IMF WEO database; and IMF staff estimates.

Figure 2. Federated States of Micronesia: Fiscal Developments



Source: FSM authorities, World Bank WDI database; and IMF staff estimates.

Figure 3. Federated States of Micronesia: External and Credit Developments



Source: FSM authorities, IMF WEO database; and IMF staff estimates.

Table 1. Federated States of Micronesia: Selected Economic Indicators, FY2012–22 1/

Nominal GDP (FY2016):	US$323 million
Population (FY2016):	102,249
GDP per capita (FY2016):	US$3,157
IMF Quota:	SDR 5.1 million

	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022
					Est.	Proj.					
Real sector (annual percent change)											
Real GDP	-1.7	-3.0	-2.4	3.7	3.0	2.0	1.4	0.9	0.7	0.7	0.6
Consumer prices	6.3	2.2	0.7	-0.2	0.5	0.9	2.0	2.0	2.0	2.0	2.0
Employment	-2.2	-2.0	-2.5	-0.3	2.4	1.4	0.8	0.3	0.1	0.1	0.0
Public (incl. public enterprises)	-0.9	-0.7	-1.3	-1.0	2.4	0.9	0.3	0.3	0.1	0.1	0.0
Private	-5.7	-4.0	-4.0	2.0	2.4	1.9	1.3	0.3	0.1	0.1	0.0
Nominal wages	3.5	1.0	0.8	3.6	2.5	2.0	2.4	1.9	1.7	1.7	1.4
public average wage/private average wage	2.0	2.1	2.2	2.2	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Consolidated government finance (in percent of GDP)											
Revenue and grants	65.9	62.0	64.8	66.0	70.2	68.9	68.4	68.4	67.9	67.4	67.2
Revenue	22.8	26.7	36.9	37.1	36.9	36.2	35.8	35.6	35.3	35.0	34.9
Tax revenue	11.6	12.1	19.0	12.4	13.2	13.3	13.3	13.3	13.3	13.3	13.3
Non-tax revenue	11.2	14.6	17.9	24.7	23.7	22.9	22.4	22.2	21.9	21.7	21.6
Fishing license fees	8.1	11.1	14.9	20.7	19.6	19.0	18.5	18.2	17.9	17.6	17.3
Grants 2/	43.1	35.3	27.9	28.9	33.3	32.7	32.6	32.8	32.6	32.4	32.3
Expenditure	65.0	59.1	53.6	55.6	61.2	60.2	59.8	59.9	59.5	59.3	59.1
Current	43.6	44.8	46.5	48.7	49.0	47.8	47.1	46.8	46.4	46.1	45.8
Capital	21.5	14.3	7.1	6.9	12.1	12.5	12.7	13.1	13.2	13.2	13.3
Overall balance	0.9	2.9	11.2	10.4	9.0	8.7	8.6	8.5	8.3	8.1	8.0
Overall balance (excl. grants)	-42.2	-32.4	-16.7	-18.5	-24.3	-24.0	-24.0	-24.3	-24.3	-24.3	-24.2
Balance of trust funds (CTF and FSMTF)	82.3	106.5	126.8	145.5	170.0	188.5	206.9	226.9	248.3	270.4	294.4
Commercial banks (in percentage of GDP; end of period)											
Loans	11.6	11.0	11.7	13.2	15.1	15.5	15.8	16.2	16.5	16.8	17.1
Deposits	62.6	67.4	74.6	80.3	80.0	82.0	83.6	85.6	87.3	88.8	90.3
Interest rates (in percent, average for FY)											
Consumer loans	14.3	15.7	15.8	15.9	15.7	...	...	...	...	...	...
Commercial loans	6.4	7.1	6.8	6.8	7.8	...	...	...	...	...	...
Balance of payments (in millions of U.S. dollars)											
Trade balance	-125.4	-128.8	-117.5	-127.9	-142.8	-141.6	-145.1	-147.7	-150.1	-152.5	-154.7
Net services and income	-27.3	-11.6	-7.9	29.6	33.8	33.4	33.3	33.3	33.3	33.4	33.6
Private and official transfers	109.1	108.6	129.1	111.6	119.4	119.3	121.9	124.4	126.8	129.3	131.6
Current account	-43.7	-31.8	3.8	13.2	10.4	11.1	10.0	10.0	10.0	10.1	10.5
(in percent of GDP)	-13.4	-10.1	1.2	4.2	3.2	3.4	3.0	2.9	2.8	2.8	2.9
External debt (in millions of U.S. dollars; end of period)											
Outstanding stock	88.4	87.7	89.7	81.1	81.6	80.1	75.2	70.2	65.1	60.2	55.3
(in percent of GDP)	27.1	27.7	28.2	25.8	25.3	24.3	22.3	20.4	18.6	16.9	15.3
Exchange rate regime		U.S. dollar is the official currency									
Real effective exchange rate 3/	98.0	99.1	101.2	113.8	117.5	...	...	...	...	...	...

Sources: FSM authorities and IMF staff estimates.

1/ Fiscal year ends on September 30.

2/ Excludes grants to the Compact Trust Fund.

3/ Calendar year. 2010=100.

Table 2. Federated States of Micronesia: General Government Operations, FY2012–22 1/

	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022
					Est.			Projections			
					(In millions of U.S. dollars)						
Revenue	215.2	196.1	206.0	207.9	226.6	226.8	230.6	235.0	237.2	239.6	242.0
Tax revenue	38.0	38.2	60.3	39.0	42.7	43.9	44.9	45.8	46.6	47.4	48.1
Wage and salary tax	7.7	7.9	8.1	8.2	8.5	8.8	9.1	9.3	9.5	9.7	9.8
Gross revenue tax	18.1	17.2	16.4	17.4	17.8	18.1	18.6	18.9	19.3	19.6	19.9
Corporate Tax	2.6	4.4	27.6	4.1	6.0	6.1	6.3	6.4	6.5	6.6	6.7
Import taxes	9.4	8.5	8.1	9.0	10.1	10.1	10.4	10.6	10.8	11.0	11.1
Other taxes	0.2	0.2	0.2	0.3	0.3	0.7	0.6	0.6	0.6	0.6	0.6
Grants (from abroad) 2/	140.6	111.7	88.8	91.1	107.5	107.6	110.0	112.8	114.0	115.1	116.3
Current	82.0	80.4	78.5	79.2	85.9	84.1	84.7	85.3	85.9	86.5	87.1
Compact current grants	65.2	63.8	61.0	64.6	65.9	63.9	64.1	64.3	64.5	64.7	64.9
Capital	58.6	31.3	10.2	11.9	21.6	23.5	25.3	27.5	28.0	28.6	29.2
Compact capital grants	28.5	16.5	4.9	7.3	7.2	8.9	10.8	12.7	13.0	13.2	13.5
Non-tax revenue	36.6	46.1	57.0	77.8	76.4	75.4	75.7	76.4	76.6	77.1	77.7
Fishing license fees	26.4	35.0	47.5	65.2	63.4	62.5	62.5	62.5	62.5	62.5	62.5
Expenditure	212.3	187.0	170.5	175.1	197.5	198.3	201.5	205.7	208.0	210.7	213.1
Expense	142.2	141.7	147.9	153.4	158.3	157.2	158.7	160.6	162.0	163.7	164.9
Goods and services	135.5	135.6	141.2	147.8	151.1	149.9	151.2	153.0	154.3	155.8	157.0
Wages and salaries	68.1	69.4	70.1	71.6	73.7	74.4	74.6	74.8	75.1	75.4	75.6
Other	67.4	66.2	71.1	76.1	77.4	75.5	76.6	78.2	79.2	80.5	81.4
Interest payments	1.0	1.2	1.2	1.1	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Subsidies	1.0	0.6	0.7	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Net transfers	4.8	4.2	4.9	4.2	5.9	6.0	6.2	6.3	6.4	6.5	6.6
Net acquisition of nonfinancial assets	70.1	45.3	22.6	21.7	39.1	41.0	42.8	45.0	46.0	47.1	48.1
Gross operating balance	73.0	54.4	58.1	54.5	68.2	69.6	71.8	74.4	75.2	75.9	77.1
Net lending/borrowing	2.9	9.1	35.5	32.7	29.1	28.6	29.0	29.4	29.2	28.9	29.0
					(In percent of GDP)						
Revenue	65.9	62.0	64.8	66.0	70.2	68.9	68.4	68.4	67.9	67.4	67.2
Tax revenue	11.6	12.1	19.0	12.4	13.2	13.3	13.3	13.3	13.3	13.3	13.3
Grants (from abroad) 2/	43.1	35.3	27.9	28.9	33.3	32.7	32.6	32.8	32.6	32.4	32.3
Non-tax revenue	11.2	14.6	17.9	24.7	23.7	22.9	22.4	22.2	21.9	21.7	21.6
Expenditure	65.0	59.1	53.6	55.6	61.2	60.2	59.8	59.9	59.5	59.3	59.1
Expense	43.6	44.8	46.5	48.7	49.0	47.8	47.1	46.8	46.4	46.1	45.8
Net acquisition of nonfinancial assets	21.5	14.3	7.1	6.9	12.1	12.5	12.7	13.1	13.2	13.2	13.3
Gross operating balance	22.4	17.2	18.3	17.3	21.1	21.2	21.3	21.7	21.5	21.4	21.4
Net lending/borrowing	0.9	2.9	11.2	10.4	9.0	8.7	8.6	8.5	8.3	8.1	8.0
Memorandum items:											
GDP in nominal prices	326.5	316.3	318.1	315.0	322.8	329.2	337.0	343.5	349.4	355.4	360.4

Sources: FSM authorities and IMF staff estimates.

1/ Fiscal year ending September. The consolidated fiscal accounts cover the national and four state governments.

2/ Excludes grants for the Compact Trust Fund.

Table 3. Federated States of Micronesia: Balance of Payments, FY2012–22

	FY2012	FY2013	FY2014	FY2015	FY2016 Est.	FY2017	FY2018	FY2019 Proj.	FY2020	FY2021	FY2022
					(In millions of U.S. dollars)						
Current account balance	-43.7	-31.8	3.8	13.2	10.4	11.1	10.0	10.0	10.0	10.1	10.5
Trade balance	-125.4	-128.8	-117.5	-127.9	-142.8	-141.6	-145.1	-147.7	-150.1	-152.5	-154.7
Exports, f.o.b.	57.8	50.2	38.2	39.9	40.8	42.6	44.2	45.4	46.5	47.6	48.3
Imports, f.o.b.	-183.2	-178.9	-155.7	-167.7	-183.6	-184.2	-189.4	-193.0	-196.6	-200.2	-203.0
Petroleum products	-57.8	-53.2	-42.4	-45.7	-46.9	-47.8	-48.9	-49.9	-50.7	-51.6	-52.3
Services account	-43.0	-37.4	-32.1	-26.3	-26.8	-27.3	-28.0	-28.5	-29.0	-29.5	-29.9
Receipts	38.3	43.5	45.2	43.6	44.6	45.5	46.6	47.5	48.3	49.1	49.8
Travel	27.7	33.0	34.6	30.9	31.6	32.3	33.0	33.7	34.3	34.8	35.3
Payments	-81.3	-81.0	-77.4	-69.8	-71.5	-72.8	-74.6	-76.0	-77.3	-78.7	-79.8
Freight and insurance	-29.7	-27.8	-25.4	-24.9	-25.5	-26.0	-26.6	-27.1	-27.6	-28.1	-28.5
Transportation 2/	-17.2	-16.8	-16.7	-17.4	-17.8	-18.2	-18.6	-19.0	-19.3	-19.6	-19.9
Income, net	15.7	25.9	24.2	55.8	60.6	60.8	61.3	61.8	62.3	62.9	63.5
Receipts	31.4	39.9	52.9	70.5	72.3	71.8	72.2	72.6	73.1	73.5	74.0
Fishing license fees	26.3	34.9	47.4	65.1	63.4	62.5	62.5	62.5	62.5	62.5	62.5
Payments	-15.7	-14.0	-28.6	-14.7	-11.7	-11.0	-11.0	-10.8	-10.8	-10.6	-10.5
Foreign workers earnings	-3.1	-2.1	-2.9	-3.6	-3.6	-3.6	-3.6	-3.6	-3.6	-3.6	-3.6
Unrequited transfers	109.1	108.6	129.1	111.6	119.4	119.3	121.9	124.4	126.8	129.3	131.6
Private	6.4	9.6	34.2	10.6	10.9	12.2	13.7	15.1	16.4	17.9	19.3
Inflows 1/	22.4	25.4	49.8	27.2	27.9	29.2	30.6	32.0	33.4	34.8	36.2
Outflows	16.0	15.7	15.5	16.6	16.9	16.9	16.9	16.9	16.9	16.9	16.9
Official	101.3	98.0	93.3	99.4	106.6	105.3	106.4	107.5	108.5	109.5	110.5
US Compact	65.2	63.8	61.0	64.6	65.9	63.9	64.1	64.3	64.5	64.7	64.9
Other	36.1	34.2	32.3	34.9	40.7	41.4	42.4	43.2	44.0	44.8	45.6
Capital account balance	68.3	42.2	21.2	22.9	15.3	24.2	30.4	33.4	33.9	35.2	35.7
Financial account balance	34.6	16.0	27.4	47.7	21.4	34.4	39.7	42.7	43.2	44.7	46.2
Direct Investment (net)	-0.9	-0.6	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Portfolio investment (net)	1.0	3.6	7.1	41.0	19.5	22.9	23.8	24.1	23.7	23.6	23.7
Other investment (net)	34.5	13.0	20.6	6.9	2.1	11.7	16.1	18.8	19.7	21.3	22.7
Memorandum items					(In percent of GDP)						
Current account balance	-13.4	-10.1	1.2	4.2	3.2	3.4	3.0	2.9	2.8	2.8	2.9
Trade balance	-38.4	-40.7	-36.9	-40.6	-44.2	-43.0	-43.1	-43.0	-43.0	-42.9	-42.9
Exports	17.7	15.9	12.0	12.7	12.6	12.9	13.1	13.2	13.3	13.4	13.4
Imports	-56.1	-56.6	-48.9	-53.3	-56.9	-55.9	-56.2	-56.2	-56.3	-56.3	-56.3
Service	-13.2	-11.8	-10.1	-8.3	-8.3	-8.3	-8.3	-8.3	-8.3	-8.3	-8.3
Income (net)	4.8	8.2	7.6	17.7	18.8	18.5	18.2	18.0	17.8	17.7	17.6
Receipts	9.6	12.6	16.6	22.4	22.4	21.8	21.4	21.1	20.9	20.7	20.5
Fishing license fees	8.1	11.0	14.9	20.7	19.6	19.0	18.5	18.2	17.9	17.6	17.3
Payments	4.8	4.4	9.0	4.7	3.6	3.4	3.3	3.2	3.1	3.0	2.9
Transfers	33.4	34.3	40.6	35.4	37.0	36.2	36.2	36.2	36.3	36.4	36.5
Private 1/	2.0	3.0	10.8	3.4	3.4	3.7	4.1	4.4	4.7	5.0	5.4
Official	31.0	31.0	29.3	31.6	33.0	32.0	31.6	31.3	31.1	30.8	30.7
Capital account balance	20.9	13.3	6.7	7.3	4.7	7.4	9.0	9.7	9.7	9.9	9.9
Capital grants	20.9	13.3	6.7	7.3	4.7	7.4	9.0	9.7	9.7	9.9	9.9
of which Compact capital grants	8.7	5.2	1.5	2.3	2.2	2.7	3.2	3.7	3.7	3.7	3.7
Financial account balance	10.6	5.1	8.6	15.1	6.6	10.4	11.8	12.4	12.4	12.6	12.8
Direct investment (net)	-0.3	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Portfolio investment (net)	0.3	1.1	2.2	13.0	6.0	7.0	7.1	7.0	6.8	6.7	6.6
Other investment (net)	10.6	4.1	6.5	2.2	0.7	3.5	4.8	5.5	5.6	6.0	6.3

Sources: FSM authorities and IMF staff estimates.

1/ Includes household remittance and corporate tax on income from abroad.

2/ Refers to passenger services transportation.

Table 4. Federated States of Micronesia: Financial and External Vulnerability Indicators, FY2012–22

	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022
					Est.	Projections					
Commercial banks											
Deposits (in percent of GDP)	62.6	67.4	74.6	80.3	80.0	...	...	...	...	...	...
Deposits (Year-on-year percent change)	22.9	4.3	11.3	6.6	2.1	...	...	...	...	...	...
Loans (in percent of GDP)	11.6	11.0	11.7	13.2	15.1	...	...	...	...	...	...
Loans (Year-on-year percent change)	8.0	-8.1	6.8	11.2	17.7	...	...	...	...	...	...
Loan to deposit ratio (in percent)	18.6	16.4	15.7	16.4	18.9	...	...	...	...	...	...
Foreign assets (in percent of GDP)	55.1	61.3	68.6	73.4	71.6	...	...	...	...	...	...
Equity capital (in percent of total asset)	7.8	7.6	7.2	7.3	7.6	...	...	...	...	...	...
Loss allowance (in percent of total loans)	3.7	3.6	3.5	3.1	4.1	...	...	...	...	...	...
Noncurrent loan (in percent of total loans)	5.3	4.4	6.5	2.8	...	...	...	...	...	...	...
FSM Development Bank											
Loans (in percent of GDP)	7.1	7.8	7.1	7.9	8.7	...	...	...	...	...	...
External indicators											
Exports (goods & services, y/y percent change)	27.2	-2.5	-11.0	0.0	2.4	3.2	3.1	2.2	2.1	2.1	1.4
Imports (goods & services, y/y percent change)	4.2	-1.7	-10.3	1.9	7.3	0.8	2.7	1.9	1.8	1.8	1.4
Current account balance (percent of GDP)											
Including official transfers	-13.4	-10.1	1.2	4.2	3.2	3.4	3.0	2.9	2.8	2.8	2.9
Excluding official transfers	-44.4	-41.0	-28.2	-27.4	-29.8	-28.6	-28.6	-28.4	-28.2	-28.0	-27.7
Total external debt											
In millions of U.S. dollars	88.4	87.7	89.7	81.1	81.6	80.1	75.2	70.2	65.1	60.2	55.3
In percent of exports of goods and services	92.0	93.6	107.5	97.2	95.5	91.0	82.7	75.6	68.6	62.2	56.4
In percent of GDP	27.1	27.7	28.2	25.8	25.3	24.3	22.3	20.4	18.6	16.9	15.3
Debt service											
In millions of U.S. dollars	5.6	6.4	8.9	8.9	7.6	7.3	6.8	6.7	6.7	6.4	6.2
In percent of exports of goods and services	5.8	6.8	10.6	10.7	8.9	8.3	7.5	7.2	7.1	6.6	6.4
In percent of GDP	1.7	2.0	2.8	2.8	2.3	2.2	2.0	1.9	1.9	1.8	1.7

Sources: FSM authorities and IMF staff estimates.

Table 5. Federated States of Micronesia: Deposit Money Banks, FY2010–16

	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016
	(In millions of U.S. dollars)						
Assets and liabilities							
Assets	178.4	190.1	228.1	237.7	262.9	281.1	288.4
Foreign assets 1/	133.9	143.5	179.8	193.8	218.0	231.2	231.1
Claims on private sector	31.9	35.2	38.0	34.9	37.3	41.5	48.8
Consumer loans	21.7	22.2	25.3	24.6	27.4	31.1	…
Commercial loans	10.3	13.0	12.7	10.3	9.9	10.3	…
Claims on the public sector	4.8	3.7	2.6	1.5	0.1	0.8	0.8
Others assets	7.4	7.7	7.7	7.5	7.5	7.6	7.6
Liabilities	178.4	190.1	228.1	237.7	262.9	281.1	288.4
Deposits	154.1	166.2	204.3	213.2	237.3	253.0	258.3
Central government deposits	29.0	37.2	62.1	63.7	34.0	57.9	62.2
Capital accounts	16.8	17.3	17.7	18.0	18.9	20.5	21.9
Other liabilities	7.5	6.5	6.0	6.5	6.8	7.6	8.2
Memorandum items							
Loan/deposit ratio (in percent)	20.7	21.2	18.6	16.4	15.7	16.4	18.9
Deposits (percent change)	16.3	7.8	22.9	4.3	11.3	6.6	2.1
Loans (percent change)	24.7	10.3	8.0	-8.1	6.8	11.2	17.7
Interest rates (percent) 2/							
Deposit rates							
Savings deposits 3/	1.2	1.0	0.9	0.6	0.5	0.2	0.2
CDs	0.9	0.6	0.4	0.4	0.5	0.6	0.4
Time Deposits	1.0	0.8	0.7	0.8	0.6	0.6	0.4
Loans rates 4/							
Consumer loans	15.1	14.4	14.3	15.7	15.8	15.9	15.7
Commercial loans	6.6	6.6	6.4	7.1	6.8	6.8	7.8

Sources: FSM authorities and IMF staff estimates.
1/ Includes loans to abroad.
2/ Calendar year average.
3/ Average rates offered by the deposit money banks.
4/ Average rates charged by the deposit money banks.

Table 6. Federated States of Micronesia: Financial Soundness Indicators, FY2013–16

	FY2013	FY2014	FY2015	FY2016
	In percent			
Capital adequacy				
Regulatory capital to risk-weighted assets	36.5	37.7	27.9	24.4
Regulatory tier 1 capital to risk-weighted assets	36.5	37.7	27.9	24.4
NPL net of provisions to capital 1/	0.9	6.1	2.0	1.0
Asset quality				
NPL to total loans ratio 1/	3.5	4.9	2.1	2.4
Sectoral distribution of loans				
Residents	67.3	66.2	61.4	68.5
Deposit-takers	0.0	0.0	0.0	0.0
Central bank	0.0	0.0	0.0	0.0
Other financial corporations	0.0	0.0	0.0	0.0
General government	0.0	0.0	0.0	0.0
Non-financial public corporations	2.7	0.2	1.2	1.0
Other domestic sectors	64.6	66.0	60.2	67.5
Non-residents	32.7	33.8	38.6	31.5
Earnings and profitability				
Return on assets	0.6	0.6	0.8	1.5
Return on equity	7.2	7.7	10.5	15.0
Interest margin	8.0	8.0	7.2	n.a.
Net interest income to gross income	79.6	80.2	79.2	83.1
Non-interest expenses to gross income	78.6	77.1	70.5	63.3
Personnel expenses to non-interest expenses	47.3	47.5	47.1	45.2
Liquidity				
Liquid assets to total assets	64.3	66.3	62.7	64.8
Liquid assets to short-term liabilities	331.9	304.3	257.4	254.3
Loan to deposit ratio	16.4	15.7	16.4	18.9
Other				
Capital-to-total assets	7.4	6.9	6.7	6.2
Risk-weighted assets to total assets	20.4	18.3	24.2	25.2

Sources: IMF, Financial Soundness Indicators (FSI) database; and IMF staff estimates.
1/ NPL=Non-performing loans.

Appendix I. Trust Funds and their Long-term Outlook[1]

The FSM has two trust funds to support its economic advancement and budgetary self-reliance after the expiration of the Compact grants in FY2023. The Compact Trust Fund is jointly managed by the U.S. and the FSM; the FSM Trust Fund is managed by the FSM only. The current trajectory of the Compact Trust Fund is not on track to compensate for expiring Compact grants in FY2023. The FSM Trust Fund can only partially offset the shortfall. Fiscal adjustment is therefore needed.

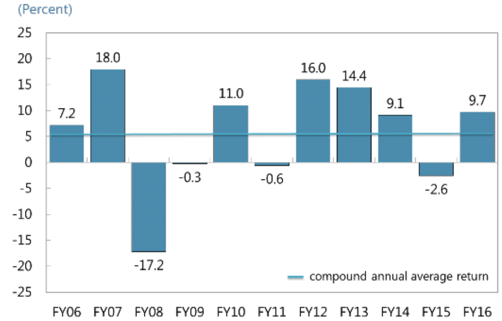
Compact Trust Fund (CTF)

1. The CTF was created in 2004 to contribute to the long-term budgetary self-reliance of the FSM. The CTF aims to provide the FSM with an ongoing source of revenue after Compact grants—in the amount of about US$80 million (20 percent of GDP)—are scheduled to expire after FY2023.

2. Contributions and structure of the CTF. The value of the CTF was US$467 million as of end-FY2016. Beyond investment gains, this includes accumulated contributions of US$280 million from the United States and US$30 million from the FSM, as envisaged under the Compact. Starting from FY2024, annual investment gains of the CTF can be withdrawn to finance budget needs up to a limit equivalent to the expired grants.[2] In years when investment earnings are not sufficiently high to cover the expired grants, the C account of the fund can be used to make up for the shortfall.[3]

3. CTF performance. The current investment strategy of the CTF stipulates that 51 percent of the fund is invested in equities, while the rest is split between fixed income (19 percent) and alternative investments (30 percent). The CTF's compound average annual return between FY06 and FY16 was 5.4 percent, net of fees, performing exactly at its benchmark. Overall, returns have been volatile with negative returns in FY08, F09, FY11, and FY15.

FSM CTF: Annual Weighted Investment Return
(Percent)



Sources: Fiscal Year 2016 Annual Report and staff calculations

4. Governance of the CTF. The CTF is administered by an independent committee that exercises oversight and fiduciary responsibility over the fund. Three voting members on the committee are appointed by the United States (from Departments of Education, Interior, and State), and two by the FSM. A custodian bank (State Street Bank) and an investment advisor (Mercer Investment Management) help manage it.

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[1] Prepared by Anne Oeking.

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

[3] Annual investment earnings above 6 percent are transferred to the C account of the CTF, which is capped at three times the projected grant assistance in FY2023. As of end-FY2016, the C account held US$94 million in assets (around 40 percent of the cap).

5. Review of CTF. An independent external evaluation was conducted in FY2015, as a mid-point review of the 20-year build-up period that ends in FY2023. The review found the CTF to be generally well governed, its service provider performance in line with industry standards, and costs for investments and administrative services comparable to similar trust funds. It recommended moving the CTF toward a more conservative investment strategy, as the build-up period nears its end. The CTF committee is working with the investment adviser to apply a "glide path" toward that goal.

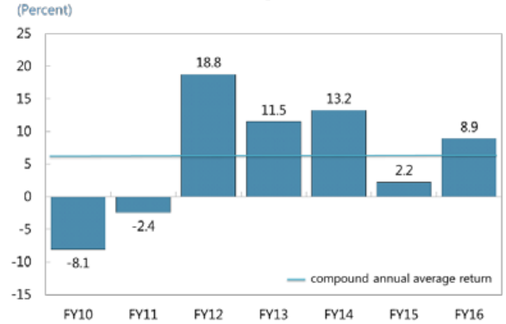
FSM Trust Fund

6. The FSM Trust Fund was created in 1999 to contribute to the long-term financial viability of the FSM and provide an additional revenue source. At end-FY2004, the accumulated balance of the FSM Trust Fund was transferred to the CTF as part of FSM's contribution to the CTF. The national government has invested in the FSM Trust Fund again since then, and has stepped up its contributions in recent years as it became clear that the CTF will not be sufficient to fully compensate for expiring Compact grants after FY2023. Amendments to the FSM Trust Fund Act in FY2016 specify that no funds can be withdrawn from the fund before FY2024 (Public Law 19–67). From FY2024 onwards, the fund's Board determines the maximum amount of available investment income for distribution to the government up to applicable limits.

7. Contributions and structure of the FSM Trust Fund. The value of the FSM Trust Fund was US$82 million as of end-FY2016. In the initial phase (from FY1999 to FY2004), the fund accumulated US$7 million, which was fully transferred to the CTF at end-FY2004. In the current phase (from FY2004 to present), new contributions amounted to US$68 million as of end-FY2016, of which US$66 million were contributed by the FSM government and US$2 million by China. Since FY2016, the national government has also been saving about US$5 million of tax revenue in the fund on behalf of states.

8. Fund performance. Between FY2010 and FY2016, the Fund's average compound annual return was 5.9 percent. During this period, net investment income was negative in FY10 and FY11.

FSM Trust Fund: Annual Weighted Investment Return
(Percent)



Sources: FSM Economic and Fiscal Update June 2017 and staff calculations

9. Governance of the Fund. The fund is to be governed by a Board of Trustees with five members nominated by the President with adequate geographical representation within the FSM, per Public Law 10–150. As the Board has not been established yet, the Secretary of the Department of Finance and Administration administers the fund on behalf of the Board. A custodian bank (Bank of New York Mellon) and an investment advisor (Wilshire Associates) help manage the fund.

10. Audit. An audit of the FSM Trust Fund by the National Public Auditor was conducted in 2015, and found several shortcomings. These include the lack of a Board of Trustees, lack of annual reports and audits, instances of improper maintenance of the books of accounts, and a transfer from the budget to the fund without an allotment, as required by law. The authorities have broadly agreed with these findings, and have established a procedure to ensure all budget transfers have an allotment.

Long-term Outlook

11. The staff's baseline scenario assumes a 5 percent nominal return on trust fund assets, broadly in line with the historical experience, and continued pace of contributions, as scheduled. Under this scenario, the combined assets of the CTF and the FSM Trust Fund are projected to reach US$1.2 billion at end-FY2023. Drawdowns from the trust funds for FY2024 and beyond are assumed at 3 percent of fund balances to maintain their value in real terms for future generations, with a 2 percent inflation adjustment. This would generate US$35 million of revenues in FY2024, representing a shortfall of US$45 million compared to expiring Compact grants (US$80 million). Hence, the fiscal position would deteriorate from a projected surplus of about US$30 million in FY2023 to an estimated deficit of US$15 million (4 percent of GDP) in FY2024. This does not consider the risk of subsequent fiscal shocks if the funds' nominal investment returns are weaker than 5 percent for several years. A 0.5 percentage point decline in long-term returns, compared to the baseline, would raise the deficit by 2 percentage points of GDP.[4]

[4] The buffer in the CTF's C Account could mitigate the risk of a revenue shortfall from weak investment returns for several years, but not permanently.

Appendix II. Main Recommendations of the 2015 Article IV Consultation

Fund Recommendations	Policy Actions
Fiscal Policy	
Formulate a medium- to long-term fiscal framework to achieve budgetary self-reliance in the post-2023 period.	The fiscal position improved with higher fishing license fees, but fiscal adjustment needs remain. The new administration has retained most recommendations of the "2023 Action Plan." A Debt Management bill was sent to Congress in 2016.
Undertake tax reform.	The FSM continues to have a very low tax-to-GDP ratio (one of the lowest in the Pacific). However, a pilot program supported by PFTAC to improve tax compliance has resulted in significant increase in tax collections in FY2015–16 (0.5 percent of GDP). Tax policy reforms are being revisited at the state level.
Extend Unified Revenue Authority (URA) to remaining two states (Pohnpei and Yap).	The URA Act was repealed in April 2015 amid objections of two states. However, there was progress with fiscal federalism in FY2016, with greater tax revenue sharing with states (with states' share of tax revenues rising from 50 to 70 percent).
Undertake expenditure reform.	The state governments continued to implement the Long-Term Fiscal Frameworks (LTFFs) that started in FY2014 to rationalize current spending. The national government completed a Public Expenditure and Financial Accountability (PEFA) self-assessment in November 2016 and are preparing a draft PFM Roadmap for 2017–20.
Transfer fiscal surpluses in full to the trust funds.	The authorities have been contributing to the FSM Trust Fund beyond their initial commitment in the Action Plan. Since FY2016, they have been making annual contributions of US$10 million on behalf of the national government and US$5 million on behalf of states. In FY2015, they have saved most of the windfall corporate tax gain. They have allocated about $60 million (20 percent of GDP) to the FSM Trust Fund over the last three years (FY2014–16).
Update infrastructure development plan (IDP).	The IDP was updated in FY2015, after which Compact infrastructure grants were made available again. The new IDP (for FY2016-25) is prioritized with each project ranked at the state level. It identifies projects linked to climate change adaptation.
Private Sector	
Increase efforts at land reform, including by expediting the land survey and registration.	Given long-standing issues, there has been little progress with land reform.
Enhance tourism development.	Nan Madol was designated as a UN World Heritage site in 2016. The national government, in consultation with states, completed the National Tourism Policy in accordance with sustainable tourism principles, and submitted it to Congress. In line with this policy, four State Tourism Investment Plans were completed. During FY2016-17, Congress appropriated US$4 million for financing of these plans.
Improve the business environment and promote inward foreign direct investment.	An amended Foreign Investment Act has been submitted to Congress, which would streamline the FDI process and establish an Investment Promotion Agency. With assistance from donors, renewable energy projects are being implemented across all states. Once completed, these projects will lower the cost of electricity, reduce reliance on diesel imports, and improve the external position. There are plans for a coconut rehabilitation project.
Financial Sector	
Strengthen the regulatory framework.	The authorities have prepared a new Credit Union Act that will expand the supervisory oversight of the Banking Board to credit unions. The draft legislation is awaiting submission to Congress.
Statistical capacity	
Improving the reliability, coverage, and timeliness of economics statistics.	TA from the Fund and PFTAC is building statistical capacity. In FY2016, FSM began to compile and report FSI data for the banking sector. In FY2017, the authorities implemented the enhanced General Data Dissemination System (e-GDSS).

Appendix III. MDG and Strategic Surveillance Matrix

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

Sources: 2015 Pacific Regional MDGs Tracking Report, Pacific Islands Forum Secretariat
1/ This assessment was partly due to data gaps to measure progress.

Multi-year Surveillance Matrix including SDG 1/

Issues to Cover	Macro-criticality	Traction with authorities	Article IV Agenda	Background work
1. Traditional macroeconomic Issues (Real, Fiscal, BOP, MON)	H	H	X	
Issues for Further Integration				
2. Macro-financial Issues 2/				
2-1. Capital Inflows and Spillovers	L	L		
2-2. Financial Development, Deepening and Inclusion	M	M		
2-3. Financial Cycle and Macro-implications	L	L		
2-4. Balance Sheet Analysis	N/A	L		
2-5. Macro-prudential Policy	N/A	L		
2-6. Financial Supervision and Regulation	H	H	X	Financial inclusion
2-7. Macroeconomic Shocks and Financial Stress	N/A	L		
3. SDGs/FfD Commitments				
3-1. Domestic Revenue mobilization	H	H	X	Fiscal reform
3-2. Infrastructure Investment	M	M		
3-3. Building Policy Space/Economic Resilience	H	M	X	Climate change/trust funds
3-4. Environmental Sustainability, Equity/Inclusion	M	M		
3-5. Fragile and Conflict-Affected States need	N/A	N/A		
3-6. Domestic Financial Market Promotion	H	M	X	Private sector development
3-7. Data Enhancement	H	H	X	STA TA follow-up
4. Fund's New "Core" Issues				
4-1. Gender	L	L		
4-2. Income Inequality	M	M	X	
4-3. Climate Change	H	H		Climate change

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

2/ Based on MCM Assessment of Pilot Countries' Reports

Appendix IV. Risk Assessment Matrix[1]

Risk		Relative Likelihood	Impact if Realized	Potential Impact	Staff Advice on Policy Response
External risks	Natural disasters and climate change	H	H	Growth slowdown due to impairment of infrastructure (flooding), weaker agricultural production (droughts or flood), impaired fishing activity	**To minimize exposure**: Ensure fiscal buffers. Develop contingency plans from diverse sources. **If risk materializes**: Changes in the composition of public expenditure or additional revenues would be needed to finance reconstruction (may require additional foreign aid).
	Persistently low rates of return on financial assets in the trust funds below 5 percent in nominal terms	L-M	M	A 0.5 percent decline in the expected return on trust fund assets would require about 2 percentage points of GDP in additional fiscal consolidation.	**If risk materializes:** Additional fiscal savings should be saved to ensure long-term sufficiency of the trust funds in real terms beyond FY2023.
	Lower energy prices	L	M	Improvement in current account, moderate positive impact on growth.	**If risk materializes**: Fiscal savings from lower energy prices should be saved to ensure long-term sufficiency of Trust Funds in real terms beyond FY2023.
Domestic risks	Delays in infrastructure projects	M	H	Short-term growth would be adversely affected.	**To minimize exposure**: A Public Investment Management Assessment (PIMA) could help identify bottlenecks. **If risk materializes**: Further technical assistance on project implementation could be requested from relevant international organizations.
	Faster progress on fiscal reforms	M	H	Fiscal position deteriorates less than expected due to implementation of measures under the 2023 Action Plan.	**If risk materializes**: Additional fiscal savings should be saved to ensure long-term sufficiency of the trust funds in real terms beyond FY2023.

[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. The blue arrows indicate whether the risk is to the upside or downside. All risks are medium-term risks, except for the lower energy scenario which is a short to medium-term risk.

Appendix V. 2016 External Sector Assessment[1]

The external sector position is weaker than fundamentals and desirable policies. The expiration of U.S. Compact grants will lead to a large structural change in FY2024. Taking into account the policy gap related to the real value of the trust funds calls for having larger buffers and a stronger external position now.

1. External position. The FSM's net international investment position has strengthened to an estimated US$235 million in FY2016, based on increases in portfolio investment assets. The current account balance has improved over the last years, turning from a deficit of 10 percent of GDP in FY2013 to a surplus of 3 percent of GDP in FY2016, with the large trade deficit offset by official transfers and fishing license fees. To build buffers for the post-FY2023 period, when Compact related transfers expire, the external position needs to be further strengthened.

2. External balance assessment. The standard IMF methodology (the EBA-lite assessment framework) is not fully suitable for the FSM due to the structural break after FY2023, data limitations which results in large margins of statistical variation around the estimates, and the special characteristics of its economy, most notably the heavy dependence on grants. Staff estimated the underlying current account to try and capture the structural change after FY2023, considering the staff's estimated fiscal adjustment need of 4 percent of GDP to maintain the real value of trust funds after FY2023 and increase the net international investment position (NIIP).

- **The external sustainability approach**, as the most appropriate model, estimates a current account norm (including official transfers) of 2.3 percent of GDP compared to an underlying current account deficit of 1 percent of GDP at end-FY2016. Hence, with a current account gap of -3.3 percent of GDP, the external position is assessed as weaker than fundamentals and desirable policies, which is consistent with the need for more buffers.

- **The current account approach** provides similar results but is less applicable due to the structural break in FY2023.

- **The REER approach** is not applied because it cannot take into account the structural break and due to data limitations.

3. Reserves. With no central bank or foreign exchange reserves, government deposits serve as the means to absorb short-term liquidity shocks. The central government deposits were around 20 percent of GDP in 2016, which corresponds to 4 months of imports and 5 months of general government current spending. This is higher than the one month of government spending proposed by Wiegand (2013) as a standard yardstick for fiscal reserves.

4. External financing. While the trade balance has had a large deficit, it has been more than offset by official transfers and fishing license fees. Compact-related grants will continue to provide a

[1] Prepared by Anne Oeking.

stable source of funding until FY2023. Fishing license fees have stabilized around 20 percent of GDP over the last three years and are expected to remain broadly unchanged under current policies.

5. Competitiveness. The FSM's manufacturing unit labor cost has increased, outpacing the United States in recent years. This is due to the FSM facing a shortage of skilled workers, aggravated by ongoing migration of workers to the United States, reflecting the wage differential which is a strong incentive for migration for the FSM citizens who can work and study in the United States without a separate permit under the Compact Agreement. Such developments do not necessarily worsen external stability as manufacturing exports are already very small and because migration to the United State can increase remittance inflows.

FSM: Unit Labor Cost
(Index, 2009=100)

Sources: FSM authorities, FRED; and IMF staff calculations.
FSM employment and wage data for the manufacturing sector proxied by total private sector.

INTERNATIONAL MONETARY FUND

FEDERATED STATES OF MICRONESIA

August 4, 2017

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

Asia and Pacific Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of June 30, 2017)

Membership Status: Joined June 24, 1993; accepted Article VIII

General Resources Account:

	SDR Million	Percent Quota
Quota	5.10	100.00
Fund holdings of currency	5.10	100.00
Reserve tranche position	0.00	0.01

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	4.81	100.00
Holdings	6.23	129.67

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to Fund[1]

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

	Forthcoming				
	2017	2018	2019	2020	2021
Principal					
Charges/Interest		0.00	0.00	0.00	0.00
Total		0.00	0.00	0.00	0.00

Exchange Rate Arrangement

The de jure and de facto exchange rate arrangement is an arrangement with no separate legal tender. The U.S. dollar is legal tender and the official currency. The Federated States of Micronesia maintains an exchange system that is free of restrictions on international payments and transfers for current and capital transactions.

Article IV Consultation

The Federated States of Micronesia is on a 24–month consultation cycle. The 2015 Article IV consultation discussions were held during March 9–20, 2015. The Executive Board discussed the staff report and concluded the consultation on May 11, 2015.

Technical Assistance: STA, MCM, LEG, and PFTAC have provided technical assistance on statistics, banking supervision, tax policy and administration, and combatting of financial crime.

Resident Representative: Mr. Tubagus Feridhanusetyawan has been the Resident Representative for Pacific Island countries since September, 2014. He is based in Suva, Fiji.

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

RELATIONS WITH THE WORLD BANK

The World Bank and the IMF country teams maintain a close working relationship and have an ongoing dialogue on a range of macroeconomic and structural issues. The teams agreed that FSM's main macroeconomic challenges are to prepare for the expiration of Compact grants after FY2023. To achieve this goal, the FSM needs a prudent fiscal adjustment plan. In parallel, improving the business environment, such as through removing structural impediments in energy and telecommunication sectors, will support private sector development. The following structural reform areas are macro-critical, in view of their central role in achieving long-term budgetary self-reliance and sustained growth:

- **Public financial management.** The FSM invited PFTAC in 2016 to assist in the preparation of a Public Expenditure and Financial Accountability (PEFA) self-assessment for the national government, which is developing a roadmap to strengthen public financial management. The World Bank is preparing a project that will help the national and state governments strengthen budget execution and financial reporting systems.

- **Investment climate.** The FMS's investment climate remains challenging, hindering the private sector to become an engine of growth. The World Bank is assisting in the areas of energy, fisheries, and telecommunications, in cooperation with other donors.

The specific activities planned in the coming year are the following:

- Strengthening budget execution and financial reporting systems in the FSM (preparation)

- Maritime transport sector - (preparation)

- FSM-Palau connectivity project (ongoing)

- FSM energy sector development project (ongoing)

- Pacific islands regional oceanscape program - FSM (ongoing)

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

1. **Since 1990, the Asian Development Bank (AsDB) has been work with the Federated States of Micronesia (FSM).** Its assistance has comprised of ten loans amounting to US$84.2 million and 51 technical assistance projects worth US$23.4 million.[2] Through its engagement with the FSM, AsDB has supported good governance, focusing on economic management and accountability; infrastructure development, including renewable energy; provision of social services; and stimulating private sector activity. As of January 2017, the FSM has been reclassified as a Group A country under the AsDB's country classification system and is now eligible for 100 percent grant financing through the Asian Development Fund (ADF).

2. **In line with the FSM's policy priorities, the AsDB supports: (i) developing key growth drivers; (ii) providing efficient and sustainable infrastructure; and (iii) establishing better public sector management** through its Country Partnership Strategy with the FSM (Pacific Approach 2016–20). AsDB is exploring support for developing sustainable ecotourism, while also continuing parallel complementary efforts to improve the business environment and encourage private investment. AsDB's infrastructure investments include projects for water and sanitation, renewable energy and improving the efficiency of power utilities, and basic education services. Technical assistance and policy dialogue continue to focus on measures to improve policymaking at both the national and state governments, including support for public administration reforms and tourism strategy and planning.

3. **Currently, there is only one active AsDB loan.** The Yap Renewable Energy Development project (totaling US$9 million), approved in 2013, focuses on the development of renewable energy to reduce dependency on imported diesel fuel, and raising energy efficiency on the supply side of the electricity grid. Project resources are also being utilized to support capacity development of the Yap power utility.

4. **AsDB's assistance pipeline includes the regional project of Improving Quality of Basic Education in the North Pacific**, which covers the FSM and the Marshall Islands. Ongoing technical assistance provides support for public administration reforms at the FSM state-level through the preparation of a medium-term public sector reform plan.

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[2] The ten loans are for: (i) fisheries development project; (ii) water supply and sanitation project; (iii) public sector reform program; (iv) basic social services project; (v) private sector development program; (vi) private sector development project; (vii and viii) omnibus infrastructure development project (OCR and ADF); and (ix and x) Yap renewable energy development project (OCR and ADF).

Table 1. Loans to the Federated States of Micronesia, by Sector
(In millions of U.S. dollars, at end-2016)

Sector	No.	Amount
Agriculture and Natural Resources	1	6.5
Energy	2	9.0
Industry and Nonfuel Minerals	0	0.0
Transportation	0	0.0
Communications	0	0.0
Law, Economic Management and Public Policy	3	31.0
Water Supply, Sanitation & Waste management	3	29.6
Multisector	1	8.0
Other	0	0.0
Total	10	84.2
Memorandum:		
Technical Assistance Provided	51	23.4

Table 2. Loan Approvals and Disbursements to the FSM, 2007–16
(In millions of U.S. dollars)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	1990–2016
Loan Approvals	0.0	0.0	0.0	0.0	0.0	0.0	9.0	0.0	0.0	0.0	84.2
Loan Disbursements	3.5	3.6	0.8	1.0	6.3	2.6	3.0	3.1	2.0	5.4	48.6
Undisbursed Balance (at end of the year)	29.7	23.8	19.0	17.7	11.5	8.9	15.0	11.5	9.1	3.7	
Memorandum: TA Approval	0.4	0.8	0.0	0.0	0.7	1.1	0.2	0.6	0.5	0.0	23.4

RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE

Background

FSM has been a moderate user of PFTAC technical assistance (TA). Most recent support has been of a fiscal nature covering both public financial management (PFM) and revenue reforms, as well as support with government finance statistics and national accounts statistics. With the Unified Revenue Agency establishment reversed in 2015, efforts have been redirected to strengthening core tax administration functions. Following the Public Expenditure and Financial Accountability (PEFA) assessment in November 2016, PFM support is now directed towards developing a PFM roadmap. Fiscal support will continue into FY2018, in addition to support financial sector supervision. The volume of TA planned for FY2018 expected to marginally increase from FY2017.

Strategy 2017–18

PFTAC's TA strategy is guided by the Fund's overall capacity development framework and APD's Regional Strategy Note (RSN) and is consistent with the PFTAC's results framework.

PFTAC TA aims to support the authorities continue to move towards long-term fiscal sustainability. Activities will focus on assisting the authorities achieve tangible results from the foundations laid with previous PFTAC assistance, with an emphasis on strengthening tax compliance. Financial sector support will increase over recent levels.

In the PFM area, the focus will be on supporting the authorities to develop a PFM roadmap following the November 2016 PEFA assessment. Activities to support the roadmap's implementation in the medium-term will be planned in coordination with other partners, including the AsDB. These are expected to include strengthened monitoring of state-owned enterprises and state governments, and multi-year budgeting.

In the tax administration area, the authorities have indicated that they would proceed with administrative reforms which commenced with PFTAC: (a) facilitating the design of a Compliance Improvement Strategy; and (b) assisting to strengthen on-time filing and payment and management of arrears and outstanding returns. Technical assistance scheduled FY2018 will continue to focus on core tax functions.

In the financial supervision area, PFTAC is assisting the Banking Board in enhancing its regulatory framework for banks and providing training on supervision of key banking risks. The Banking Board attended PFTAC's Regulatory Framework Workshop in July 2017, where TA was provided to enhance banking legislation and prudential standards, in line with current international practice. The Banking Board has also requested training for bank examiners, which PFTAC has earmarked for FY2018.

In the area of statistics, the FSM implemented the enhanced General Data Dissemination System (e-GDDS) in July 2017, with support from the IMF's Statistics Department. PFTAC will continue to support enhancements in national accounts and provide hands-on annual training in compilation methods, provided that staffing remains adequate in the Statistics Office. For Government Finance Statistics (GFS), FSM received TA and training under the Japan Funded Administered Account (JSA 1) for selected Asia and Pacific countries up to October 2015. With the conclusion of the JSA 1 project, PFTAC, in collaboration with IMF headquarters, assumed the responsibility for delivery, staffing, and funding of GFS capacity development. The most recent GFS mission was in October 2016 and focused on expanding the coverage of GFS data and increasing the frequency of reporting for the budgetary central government. On external sector statistics (ESS), a PFTAC mission is tentatively planned for later 2017 to assess the progress made since the last ESS mission in November 2015.

In macroeconomics, no direct input is currently anticipated. However, support to forecasting of long-term economic and fiscal scenarios may be provided, in cooperation with other TA providers.

STATISTICAL ISSUES

Table 1. Federated States of Micronesia: Statistical Issues Appendix
As of July 19, 2017

I. Assessment of Data Adequacy for Surveillance

General: Data provision has serious shortcomings that significantly hamper surveillance. While coverage of key macroeconomic data is broadly sufficient (except external sector statistics), they are not compiled in a timely manner. Most affected areas are: national accounts and external sector statistics, where data are compiled annually with nearly a year lag. This makes it difficult to make accurate and timely evaluation of economic developments on an ongoing basis. To improve data dissemination, the authorities implemented the enhanced General Data Dissemination System (e-GDDS) in July 2017, with technical assistance from STA.

National accounts: National accounts have been prepared, with the support of the U.S. Graduate School, dating back to FY1995. Annual GDP estimates based on the production and income approaches are compiled and released with a lag of 11 months. GDP data have not been rebased for more than 10 years (current base year is FY2004). A national census was conducted in 2010 and a household survey in 2013. GDP estimates based on the expenditure approach are not compiled, leading to a lack of investment/savings indicators. Fixed ratios are used in estimating value added for private sector operating surplus. The authorities are planning to conduct a business survey that would help with the rebasing of GDP.

Employment: Data on employment and wages are available on an annual basis and classified by sectors based on the filings to Social Security Administration. However, no unemployment data are available except for 2013 when the household survey was conducted.

Price statistics: A quarterly consumer price index (CPI), rebased to 2008Q2 and utilizing expenditure weights derived from an earlier household survey, is published for the FSM and for each state. However, data releases are often delayed. The authorities are in the process of rebasing the CPI.

Government finance: Fiscal data for the central and general government have been prepared, with the support of U.S. Graduate School, going back to FY2004. Data are compiled in line with *Government Finance Statistics Manual 2001 (GFSM 2001)* based on annual audit reports of the national and state governments. The fiscal accounts are consolidated between the national and state governments. However, government agencies and local governments (municipalities) are not covered. Work to improve coverage and periodicity of fiscal data submitted to the Government Financial Statistics Yearbook is continuing, with PFTAC support.

Monetary statistics: The Banking Board compiles monthly monetary data with a three-month lag. The data comprise interest rates, the accounts of commercial banks, and the FSM Development Bank. The depository survey data are not compiled with standardized report forms (SRFs), hindering international comparability.

Financial sector surveillance. The FSM started compiling Financial Soundness Indicators (FSIs) data in 2016 (data are available on a quarterly basis going back to 2013). The FSM also participates in the Financial Access Survey (FAS), with data going back to 2004. Both data are often reported with delays.

External sector statistics: The authorities compile annual balance of payments and international investment position statistics in broad conformity with the sixth edition of the *Balance of Payments and International Investment Position (BPM6)*. However, there are persistent large errors and omissions in the balance of payments, which complicate the assessment of external sustainability. The coverage and classification of imports of goods, personal transfers, direct investment liabilities, and public external assets require enhancements. A PFTAC technical assistance mission is planned for 2017 to follow up on these shortcomings.

II. Data Standards and Quality

Participant in the Fund's General Data Dissemination System (GDDS) since November 2014. Implemented the enhanced GDDS (e-GDDS) in July 2017. The National Summary Data Page (NSDP) is available at: http://www.fsmstats.fm/?page_id=605	Data ROSC is not available.

Table 2. Federated States of Micronesia: Table of Common Indicators Required for Surveillance
As of July 19, 2017

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

[1] The U.S. dollar is legal tender and the official currency.
[2] Includes the interest rate on consumer loans and commercial loans, as well as deposit rates.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra-budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).

Table 3. Federated States of Micronesia: Data Adequacy for Surveillance and Dissemination Practices Compared with the e-GDDS Framework

Data Category	Methodology			Periodicity		Timeliness		Advance Release Calendar
	Base year	Coverage (adequate)	Other	e-GDDS	FSM	e-GDDS	FSM	
Real Sector 1/								
National accounts (GDP)	>10Y	Yes	Exp. approach; fixed ratios	Q	A	1Q	11M	No
Consumer price index (CPI)	>5Y	Yes	...	M	Q	2M	1Q-3Q	No
Fiscal Sector 2/								
General government operations	...	Broadly	...	A	A	3Q	11M	No
Central government operations	...	Yes	...	Q	A	1Q	3Q	No
Central government gross debt	...	Yes	...	Q	A	2Q	3Q	No
Financial Sector 3/								
Depository corporations survey	...	Yes	Classification (no SRFs)	M	M	1Q	3Q	No
Central bank survey (not applicable)								
Interest rates	...	Yes	...	M	M	...	3Q	No
Stock market (not applicable)								
External Sector 4/								
Balance of payments	...	Partially	...	Q	A	1Q	11M	No
External debt	...	Yes	...	Q	A	2Q	11M	No
Foreign exchange reserves (not applicable)								
Merchandise trade	...	Duty-free imports	...	M	A	12W	11M	No
International investment position (IIP)	...	Partially	...	A	A	3Q	11M	No
Exchange rates (not applicable)								
Supplementary Data								
Labor market	...	Yes	...	A	A	3Q	11M	No
Financial soundness indicators (FSI)	...	Yes	...	Q	Q	1Q	1Q-3Q	No

Note: The timeliness benchmark is typically three quarters (3Q) for annual data and one quarter (1Q) for quarterly data.

1/ Annual GDP data are compiled and released with a lag of 11 months, which complicate timely assessment of economic developments. GDP data have not been rebased for more than 10 years (current base year is FY2004). GDP estimates based on the expenditure approach are not compiled, leading to a lack of investment/savings indicators. Fixed ratios are used in estimating value added for private sector operating surplus. The CPI is compiled quarterly, but is often disseminated with long lags. The CPI has not been rebased for more than 5 years.

2/ The FSM compiles fiscal data for central and general government operations based on GFSM 2001. The fiscal accounts are consolidated between the national and state governments. However, government agencies and local governments (municipalities) are not covered.

3/ The FSM does not have a central bank and uses the U.S. dollar as legal tender. The depository survey data are not compiled with standardized report forms (SRFs), hindering international comparability. The FSIs are being compiled since 2016, but disseminated with occasional long lags.

4/ The FSM reports balance of payments and international investment position statistics in broad conformity with BPM6. However, the coverage and classification of imports of goods, personal transfers, direct investment liabilities, and public external assets require enhancements. In particular, the coverage of imports data suffers from non-inclusion of duty-free imports.

INTERNATIONAL MONETARY FUND

FEDERATED STATES OF MICRONESIA

August 4, 2017

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

Approved By
Alison Stuart and Zuzana Murgasova (IMF), and John Panzer (IDA)

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

The 2017 Debt Sustainability Analysis (DSA) assesses that the Federated States of Micronesia (FSM) remains at high risk of debt distress. Currently, the ratios of the present value (PV) of external public and publicly-guaranteed debt to GDP and exports are below their respective policy-dependent thresholds. However, they are expected to exceed the thresholds over the projection horizon. Moreover, for most indicators of external debt, thresholds would be breached under stress test scenarios. Although the FSM does not currently face any debt servicing risks due to the concessionality of debt obligations and access to stable flow of funds from Compact grants until FY2023, vulnerability to natural disasters and climate change call for a prudent debt management strategy. Containing the risk of debt distress requires continuation of grants to support the country's large development needs, and implementation of fiscal and further structural reforms to promote fiscal sustainability and growth.

[1] This DSA was prepared jointly with the World Bank, in accordance with the standard Debt Sustainability Framework for Low-income Countries approved by the Executive Boards of the IMF and the IDA. Debt sustainability is assessed in relation to policy-dependent debt burden thresholds. The FSM, with an average Country Policy and Institutional Assessment (CPIA) score of 2.7 over the last three years, is considered to have weak policy and institutional capacity for the purposes of the DSA framework, and assessed against relatively lower debt thresholds. Thus, the external debt burden thresholds for the FSM are (i) PV of debt-to-GDP ratio: 30 percent; (ii) PV of debt-to-exports ratio: 100 percent; (iii) PV of debt-to-revenue ratio: 200 percent; (iv) debt service-to-exports ratio: 15 percent: and (v) debt service-to-revenue ratio: 18 percent.

BACKGROUND

1. The FSM is a small state in the North Pacific with a total population of around 100,000. It is dependent on external grants and fishing license fees to finance public spending. The loosely federated structure of the country makes policy decisions difficult.

2. The FSM faces a long-term fiscal challenge as U.S. grants provided under the Compact of Free Association (Compact grants) will expire FY2024 onward, while the private sector is yet to become the engine of growth. Part of the Compact grants has been disbursed into the Compact Trust Fund (CTF), jointly managed by the U.S. and the FSM, with the goal that returns from the trust fund would contribute to the FSM's fiscal sustainability after FY2023. The FSM has also been accumulating assets in its own trust fund (FSM Trust Fund), especially in recent years. The current trajectory of the CTF is not on track to compensate for expiring Compact grants in FY2023. The FSM Trust Fund can only partially offset the shortfall.

3. The FSM's debt management has been relatively prudent. The FSM's external public and publicly guaranteed (PPG) debt has been declining gradually from a peak of 31 percent of GDP in FY2009 to 25 percent in FY2016 (21 percent on present value terms). Most of the debt is concessional and is contracted with official lenders. About two-thirds is from the Asian Development Bank (ADB) and thirty percent from the U.S. Department of Agriculture (Rural Utilities Services). The rest of the debt (4 percent of the total) is from the European Investment Bank (EIB) and a commercial lender (telecom vendor). All loans, except for the EIB loan, are denominated in U.S. dollars, the legal tender and official currency in the FSM. At 25 percent of GDP, FSM's total public debt remains below the relevant benchmark of 38 percent, but stress tests suggest the benchmark could be breached with extreme shocks (see paragraph 9).

UNDERLYING ASSUMPTIONS

4. The key assumptions are consistent with the macroeconomic framework set out in Box 1. The baseline scenario assumes a long-run real GDP growth rate of 0.6 percent, based on the historical track record of the FSM since FY2000. This reflects the impact of natural disasters, as the FSM experienced seven natural disasters during this period. The fiscal surplus is projected to decline gradually and turn into deficit of 4 percent of GDP in FY2024, when Compact grants expire. On the revenue side, Compact grants are projected to decrease in real terms until FY2023, as scheduled, while grants from other donors are expected to remain stable as a percentage of GDP. The tax-to-GDP ratio is assumed to remain unchanged, as the baseline scenario does not assume tax reforms. Fishing licenses fees are assumed to remain stable in nominal terms.[2] The wage bill is assumed to grow in line with the Compact current grants until FY2023 and then in line with the nominal GDP. Concessional loans from bilateral and multilateral sources are expected

[2] Fishing license fees have stabilized in the range of US$60-65 million (about 20 percent of GDP) over the last three years (FY2015-17). The Parties to the Nauru Agreement (PNA), a regional agreement that sets minimum benchmark fees for fishing companies operating in the region, is not requiring further increases in the minimum rates.

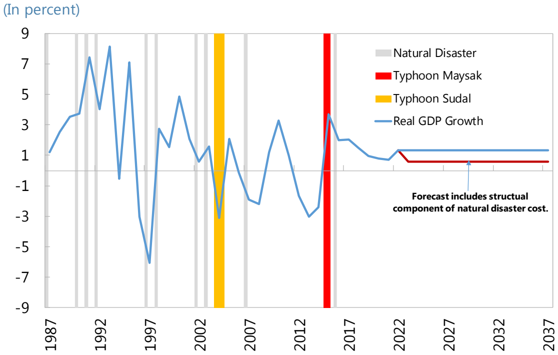
to finance one-third of public investment starting in FY2024 to safeguard priority development spending.[3]

INCORPORATING THE IMPACT OF NATURAL DISASTERS

5. The FSM is vulnerable to natural disasters and the adverse effects of climate change. In 2015, Typhoon Maysak struck Chuuk and Yap resulting in 5 deaths and losses of US$11 million (4 percent of GDP). In 2004, Typhoon Sudan caused extensive damages to public and private properties, food crops and private homes. In July 2002, Tropical Storm Chata'an severely affected Chuuk state, causing floods and landslides that killed 47 and injured over 100. The Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI) estimates that the FSM is expected to incur a severe tropical typhoon every 20 years resulting in losses and damages of 10 percent of GDP.

6. These major long-term costs and risks are incorporated into the DSA to assess how they impact FSM's fiscal position and debt sustainability. Accordingly, the baseline scenario considers the impact of future natural disasters, in line with the 2016 IMF Board Paper on "Small States' Resilience to Natural Disasters and Climate Change."[4] From 2017–2021, staff's projections assume no natural disasters, in line with the guidance from the Board Paper. This ensures that adjustments for natural disasters do not complicate the near-term policy discussions. However, for a realistic assumption over the longer horizon, the baseline projections after 2021 take into account the average annual impact of natural disasters by adjusting downward the average growth rate. In particular, long-term growth is adjusted down by 0.5 percentage points (to 0.6 percent, compared with a non-disaster potential growth rate of 1.1 percent). This approach is illustrated in the text figure.[5] In addition, occurrences of natural disasters are incorporated in the DSA through the standard contingent liability shock scenario, given PCRAFI estimates that the FSM is expected to incur a typhoon that would lead to losses and damages of 10 percent of GDP over 20 years.[6]

GDP growth
(In percent)



Sources: Country authorities; and IMF staff calculations.

[3] This is in line with the FSM's Policy for Overseas Development Assistance ("ODA Policy"), adopted in 2013, which specifies that loans shall only be considered if concessional and estimated economic returns outweigh the costs.

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

[5] The baseline scenario projects long-term growth at 0.6 percent, based on the historical track record of the FSM since FY2000 (see Box 1). This reflects the impact of natural disasters, as the as the FSM experienced seven natural disasters during this period. Excluding disasters years, the historical growth average was 1.1 percent.

[6] The debt sustainability framework includes a standard contingent liability shock scenario—a 10-percent-of-GDP increase in debt creating flows—that is modelled after a generic contingent liability shock (IMF, 2013). The impact of the shock is shown in Tables 2 and 4 under bound tests 6 and 5, respectively.

EXTERNAL DEBT SUSTAINABILITY ANALYSIS

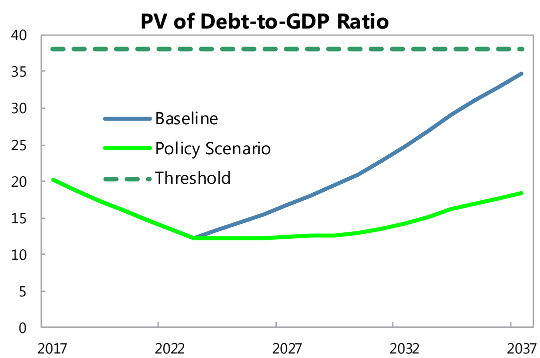
7. **Under the baseline scenario, FSM's breaches indicative external debt thresholds over the projection horizon**. The PV of external debt-to-GDP ratio is expected to exceed the threshold of 30 percent in FY2035, while the ratio of PV of external debt-to-exports is expected to exceed the threshold of 100 percent in FY2034.[7] However, as the bulk of external debt is on concessional terms, the debt service to export ratio will remain below the relevant threshold.

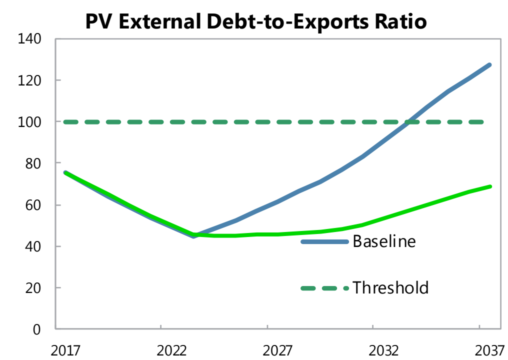
8. **Stress tests confirm the vulnerability of the debt position, particularly to natural disasters**. The most extreme shock scenarios reflect the effect of natural disasters, incorporated in the DSA through the standard contingent liability shock scenario. Under this scenario, the PV of the external debt-to-GDP ratio would exceed the threshold earlier than in the baseline, particularly in FY2032. The PV of the external debt-to-exports ratio would exceed the threshold in FY2030. In a scenario under which key macroeconomic variables follow their historical averages, the thresholds would also be breached. [8]

PUBLIC DEBT SUSTAINABILITY ANALYSIS

9. **Public debt follows very closely the dynamic of external debt.** Under the baseline scenario, the PV of public debt-to-GDP ratio is projected to increase from 21 percent of GDP in FY2016 to 35 percent of GDP in FY2037, but remain below the benchmark of 38 percent.[9] Debt dynamics are particularly sensitive to growth shocks. Under the most extreme shock, the PV of debt-to-GDP and debt-to-revenue would remain on an upward trend. Under a shock to the primary balance, the debt service-to-revenue ratio would also keep growing throughout the projection period.

10. **Policy action including fiscal and structural reforms would greatly reduce the risk of debt distress.** Under the alternative scenario with policy actions, potential GDP growth is assumed to be higher than the baseline by ½ percentage points. Furthermore, the implementation of fiscal reforms including





[7] In the 2015 DSA, the PV of external debt-to-GDP ratio was projected to exceed the threshold of 30 percent in FY2030, while the PV of external debt-to-export ratio was projected to exceed threshold of 100 percent in FY2027.

[8] The historical scenario holds the set of key variables related to debt dynamics at ten-year averages. This does not appear to provide a relevant comparator to the baseline, given the recent structural changes in fiscal and current account balances due to higher fishing license fees obtained under the Parties to the Nauru Agreement (PNA).

[9] In the 2015 DSA, the PV of PPG debt-to-GDP ratio was projected to increase gradually from 22 percent of GDP in FY2014 to reach 32 percent of GDP in FY2034, but still below the threshold of 38 percent.

domestic revenue mobilization and expenditure reforms would eliminate the financing gap in the post-FY2023 period, resulting in less borrowing. Under this alternative scenario with policy actions, the debt indicators remain well below the threshold throughout the projection period.

AUTHORITIES' VIEW

11. The authorities agreed with the DSA findings, noting that the current risk of debt distress is high. They saw the need for fiscal adjustment and improvements in public financial management (PFM) to prepare for the scheduled expiration of Compact grants, as called for in their Action Plan 2023. However, they emphasized that these efforts, particularly tax reform, require broad support from states. They noted that a PFM roadmap is being developed, building on the Public Expenditure and Financial Accountability (PEFA) self-assessment in November 2016. Finally, they noted that a Debt Management bill is currently with Congress to further strengthen the institutional capacity to manage public debt.

CONCLUSION

12. The standard DSA framework for LICs assesses the FSM to remain at high risk of debt distress. The baseline scenario indicates that the PV of external debt-to-exports ratios could breach the threshold in FY2034, while the PV of external debt to GDP crosses threshold in the following year. Stress tests confirm the vulnerability of the debt position to export shocks. However, FSM's vulnerability to debt distress is partly alleviated by several factors. Most debt is on concessional terms from development partners, and the authorities are building up trust funds that can provide a source of funding to partly offset expiring Compact grants after FY2023.

Box 1. Baseline Macroeconomic Assumptions

The key assumptions of the 2017 DSA are consistent with the macroeconomic framework outlined in the 2017 Article IV Report. Relative to the previous DSA, short-term indicators have improved somewhat mainly due to the upward revision of fiscal revenues, notably from fishing license fees, but the long-term dynamics remain broadly unchanged.

GDP growth in the long-run is projected at around 0.6 percent, which is based on historical experience (including years with natural disasters).[1]

The GDP deflator is expected to remain 1 percentage points below CPI inflation, consistent with historical trends. CPI inflation is projected to follow the U.S. rate of inflation.

The overall fiscal surplus will decline gradually and turn into deficit of 4 percent of GDP in FY2024, when Compact grants expire. On the revenue side, Compact grants in real terms are projected to decrease as scheduled, while grants from other donors are expected to remain stable as a percent of GDP. The tax revenues-to-GDP ratio is assumed to remain broadly unchanged, as the baseline scenario does not assume tax reforms. Fishing licenses fees are assumed to remain stable in nominal terms. The wage bill is assumed to grow in line with the Compact current grants until FY2023 and then in line with the nominal GDP.

External financing: In the absence of access to the international capital market and a very limited domestic market, the financing gap is assumed to be financed by a combination of grants from development partners and bilateral concessional lending. Concessional loans from bilateral and multilateral sources are expected to finance one-third of public investment starting in FY2024 to safeguard priority development spending.

The Compact Trust Fund and the FSM Trust Fund are projected to yield an average nominal return of 5 percent.[2] Drawdowns from the trust funds will start from FY2024 onward. The baseline scenario assumes that the real balance of the combined trust funds is kept intact.

The **current account balance (including official transfers)** is expected to worsen gradually from a surplus of 3 percent of GDP in FY2016 to a deficit of 4 percent of GDP by FY2024. The deficit is assumed to be financed by bilateral and multilateral concessional loans.

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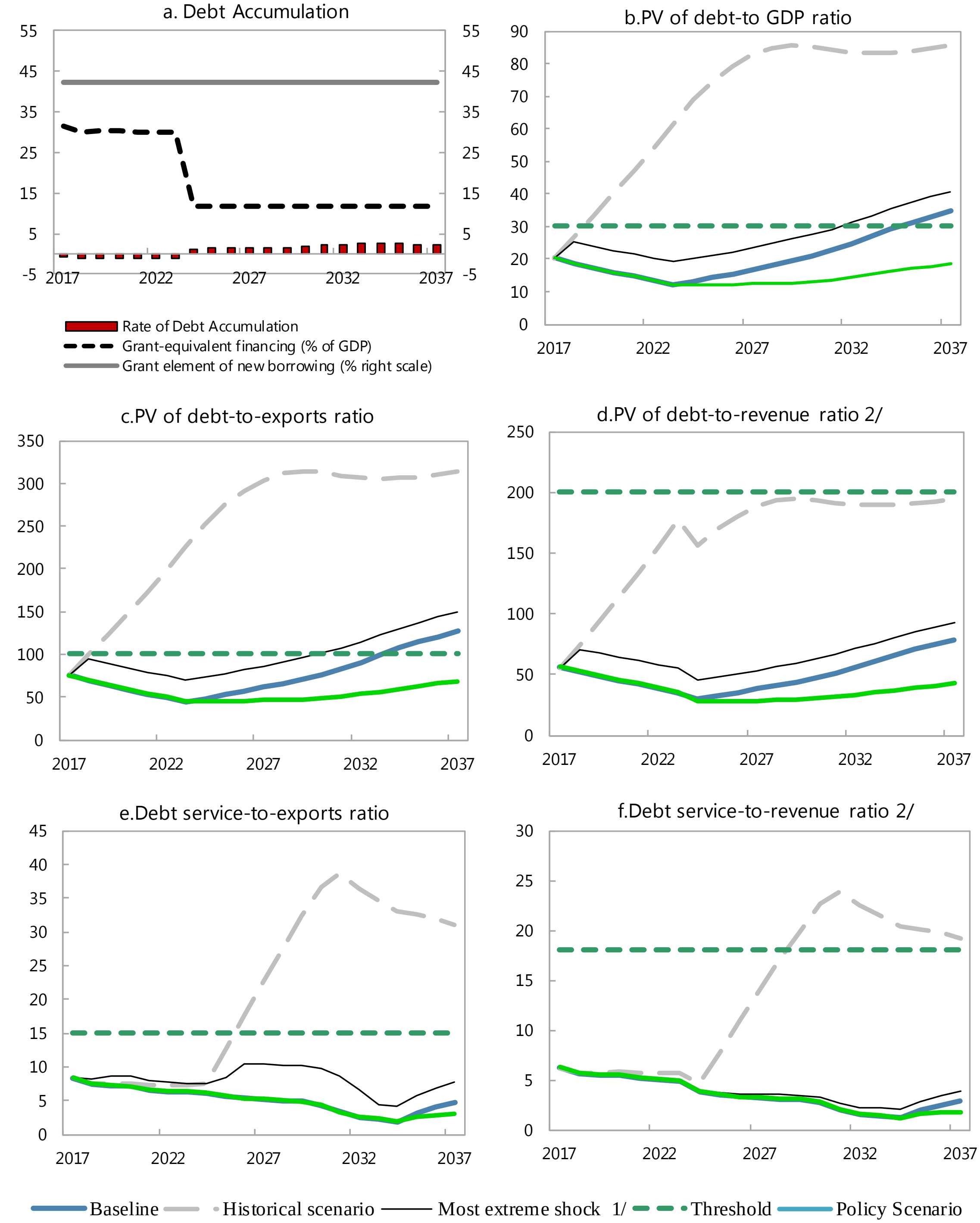
[1]Average GDP growth between FY2000 and FY2015 was 0.6 percent (excluding FY2013 when growth took a severe hit with the suspension of Compact infrastructure grants). The FSM experienced seven natural disasters during this period. Excluding disasters years, the historical growth average was 1.1 percent. Hence, the impact of natural disasters is assessed to be 0.5 percentage points on impact.

[2]The 2015 Article IV report assumed a 6 percent nominal return on trust fund assets, which appears somewhat high in the current low interest environment and considering FSM's historical experience. The Compact Trust Fund's compound average annual return has been 5.4 percent, net of fees, while that of FSM Trust Fund has been 5.9 percent, as of end-FY2016.

Figure 1. Federated States of Micronesia: Indicators of Public and Publicly Guaranteed External Debt Baseline Scenario, 2017–37 1/

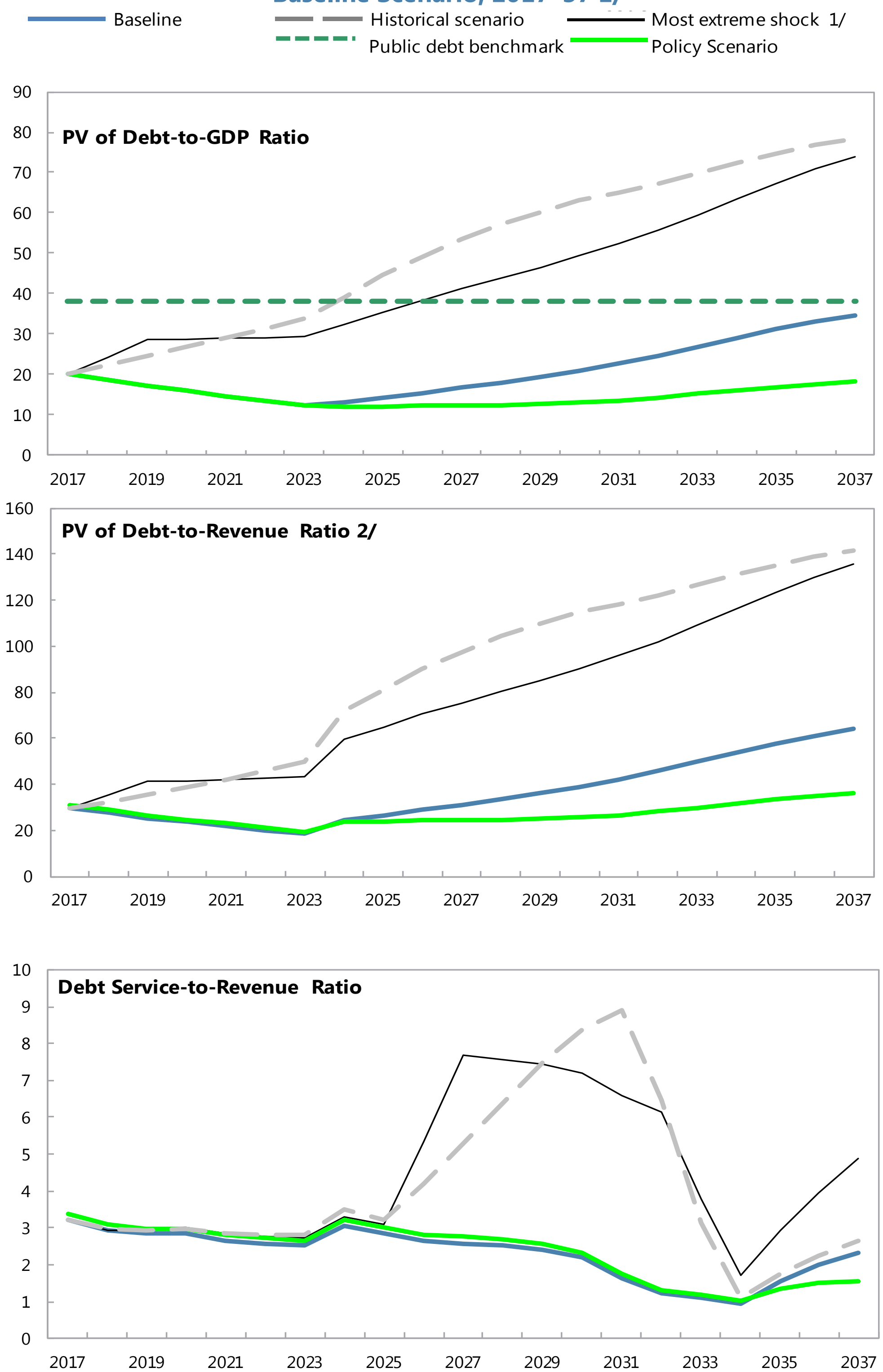


Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2027. In figure b. it corresponds to a Contingent Liability shock; in c. to a Contingent Liability shock; in d. to a Contingent Liability shock; in e. to a Exports shock and in figure f. to a Exports shock

2/ Revenues are defined exclusive of grants. Revenues increase in FY2024 due to annual distributions from the Compact Trust Fund (CTF) and FSM Trust Fund starting that year.

Figure 2. Federated States of Micronesia: Indicators of Public Debt, Baseline Scenario, 2017–37 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2027.

2/ Revenues are defined inclusive of grants.

Table 1. Federated States of Micronesia: External Debt Sustainability Framework, Baseline Scenario, 2014–37 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/	Standard 6/	Projections									
	2014	2015	2016	Average	Deviation	2017	2018	2019	2020	2021	2022	2017-2022 Average	2027	2037	2023-2037 Average
External debt (nominal) 1/	**28.2**	**25.8**	**25.3**			**24.3**	**22.3**	**20.4**	**18.6**	**16.9**	**15.3**		**23.5**	**48.7**	
of which: public and publicly guaranteed (PPG)	28.2	25.8	25.3			24.3	22.3	20.4	18.6	16.9	15.3		23.5	48.7	
Change in external debt	0.5	-2.5	-0.5			-0.9	-2.0	-1.9	-1.8	-1.7	-1.6		2.4	2.0	
Identified net debt-creating flows	-1.3	-3.9	-3.8			-3.8	-3.2	-3.1	-2.9	-2.9	-3.0		5.2	5.1	
Non-interest current account deficit	**-2.3**	**-5.4**	**-4.0**	**8.6**	**9.2**	**-4.0**	**-3.5**	**-3.4**	**-3.3**	**-3.3**	**-3.3**		**5.1**	**5.3**	4.6
Deficit in balance of goods and services	47.0	48.9	52.5			51.3	51.4	51.3	51.3	51.2	51.2		51.0	50.4	
Exports	26.2	26.5	26.5			26.8	27.0	27.0	27.1	27.2	27.2		27.2	27.2	
Imports	73.3	75.4	79.0			78.1	78.3	78.3	78.4	78.5	78.5		78.2	77.7	
Net current transfers (negative = inflow)	-40.6	-35.4	-37.0	-37.3	2.7	-36.2	-36.2	-36.2	-36.3	-36.4	-36.5		-19.1	-19.7	-20.5
of which: official	-29.3	-31.6	-33.0			-32.0	-31.6	-31.3	-31.1	-30.8	-30.7		-12.7	-12.8	
Other current account flows (negative = net inflow)	-8.8	-18.9	-19.6			-19.0	-18.7	-18.5	-18.3	-18.1	-18.0		-26.8	-25.5	
Net FDI (negative = inflow)	**0.1**	**0.1**	**0.1**	**-0.1**	**0.7**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**		**0.1**	**0.1**	0.1
Endogenous debt dynamics 2/	**1.0**	**1.5**	**0.2**			**0.1**	**0.2**	**0.3**	**0.3**	**0.3**	**0.3**		**0.1**	**-0.3**	
Contribution from nominal interest rate	1.1	1.2	0.8			0.6	0.5	0.5	0.5	0.4	0.4		0.2	0.0	
Contribution from real GDP growth	0.7	-1.1	-0.8			-0.5	-0.3	-0.2	-0.1	-0.1	-0.1		-0.1	-0.3	
Contribution from price and exchange rate changes	-0.8	1.3	0.1			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**1.7**	**1.4**	**3.3**			**2.9**	**1.2**	**1.2**	**1.1**	**1.2**	**1.4**		**-2.8**	**-3.0**	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	21.3			20.2	18.7	17.3	16.0	14.7	13.4		16.7	34.6	
In percent of exports	...	...	80.4			75.6	69.4	64.1	58.8	53.9	49.4		61.5	127.1	
PV of PPG external debt	**...**	**...**	**21.3**			**20.2**	**18.7**	**17.3**	**16.0**	**14.7**	**13.4**		**16.7**	**34.6**	
In percent of exports	**...**	**...**	**80.4**			**75.6**	**69.4**	**64.1**	**58.8**	**53.9**	**49.4**		**61.5**	**127.1**	
In percent of government revenues (excluding grants)	**...**	**...**	**57.6**			**55.8**	**52.3**	**48.7**	**45.2**	**41.9**	**38.5**		**38.1**	**78.7**	
Debt service-to-exports ratio (in percent)	**4.3**	**4.4**	**3.0**			**8.3**	**7.5**	**7.2**	**7.1**	**6.6**	**6.4**		**5.1**	**4.6**	
PPG debt service-to-exports ratio (in percent)	**4.3**	**4.4**	**3.0**			**8.3**	**7.5**	**7.2**	**7.1**	**6.6**	**6.4**		**5.1**	**4.6**	
PPG debt service-to-revenue ratio (in percent)	**3.1**	**3.2**	**2.1**			**6.2**	**5.6**	**5.5**	**5.4**	**5.1**	**5.0**		**3.2**	**2.9**	
Total gross financing need (Millions of U.S. dollars)	-3.5	-13.1	-10.2			-5.5	-4.9	-4.8	-4.6	-5.0	-5.4		25.3	29.3	
Non-interest current account deficit that stabilizes debt ratio	-2.8	-2.9	-3.5			-3.0	-1.5	-1.5	-1.5	-1.6	-1.7		2.7	3.2	
Key macroeconomic assumptions															
Real GDP growth (in percent)	-2.4	3.7	3.0	0.1	2.6	2.0	1.4	0.9	0.7	0.7	0.6	1.1	0.6	0.6	0.6
GDP deflator in US dollar terms (change in percent)	3.1	-4.5	-0.5	2.4	3.3	-0.1	1.0	1.0	1.0	1.0	0.8	0.8	0.8	0.8	0.8
Effective interest rate (percent) 5/	4.1	4.1	3.1	3.2	0.5	2.3	2.3	2.3	2.3	2.3	2.3	2.3	0.9	0.0	0.7
Growth of exports of G&S (US dollar terms, in percent)	-11.0	0.0	2.4	7.0	12.3	3.2	3.1	2.2	2.1	2.1	1.4	2.3	1.4	1.4	1.4
Growth of imports of G&S (US dollar terms, in percent)	-10.3	1.9	7.3	3.0	6.7	0.8	2.7	1.9	1.8	1.8	1.4	1.7	1.3	1.3	1.3
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	42.3	42.3	42.3	42.3	42.3	42.3	42.3	42.3	42.3	42.3
Government revenues (excluding grants, in percent of GDP)	36.9	37.1	36.9			36.2	35.8	35.6	35.3	35.0	34.9		44.0	44.0	43.4
Aid flows (in Millions of US dollars) 7/	178.5	172.2	189.1			187.7	185.1	183.0	179.0	175.3	171.6		130.0	261.4	
of which: Grants	88.8	91.1	107.5			107.6	110.0	112.8	114.0	115.1	116.3		39.4	45.2	
of which: Concessional loans	89.7	81.1	81.6			80.1	75.2	70.2	65.1	60.2	55.3		90.6	216.2	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			31.4	30.1	30.4	30.2	30.0	29.9		11.8	11.8	13.0
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			92.5	92.4	92.6	92.6	92.7	92.8		84.0	84.0	84.6
Memorandum items:															
Nominal GDP (Millions of US dollars)	318.1	315.0	322.8			329.2	337.0	343.5	349.4	355.4	360.4		386.4	444.2	
Nominal dollar GDP growth	0.6	-1.0	2.5			2.0	2.4	1.9	1.7	1.7	1.4	1.8	1.4	1.4	1.4
PV of PPG external debt (in Millions of US dollars)			68.6			66.6	63.1	59.5	55.7	52.1	48.5		64.7	153.8	
(PVt-PVt-1)/GDPt-1 (in percent)						-0.6	-1.1	-1.1	-1.1	-1.0	-1.0	-1.0	1.5	2.2	1.7
Gross workers' remittances (Millions of US dollars)	14.3	14.3	14.6			14.9	15.3	15.8	15.8	15.8	15.8		15.8	15.8	
PV of PPG external debt (in percent of GDP + remittances)	...	...	20.3			19.3	17.9	16.6	15.3	14.0	12.9		16.1	33.4	
PV of PPG external debt (in percent of exports + remittances)	...	...	68.6			64.6	59.4	54.8	50.4	46.3	42.5		53.5	112.5	
Debt service of PPG external debt (in percent of exports + remittanc	...	...	2.5			7.1	6.4	6.2	6.1	5.7	5.5		4.5	4.1	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

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

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes. This line item also reflects projected capital transfers for investment projects.

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

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

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

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

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

Table 2. Federated States of Micronesia: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2017–37
(In percent)

	Projections							
	2017	2018	2019	2020	2021	2022	**2027**	2037
PV of debt-to GDP ratio								
Baseline	20	19	17	16	15	13	**17**	35
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	20	27	33	40	47	54	**83**	86
A2. New public sector loans on less favorable terms in 2016-2036 2/	20	19	17	16	15	13	**20**	48
A3. Alternative Scenario : Policy Scenario	20	19	17	16	15	13	12	18
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	20	19	19	17	16	14	**18**	37
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	20	20	21	20	19	18	**20**	35
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	20	19	18	17	15	14	**17**	36
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	20	20	20	19	18	17	**19**	35
B5. Combination of B1-B4 using one-half standard deviation shocks	20	21	22	21	19	18	**21**	37
B6. 10 percent of GDP increase in other debt-creating flows in 2018	20	25	24	23	21	20	**23**	41
PV of debt-to-exports ratio								
Baseline	76	69	64	59	54	49	**61**	127
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	76	99	123	147	172	199	**304**	314
A2. New public sector loans on less favorable terms in 2016-2036 2/	76	69	64	59	54	49	**75**	177
A3. Alternative Scenario : Policy Scenario	75	70	65	59	55	50	46	69
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	76	69	64	59	54	49	**61**	127
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	76	81	93	88	82	78	**87**	150
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	76	69	64	59	54	49	**61**	127
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	76	75	75	70	65	61	**70**	127
B5. Combination of B1-B4 using one-half standard deviation shocks	76	76	80	75	70	66	**75**	132
B6. 10 percent of GDP increase in other debt-creating flows in 2018	76	94	89	84	79	74	**86**	149
PV of debt-to-revenue ratio								
Baseline	56	52	49	45	42	39	**38**	79
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	56	75	94	113	134	155	**188**	194
A2. New public sector loans on less favorable terms in 2016-2036 2/	56	52	49	45	42	39	**46**	110
A3. Alternative Scenario : Policy Scenario	57	53	50	46	43	39	29	43
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	56	54	52	49	45	42	**41**	85
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	56	56	60	57	54	52	**46**	79
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	56	53	51	47	43	40	**40**	82
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	56	56	57	54	50	47	**43**	79
B5. Combination of B1-B4 using one-half standard deviation shocks	56	58	62	58	55	52	**47**	83
B6. 10 percent of GDP increase in other debt-creating flows in 2018	56	71	67	64	61	58	**53**	93

Table 2. Federated States of Micronesia: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2017–37 (concluded)

(In percent)

	Projections							
	2017	2018	2019	2020	2021	2022	**2027**	2037
Debt service-to-exports ratio								
Baseline	8	7	7	7	7	6	**5**	5
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	8	8	7	8	7	7	**23**	31
A2. New public sector loans on less favorable terms in 2016-2036 2/	8	8	7	7	7	6	**6**	11
A3. Alternative Scenario : Policy Scenario	8	8	7	7	7	6	5	3
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	8	8	7	7	7	6	**6**	6
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	8	8	9	9	8	8	**10**	8
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	8	8	7	7	7	6	**6**	6
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	8	8	7	7	7	6	**8**	7
B5. Combination of B1-B4 using one-half standard deviation shocks	8	8	8	7	7	7	**9**	7
B6. 10 percent of GDP increase in other debt-creating flows in 2018	8	8	7	7	7	6	**6**	6
Debt service-to-revenue ratio								
Baseline	6	6	5	5	5	5	3	3
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	6	6	6	6	6	6	**14**	19
A2. New public sector loans on less favorable terms in 2016-2036 2/	6	6	5	5	5	5	**4**	7
A3. Alternative Scenario : Policy Scenario	6	6	6	6	5	5	3	2
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	6	6	6	6	6	5	**4**	4
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	6	6	6	6	5	5	**5**	4
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	6	6	6	6	5	5	**4**	4
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	6	6	6	6	5	5	**5**	4
B5. Combination of B1-B4 using one-half standard deviation shocks	6	6	6	6	6	5	**5**	4
B6. 10 percent of GDP increase in other debt-creating flows in 2018	6	6	6	6	5	5	**4**	4
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 5/	33	33	33	33	33	33	**33**	33

Sources: Country authorities; and staff estimates and projections.

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

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

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

4/ Includes official and private transfers and FDI.

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

Table 3. Federated States of Micronesia: Public Sector Debt Sustainability Framework, Baseline Scenario, 2014–37

(In percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections								
	2014	2015	2016	Average 5/	Standard Deviation 5/	2017	2018	2019	2020	2021	2022	2017-22 Average	2027	2037	2023-37 Average
Public sector debt 1/	28.2	25.8	25.3			24.3	22.3	20.4	18.6	16.9	15.3		23.5	48.7	
of which: foreign-currency denominated	28.2	25.8	25.3			24.3	22.3	20.4	18.6	16.9	15.3		23.5	48.7	
Change in public sector debt	0.5	-2.5	-0.5			-0.9	-2.0	-1.9	-1.8	-1.7	-1.6		2.4	2.0	
Identified debt-creating flows	-11.3	-10.1	-9.6			-9.2	-9.2	-8.9	-8.7	-8.4	-8.2		4.2	3.8	
Primary deficit	-12.3	-11.6	-9.8	-4.0	5.4	-9.3	-9.1	-9.0	-8.8	-8.5	-8.4	-8.9	4.3	4.4	3.5
Revenue and grants	64.8	66.0	70.2			68.9	68.4	68.4	67.9	67.4	67.2		54.2	54.2	
of which: grants	27.9	28.9	33.3			32.7	32.6	32.8	32.6	32.4	32.3		10.2	10.2	
Primary (noninterest) expenditure	52.5	54.4	60.4			59.7	59.3	59.4	59.1	58.9	58.8		58.4	58.6	
Automatic debt dynamics	1.0	1.5	0.2			0.1	0.0	0.1	0.1	0.1	0.1		-0.1	-0.6	
Contribution from interest rate/growth differential	1.3	-0.2	-0.3			-0.5	-0.3	-0.2	-0.1	-0.1	-0.1		-0.4	-1.2	
of which: contribution from average real interest rate	0.7	0.8	0.4			0.0	0.0	0.0	0.1	0.0	0.0		-0.2	-0.9	
of which: contribution from real GDP growth	0.7	-1.0	-0.8			-0.5	-0.3	-0.2	-0.1	-0.1	-0.1		-0.1	-0.3	
Contribution from real exchange rate depreciation	-0.4	1.6	0.5			0.6	0.3	0.3	0.2	0.2	0.2		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	11.8	7.7	9.2			8.2	7.1	7.1	6.9	6.7	6.6		-1.7	-1.8	
Other Sustainability Indicators															
PV of public sector debt	...	...	21.3			20.2	18.7	17.3	16.0	14.7	13.4		16.7	34.6	
of which: foreign-currency denominated	...	...	21.3			20.2	18.7	17.3	16.0	14.7	13.4		16.7	34.6	
of which: external	...	...	21.3			20.2	18.7	17.3	16.0	14.7	13.4		16.7	34.6	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	-11.2	-10.4	-9.0			-7.0	-7.1	-7.1	-6.9	-6.7	-6.6		5.7	5.7	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	30.3			29.3	27.4	25.3	23.5	21.8	20.0		30.9	63.9	
PV of public sector debt-to-revenue ratio (in percent)	...	...	57.6			55.8	52.3	48.7	45.2	41.9	38.5		38.1	78.7	
of which: external 3/	...	...	57.6			55.8	52.3	48.7	45.2	41.9	38.5		38.1	78.7	
Debt service-to-revenue and grants ratio (in percent) 4/	1.8	1.8	1.1			3.2	3.0	2.8	2.8	2.7	2.6		2.6	2.3	
Debt service-to-revenue ratio (in percent) 4/	3.1	3.2	2.1			6.2	5.6	5.5	5.4	5.1	5.0		3.2	2.9	
Primary deficit that stabilizes the debt-to-GDP ratio	-12.8	-9.1	-9.3			-8.3	-7.1	-7.1	-7.0	-6.8	-6.8		1.8	2.4	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	-2.4	3.7	3.0	0.1	2.6	2.0	1.4	0.9	0.7	0.7	0.6	1.1	0.6	0.6	0.6
Average nominal interest rate on forex debt (in percent)	4.1	4.1	3.1	3.2	0.5	2.3	2.3	2.3	2.3	2.3	2.3	2.3	0.9	0.0	0.7
Average real interest rate on domestic debt (in percent)	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Real exchange rate depreciation (in percent, + indicates depreciation	-1.2	5.8	1.8	-0.7	3.1	2.3	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	3.1	-4.5	-0.5	2.4	3.3	-0.1	1.0	1.0	1.0	1.0	0.8	0.8	0.8	0.8	0.8
Growth of real primary spending (deflated by GDP deflator, in percer	-12.2	7.5	14.3	1.0	6.7	0.8	0.7	1.1	0.2	0.4	0.4	0.6	0.7	0.6	0.6
Grant element of new external borrowing (in percent)	...	...	...	...	...	42.3	42.3	42.3	42.3	42.3	42.3	42.3	42.3	42.3	...

Sources: Country authorities; and staff estimates and projections.

1/ Public sector is defined as general government. Debt is defined as gross debt.

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

3/ Revenues excluding grants.

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

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

Table 4. Federated States of Micronesia: Sensitivity Analysis for Key Indicators of Public Debt, 2017–37

	Projections							
	2017	2018	2019	2020	2021	2022	2027	2037
PV of Debt-to-GDP Ratio								
Baseline	20	19	17	16	15	13	17	35
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	20	22	25	27	29	31	53	78
A2. Primary balance is unchanged from 2017	20	19	17	15	14	12	-22	-106
A3. Permanently lower GDP growth 1/	20	19	18	17	16	16	27	79
A4. Alternative Scenario :Policy Scenario	20	19	17	16	15	13	12	18
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2018-2019	20	20	21	22	22	23	39	82
B2. Primary balance is at historical average minus one standard deviations in 2018-2019	20	25	31	30	29	28	33	49
B3. Combination of B1-B2 using one half standard deviation shocks	20	24	29	29	29	29	41	74
B4. One-time 30 percent real depreciation in 2018	20	28	26	25	23	22	23	36
B5. 10 percent of GDP increase in other debt-creating flows in 2018	20	25	24	23	22	21	24	42
PV of Debt-to-Revenue Ratio 2/								
Baseline	29	27	25	23	22	20	31	64
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	29	32	36	39	42	46	97	142
A2. Primary balance is unchanged from 2017	29	27	25	23	20	18	-41	-195
A3. Permanently lower GDP growth 1/	29	28	26	25	24	23	49	142
A4. Alternative Scenario :Policy Scenario	31	29	27	25	23	21	24	36
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2018-2019	29	29	30	31	32	33	70	149
B2. Primary balance is at historical average minus one standard deviations in 2018-2019	29	37	45	44	43	42	60	91
B3. Combination of B1-B2 using one half standard deviation shocks	29	35	41	41	42	42	75	136
B4. One-time 30 percent real depreciation in 2018	29	40	38	36	35	33	42	67
B5. 10 percent of GDP increase in other debt-creating flows in 2018	29	37	35	33	32	31	45	77
Debt Service-to-Revenue Ratio 2/								
Baseline	3	3	3	3	3	3	3	2
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	3	3	3	3	3	3	5	3
A2. Primary balance is unchanged from 2017	3	3	3	3	3	3	2	-19
A3. Permanently lower GDP growth 1/	3	3	3	3	3	3	3	7
A4. Alternative Scenario :Policy Scenario	3	3	3	3	3	3	3	2
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2018-2019	3	3	3	3	3	3	4	9
B2. Primary balance is at historical average minus one standard deviations in 2018-2019	3	3	3	3	3	3	8	5
B3. Combination of B1-B2 using one half standard deviation shocks	3	3	3	3	3	3	7	8
B4. One-time 30 percent real depreciation in 2018	3	4	4	4	4	4	4	5
B5. 10 percent of GDP increase in other debt-creating flows in 2018	3	3	3	3	3	3	5	4

Sources: Country authorities; and staff estimates and projections.

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

2/ Revenues are defined inclusive of grants.

Statement by Grant Johnston, Alternate Executive Director for Micronesia
and Eugene Amor, Advisor to Executive Director
September 1, 2017

The Federated States of Micronesia is a small, widely-dispersed Pacific island country consisting of four autonomous states. A key challenge is the forthcoming expiry of annual grants from the United States – equivalent to more than 20 percent of GDP – made under the Compact of Free Association. After 2023, most of these will be replaced by distributions from investment funds currently being built up by the US and FSM. However, the current track for contributions, together with expected investment returns, means that fund distributions will not fully compensate for the loss of grants while also maintaining the funds' real value over time.

Sustainable growth for the FSM in the long-term therefore hinges on progressing fiscal reforms and on developing the private sector as a new engine of growth. The authorities have an Action Plan 2023 which targets annual growth of 2 percent, increased revenue mobilization, the building of fiscal buffers and a better environment for the private sector. The new government has formed a review and planning committee to evaluate progress and recommend further reforms to achieve fiscal sustainability and economic self-reliance.

The authorities greatly appreciate staff's assessment and largely agree with it. Recommendations relating to growth and fiscal sustainability are in line with the current policy agenda. The authorities also remain highly appreciative of the technical assistance they receive from the Fund.

Economic outlook

The Micronesian economy expanded by around 3 percent in 2015 and 2016, driven by increased activity in the fisheries and construction sectors. The completion of an updated Infrastructure Development Plan should expedite the implementation of Compact and donor-funded projects which will sustain growth in the short term. Further out, risks are tilted to the downside. However, the authorities have a policy agenda to bolster growth over the remaining Compact period. This includes establishing a "competent authority" to allow domestic-based fishing fleets to export to the EU market and help attract investment. The agriculture sector is expected to improve with the ongoing investment in rehabilitating the coconut industry. The authorities expect tourism benefits from the recent designation of Nan Madol as a World Heritage Site and from the introduction of two new airline operators. They will also continue working with bilateral and multilateral partners to increase infrastructure investment, given the anticipated drop in Compact financing after 2023.

Fiscal policy

The authorities agree with the need for additional medium-term fiscal adjustments, although a major challenge is to achieve consensus across the four autonomous states. A key policy objective for national and state governments is to limit expenditure growth to 2 percent a year over the medium-to-long term. The authorities also plan to lift the tax-to-GDP ratio from 12 percent to 16 percent and are working to improve tax administration and compliance. The new government is revisiting the tax reform agenda, including a second attempt at introducing a value-added tax and a net profits tax. Ongoing technical assistance from PFTAC and other development partners is greatly appreciated in supporting these revenue mobilization goals.

The authorities have also made additional contributions to the FSM Trust Fund in recent years, on top of the $10 million annual investment set out in the Action Plan. In 2015, for example, $28 million of windfall revenue was transferred to the Trust Fund. Staff recommend raising the annual contribution to the Trust Fund. However, the authorities see the need for a balanced investment in growing the economy today alongside saving for the future. The current level of annual Trust Fund savings will therefore continue while additional contributions are sought from other partners.

While the FSM's public debt is currently stable and low as a percent of GDP, the authorities recognize that the expiration of Compact grants may result in new concessional borrowing to maintain development spending. The authorities therefore agree with the debt sustainability analysis. They have recently developed a debt management policy and introduced a Debt Management Bill, to help ensure continued prudent management of public debt.

Financial sector

The authorities welcome staff's appraisal that the commercial banking sector is sound and stable with adequate capital and ample liquidity. They remain committed to supporting small and medium-sized enterprises through the FSM Development Bank's targeted loan program and training initiatives to promote financial literacy and improve management capacity. Technical assistance from PFTAC has been critical in completing the Credit Union Act which will expand the supervisory mandate of the Banking Board.

Private sector development

The authorities agree that improving the investment climate is key to achieving private sector-led growth, and they remain committed to reducing regulatory burdens. A new Foreign Direct Investment Bill has been developed and submitted for legislative approval, aimed at streamlining the FDI process and establishing a Foreign Direct Investment Promotion Agency. A Corporate Act has recently been passed to improve protection and provide reassurance to investors, accord proper rights and privileges to shareholders and promote safe and prudent corporate practices in line with international best practice.

The authorities have welcomed two new airline operators in Air Niguini and Nauru Airlines, and have engaged key development partners in planning for a major sea port expansion. National Sustainable Tourism Policy and State Tourism Investment Plans have been completed and received annual budget allocations of $2 million. The authorities believe that support for tourism development and more airline competition will encourage growth in the tourism sector. A World Bank-funded fiber optic cable project is currently underway to connect the four states to broadband internet. The authorities remain committed to liberalizing the telecommunications sector to lower cost and improve service quality.

In regards to ownership and leasing of land, the authorities continue to see the need to harmonize and provide greater clarity on land tenure practices, while respecting local investors' legitimate interests. As is the case in other Pacific island countries, land issues are delicate and intricately connected to people's perception of inheritance and community. They need to be tackled sensitively to produce solutions that are sustainable in the long term and maintain peace and harmony.

Climate Change

In response to the increasing frequency of natural disasters, the authorities have intensified their efforts in climate change adaptation through the Infrastructure Development Plan and Joint-State Action Plans. They agree that continued efforts are needed, including explicit recognition of fiscal costs in the budget, which could support access to donor funding. The FSM will continue to make an annual contribution to the Disaster Assistance Emergency Fund, which is their traditional source of emergency support. The authorities will also seek other means of disaster financing – self-insurance, other donors or other insurance arrangements – and will continue to seek technical assistance to access climate change adaptation financing from the international community.