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Federated States of Micronesia: 2002 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director of 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 2002 Article IV consultation with the Federated States of Micronesia, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **October 31, 2002** 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 January 3, 2003**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its January 24, 2003 discussion** of the staff report that concluded the Article IV consultation.

- statement by the Executive Director for the Federated States of Micronesia.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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FEDERATED STATES OF MICRONESIA

Staff Report for the 2002 Article IV Consultation

Prepared by Staff Representatives for the 2002 Consultation
with the Federated States of Micronesia

(In consultation with other departments)

Approved by Steven Dunaway and Michael Hadjimichael

January 3, 2003

- The 2002 Article IV consultation discussions were held in Pohnpei during October 22–31. The staff team comprised Padma Gotur (head, SEC), Takuo Komori, Hong Liang, and Rania Al-Mashat (all APD). The Federated States of Micronesia (FSM) is on a 24-month cycle.
- The mission met with Secretary of Finance and Administration Ehsa, Secretary of Foreign Affairs Iehsi, Chairman of the Senate Ways and Means Committee Mori, other senior government officials, the Banking Board, private sector, and donors. The mission overlapped with Messrs. Leruth and Wilson from the PFTAC, and a team from the Asian Development Bank.
- At the conclusion of the last Article IV consultation in January 2001, Directors commended the authorities for the fiscal adjustment achieved under the Public Sector Reform Program (PSRP), but recognized the need for further wide-ranging fiscal and structural reforms in order to sustain the growth momentum, and to adjust to possible reductions in Compact financing. Consistent with the authorities' own reform agenda, Directors called for further reductions in current government expenditure, particularly wages, and steps to reduce the role of the government, as well as for measures, including the VAT, to raise the tax effort. Structural reforms to promote the sustainable growth of the private sector were considered essential. Directors also advocated steps to improve fiscal transparency and accountability and to strengthen economic statistics.
- The FSM has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions.
- Despite some improvements, data quality and coverage suffer from deficiencies that hamper economic assessment and management. The authorities intend to strengthen the FSM's statistical capacity.
- The principal authors of this report are Padma Gotur and Hong Liang.

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Executive Summary

Economic Setting

- **In November 2002, the U.S. and the FSM initialed a second Compact of Free Association (Compact) agreement**, which entails declining levels of annual U.S. grant assistance over the period FY2004–23 (fiscal year ends September 30), and a Trust Fund to provide for revenue thereafter.

- **Real output growth is estimated to have slowed in the past two years**, reflecting a fiscal crisis in the Chuuk state and a "wait and see" attitude of the private sector in the face of uncertainty associated with the new Compact. Some improvement in growth is expected in FY2003. Inflation declined to near zero in FY2002.

- **The consolidated fiscal position has deteriorated since FY1997**. Excluding a substantial but temporary increase in Compact assistance (the so-called bump-up funds) in FY2002 and FY2003, a fiscal deficit in the range of 5–6 percent of GDP is projected for these years. Financing of the recent deficits has led to a sharp decline in the combined holdings of usable (uncommitted) financial assets by the National government and the states—excluding the Yap state that maintains a comfortable reserve position—from $24 million in FY1999 to practically zero at end-FY2001.

Key Policy Issues

- **The main challenge facing the country is to adjust to the significant reduction in assistance under the new Compact**. This calls for an immediate strengthening of the fiscal position of the national and state governments, especially of the Chuuk state, as well as for medium-term adjustment in response to anticipated continuing declines in real levels of assistance. An increase in private sector growth driven by structural reforms will be essential to ensure macroeconomic stability and to mitigate the likely declines in living standards resulting from fiscal retrenchment.

- **Fiscal adjustment will require revenue and expenditure measures**. The staff welcomed the recent initiative to introduce a VAT, and encouraged its early implementation. However, as the VAT may take a few years to be fully operational, expenditure would have to bear the initial brunt of adjustment. Current spending should be cut by 4 to 5 percent of GDP in the next few years, with most of this adjustment coming from a reduction in the wage bill. The authorities were receptive to the mission's recommendations, but foresaw difficulty in garnering broad internal support for them given the upcoming presidential elections and the autonomy enjoyed by the four state governments.

- **The authorities and the staff agreed that prospects for private sector development are uncertain, reflecting typical small island constraints**. The mission stressed that, nevertheless, the resolute implementation of structural reforms—in the areas of land tenure and titling, the regime for foreign direct investment, and the public enterprise sector—will be important for harnessing the limited available potential. The country will also be well served by increasing investment in human capital.

I. ECONOMIC SETTING

1. **Situated in the western Pacific, the Federated States of Micronesia is one of the smallest members of the Fund, with a population of about 110,000, spread across the four states of Chuuk, Kosrae, Pohnpei, and Yap**. The country's relatively high per capita GDP—of about $2,000 in recent years—has largely been supported by the United States financing provided under the Compact of Free Association (Box 1). The U.S. dollar is used as the domestic currency. The first Compact (hereafter, Compact I) covered the period FY1987–FY2001, with stepdowns in funding first in FY1992 and then in FY1997; a second Compact (hereafter, Compact II) is nearly finalized, and will cover the period FY2004–23. Compact II entails declining levels of annual U.S. grant assistance, and a Trust Fund to provide revenue after the cessation of this assistance. For FY2002 and FY2003, Compact I provided for funding to continue at the average level of the previous fifteen years, resulting in a substantial increase in assistance—or "bump up funds"—in these two years relative to FY2001.

2. **Economic activity is dominated by the public sector despite its downsizing in the mid-1990s**; and the private sector remains largely a provider of services to the public sector. Government expenditure accounts for some 70 percent of GDP; and about 50 percent of government revenue consists of external grants—more than two-thirds of which are Compact funds (Box 2). In the wake of the second stepdown ($15 million or 7 percent of GDP) in Compact I assistance in FY1997, the authorities sought to reduce the size of the government sector under the Public Sector Reform Program (PSRP) supported by the Asian Development Bank (AsDB). The Program achieved initial success in pruning the government's wage bill, but more recently, some of this progress has been reversed owing to resumed hiring and a return to longer workweeks (Box 3).

Micronesia: General Government Expenditure and Real GDP

Source: Data provided by FSM authorities.

3. **Growth has averaged 1.8 percent since independence in late 1986, but economic performance has varied considerably across the FSM's four states**, reflecting not only differences in resource endowment, size, and location, but also the considerable autonomy enjoyed by the four states in policy making and economic management (Box 4). The FSM's income distribution is therefore uneven, with sizable differences across states (per capita GDP ranges from $1,252 in Chuuk to $3,451 in Yap), and within each state (between urban areas and the outer islands).[1]

[1] In recent years, per capita income has benefited from a markedly slower population growth, reflecting in part increased migration to the U.S. in search of better employment opportunities. Compact I allowed FSM nationals to emigrate freely to the U.S. This provision is being renegotiated at present, but the U.S. is unlikely to fundamentally change FSM emigration privileges.

Box 1: The Compact of Free Association with the U.S.

Origins. The United Nations created the Trust Territory of the Pacific Islands in 1947, with the United States (U.S.) as Trustee. In the late 1970s, four of the territory's districts—Chuuk, Kosrae, Pohnpei, and Yap—voted to form a self-governing federation under the Constitution of the Federated States of Micronesia (FSM). Effective 1986, a Compact of Free Association (Compact I) was signed between the FSM and the U.S., covering the period 1987–2001.

Key provisions. In exchange for certain defense and security rights from the FSM, the United States would promote the country's economic self-sufficiency through sustained funding to cover government expenditures over a 15-year period, with amounts decreasing every five years. Compact I allowed for annual cash grants of $97.9 million per year for FY1987–91, $91.1 million for FY1992–96, and $79.2 million for FY1997–2001. The funds were to cover general government and capital expenditures with a condition for 40 percent minimum outlay on capital spending (this target was met but the overall quality of this spending was questionable).

Post-2001 and Compact II. Compact I also provided for assistance for a two-year transitional period following Compact I's expiration in September 2001 if a new agreement was being negotiated in good faith. This assistance was set at the average level of the first 15 years—$88 million. The U.S. and the FSM initialed in early November 2002 a Compact II agreement covering the twenty-year period, FY2004–2023, but the FSM has reserved the right to raise, directly with the U.S. Congress, its concerns on a few issues—the grant amounts, the inflation adjustment, and the termination of the U.S. Federal Emergency Management Assistance (FEMA) program for the FSM. Compact II will entail:

- Declining annual grant assistance over the 20-year period.
- Allocation of funds to six priority sectors, with specific allotments to be agreed between the U.S. and the FSM in advance each year.
- Strict procedures/audits governing grant use and administration to enhance accountability and transparency, under joint U.S.-FSM management oversight.[1]
- A Trust Fund—to be built up mainly from U.S. contributions over the 20-year period and a $30 million payment by the FSM in FY2004—to provide annual revenue after the cessation of U.S. grant assistance in 2023.
- Less-than-full indexation for inflation (precise terms yet to be agreed).
- Some possible reduction in the scale of benefits under U.S. federal programs (to be determined by the U.S. Congress).
- Some modification to the current emigration provision (final understandings yet to be reached, see footnote 1 in the main text).

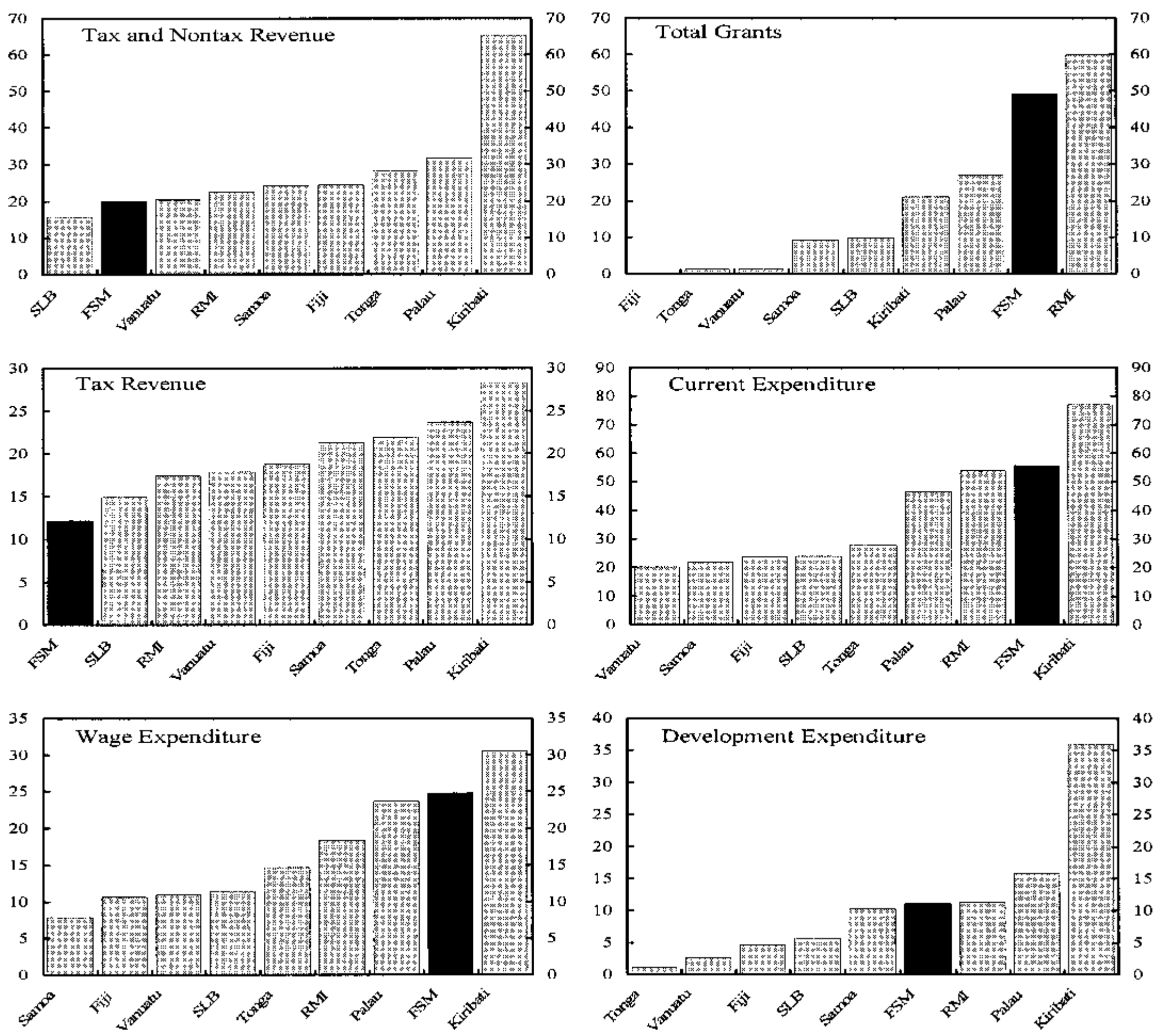
[1] A key feature of Compact II is a new management body, the Joint Economic Management Committee, comprising three U.S. and two FSM representatives, to improve the effectiveness of U.S. assistance, in particular through addressing previous shortcomings in accountability and transparency identified in U.S. General Accounting Office reports.

Box 2: The FSM's Fiscal Structure—Comparison with Other Pacific Island Economies

The FSM's government sector is large. While similar to that of the Republic of the Marshall Islands (RMI) and Kiribati, the size of government expenditure in the FSM, in particular, spending on wages and salaries, is almost twice that of other countries in the region. The sizable spending on wages and salaries reflects both high public sector wages and the large share of the public sector in total employment.

Government revenue is highly reliant on external grants, which are more than twice the size of domestic revenue. Although domestic revenue mobilization is low in all Pacific Island economies, tax revenue as a percent of GDP is the lowest in the FSM.

Pacific Islands: Comparative Fiscal Performance, 2002 [1]
(In percent of GDP)



Source: Data provided by the FSM authorities; and IMF staff estimates.
1/ 2001 for RMI.

Box 3: The Public Sector Reform Program

Supported by an $18 million loan from the AsDB during FY1997–1999, the FSM's Public Sector Reform Program (PSRP) sought mainly to reduce the size and cost of the public sector and increase the efficiency of public services. It also aimed at restructuring government operations and public enterprises, increasing domestic revenues, and fostering private sector development. While progress was slow in other targeted areas, the PSRP's main objective of public sector retrenchment met with considerable success:

Lower payroll costs. The PSRP reduced public sector payroll costs and employment through the Early Retirement Program, with significant budgetary savings (see table). Between FY1996 and FY1999, total government employment was reduced broadly in line with the targeted 27 percent, albeit with notably varied performance at the state level. Cuts in total payroll costs approached the targeted 35 percent, reflecting, in addition to the employment cutbacks, reductions in weekly work hours and some wage rates. However, these achievements were subsequently reversed in part, with resumed hiring and a return to longer work weeks.

Mitigated social impact. Early retirement payments mitigated the impact of the downsizing. Efforts to train and absorb retrenched workers into the private sector were, however, less successful.

Improved revenue picture. Some useful reforms were implemented and tax collection was improved. Taxes rose by 20 percent as a result of the shift from an f.o.b to a c.i.f. accounting basis and extension of import duties to cover all sectors of the economy.

PSRP Workforce and Payroll Reduction Performance

(Progress at Loan Closing, December 1999, and as of September 2002)

	Workforce Reduction Target	Workforce Reduction Dec-99	Workforce Reduction Sept-02	Wage Bill Reduction Target	Wage Bill Reduction Dec-99	Wage Bill Reduction Sept-02	Annual Payroll Savings Sept-02
		(in percent)			(in percent)		(in millions of U.S. dollars)
Chuuk	-29	-24	-10	-43	-32	-16	3.3
Kosrae	-14	-19	-19	-24	-17	-7	0.4
Pohnpei	-28	-19	-18	-34	-31	-25	4.0
Yap	-30	-34	-33	-30	-34	-34	2.2
National government	-21	-7	-3	-21	-15	-11	1.0
FSM	**-27**	**-22**	**-15**	**-35**	**-28**	**-19**	**10.9**

Source: Information from the Economic Management and Policy Assistance Team, Ministry of Economic Affairs, the FSM.

Box 4: Differences in Economic Performance among the Four States

The FSM consists of four states, Chuuk, Kosrae, Pohnpei, and Yap, and a National Government. The National Government has responsibility for domestic policy coordination, foreign policy, and defense, while the state governments, which enjoy substantial autonomy, are responsible for the provision of most economic services and account for about 70 percent of total government expenditure.

The four autonomous states of the FSM, a loose federation, differ not only in area, population, and resources, but also in economic performance. Available data show disparities not only in the states' growth rates but also in their relative contributions to public and private sector activity. By and large, Yap and Pohnpei—which together account for over 40 percent of the country's population—have been the fastest growing states, recording well over 2 percent average annual growth during the Compact I period. In both states, the performance of the private sector has also been more impressive, particularly in the earlier Compact I years.

FSM States: Selected Indicators
(FY2001)

	Chuuk	Kosrae	Pohnpei	Yap	FSM Total
Real GDP (percent of total)	29	8	46	17	217.4[1]
Population (percent of total)	50	7	32	10	107,260
Per capita GDP (in dollars)	1,252	2,306	3,067	3,451	2,145
Real GDP growth rate (percent) (during Compact I)	0.8	0.1	2.5	2.7	1.8
Private sector employment (percent of total)[2]	24	8	42	26	6,561
Increase in private sector employment during Compact I (growth rate in percent)	1	4	5	10	4.6

Source: FSM authorities.

[1] Base FY1998: in millions of dollars

[2] Excluding workers who cannot be classified by state.

Yap has had the most success in generating private sector growth and employment. During the Compact I period, private sector employment rose by more than twice the rate in other states, owing to garment production—one of the FSM's few manufacturing activities. Other sectors, such as distribution, tourism, and transportation also fared relatively well. Yap's good performance may be related to its tradition of strong economic and financial management (discussed in the forthcoming Selected Issues paper).[1] Another factor aiding Yap's private sector appears to be the much smaller differential between public and private sector wages compared with other states where high public sector wages have tended to limit the supply of skilled labor to the private sector.

As for the other states, **Pohnpei** has not managed to sustain the strong overall growth achieved initially in the Compact I period. However, it houses the nation's capital and, as the FSM's largest land mass with better infrastructure than other states, enjoys considerable growth potential. Performance in **Kosrae** has been unimpressive. It is the country's smallest state, and is also the one most dependent on the public sector and has failed to generate private sector activity, reflecting probably its geographical remoteness and limited resource endowments. Recent evidence, however, points to some potential for economic diversification into farming, citrus fruits, and bananas. The economic performance of **Chuuk**, the most populous state, continues to be negatively affected by recurring episodes of fiscal mismanagement.

[1] A case in point is the experience with the Public Sector Reform Program, under which Yap achieved the best results among all the states (see Table in Box 3).

II. Recent Economic Developments and Near-Term Outlook[2]

4. **Real output growth is estimated to have slowed in the past two years**. Despite a boost to government spending during FY2002 financed by the bump-up funds, GDP is estimated to have grown by only 0.8 percent. This stimulus appears to have been mostly offset by a fiscal crisis in Chuuk[3], land slides in Chuuk that caused loss of life and property, and a more general "wait and see" attitude of the private sector in the face of uncertainty associated with the new Compact. In FY2003, real output is projected to grow by 2.4 percent, reflecting the expansionary impact of an expected $8 million U.S. grant assistance to the landslide victim families and a likely return to normal activity following the finalization of the new Compact. While averaging close to 2 percent over the past several years, inflation fell to almost zero in FY2002, owing to price declines in the domestic components of the CPI and the low rate of inflation in the U.S.

5. **The consolidated fiscal position of the National Government and the four states has deteriorated since FY1997** (Table 2). Between FY1998 and FY2001, the fiscal position averaged an annual deficit of $15 million (7 percent of GDP), before shifting into a small surplus in FY2002, and it is expected to remain in surplus in FY 2003. The weakening in the public finances over the FY1998–2001 period basically reflected inadequate fiscal adjustment in response to the reduction in Compact assistance in FY1997, notwithstanding the initial success in government downsizing. Performance across the National and four state governments has varied considerably,[4] with the National government and Chuuk accounting wholly for the deficits in recent years. The FY2002 and FY2003 budgets have not envisaged any new measures to strengthen the underlying fiscal position.[5] Thus, the estimated small surpluses in these two years result entirely from the availability of the bump-up Compact grants; excluding these funds, there would have been a consolidated fiscal deficit of about $11–$12 million (5–6 percent of GDP). Financing of the recent deficits has led to a sharp decline in the combined holdings of usable (uncommitted) government assets by the National and state governments—excluding the Yap state that has a comfortable reserve position—from $24 million in FY1999 to practically zero at end-FY2001.[6]

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[2] See Table 1 and the forthcoming Selected Issues Paper for a fuller discussion.

[3] A large expansion in expenditure led to a rapid deterioration in Chuuk's finances in FY2000–01, and a build-up of arrears of about $15 million.

[4] The National government and the four state governments each formulate a budget, with separate expenditure and revenue policies in the absence of significant coordination.

[5] The FSM Congress passed only a half-year budget for FY2003 because of presentational problems related to the new performance-based budgeting format. The budget for the second half of this fiscal year was approved by Congress in December 2002.

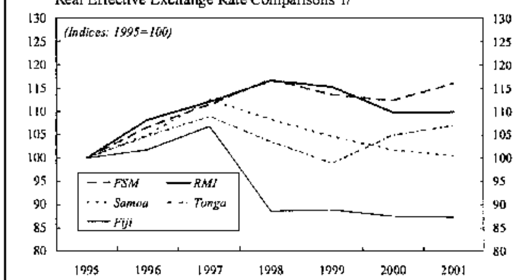
[6] The total holdings of foreign assets by the five governments stood at $104.5 million (8 months of imports) at end-August 2002. However, with the exception of Yap, the four other governments have made spending appropriations against a large share of their holdings

(continued)

6. **In view of the recent weakness of the fiscal position and the prospect of reduced assistance under Compact II, the authorities originally intended—consistent with Fund advice—to set aside the bump up funds as a cushion for future use**. In this vein, the U.S. suggested that they be saved for the purpose of financing the FSM's $30 million contribution to the Trust fund in FY2004 required under Compact II. In the event, however, most of the bump up funds for FY2002 have been spent, providing financing for the resumed hiring and the progressive return to longer workweeks, as well as for discretionary spending by the National and Chuuk governments. As for FY2003, appropriations have been made by the five governments to set aside the bump-up funds for making the Trust Fund contribution.

7. **The current account (excluding official transfers) of the balance of payments has remained weak in recent years**, as the trade deficit continues to run at around 40 percent of GDP, reflecting the small export sector—comprising mainly of fish and some agricultural produce—and the economy's heavy dependence on imports (Table 3). Owing to the bump-up funds, the current account position (including official transfers) is projected to improve markedly in FY2002 and FY2003. The REER is estimated to have appreciated by about 5 percent since end-FY2000 mainly reflecting the strengthening of the U.S. dollar during this period. The external debt service ratio fell significantly to 6 percent of exports of goods and services in FY2002, following the full repayment of the earlier commercial borrowing secured against future Compact funds.

Real Effective Exchange Rate Comparisons 1/



Sources: IMF, Information Notice System; and staff calculations.
1/ Average of monthly/quarterly REER is used for 2000.

8. **Bank lending has remained small in recent years, given the limited availability of bankable projects and other structural constraints**; as a result, about one-half of bank assets are deposited in overseas banks. The banking system remains well regulated and supervised, benefiting from the support of the Federal Deposit Insurance Corporation (FDIC) of the U.S. under the Compact arrangement.[7] [8] Nevertheless, the fiscal crisis in Chuuk has contributed to an increase in non-performing loans (Table 4), as arrears on wages to

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of these assets; thus, only a small part of them can be regarded as "usable". In addition, under the FSM constitution, the assets of each of the five governments belong to that government—although the governments are not precluded from borrowing from each other in the event of a crisis. The money is mostly invested in the U.S. equity market.

[7] The commercial banks are licensed and regulated by the Banking Board, and their deposits are insured by the FDIC.

[8] The Bank of Hawaii, the most profitable of the country's three commercial banks, withdrew from the FSM at end-November 2002, motivated by corporate restructuring considerations, as it has from some other countries in the region. The transfer of its deposit base and loan base to the remaining two banks is generally proceeding on an orderly basis.

employees and on payments to vendors have resulted in delays in loan repayments; this situation, in turn, has contributed to a decline in credit to the private sector.

9. **Policy reforms—especially structural measures to promote private sector activity—have advanced little in the past few years, but some initial steps are under way.** In recent months, the requisite approval for an AsDB-supported Private Sector Development Program (PSDP) loan has been granted by all governments except Chuuk. In the area of tax reform, a high-level Revenue Symposium recommended the introduction of a VAT in October 2002, with support from the Pacific Financial Technical Assistance Center (PFTAC).

III. Policy Discussions

10. **Given the FSM's heavy dependence on transfers from the United States, the discussions focused on the economic consequences of the expected decline in assistance under Compact II and the needed policy response.** The country faces the major challenge of having to adjust to a significant reduction in external assistance. In the immediate future, a substantial fiscal consolidation, requiring both revenue and expenditure measures, is vital. The fiscal tightening will likely result in curtailed economic activity and declining living standards in the near term. In the medium term, however, an increase in private sector growth—within the limits of the available potential—driven by structural reforms will be essential to ensure macroeconomic stability and mitigate any declines in living standards.

11. **The policy challenges faced by the authorities are largely the same as those discussed at the 2000 Article IV consultation.** The staff had then recommended a strengthening of the fiscal position and structural reforms to promote the private sector—actions that would help the economy adjust to the expected reduction in assistance in a gradual and forward-looking manner (Box 5). Apart from the Revenue Symposium on tax

Box 5: Prior Policy Recommendations and Implementation

The Fund's policy advice to the FSM at the 1998 Article IV consultation and again at the 2000 consultation centered on fiscal consolidation and structural reforms. These measures were deemed key to private sector-led growth and a sustainable external position in the face of the prospective reduction in Compact financing. In many policy areas, Fund advice drew on the authorities' own reform agenda:

- The cornerstone of this agenda was to reduce current expenditures, and the wage bill in particular—building on the gains made under the PSRP. In the past two years, however, progress has been limited in these areas; and some of the gains under the PSRP have been reversed.
- Another key objective was to raise the tax effort. In the event, the tax ratio has remained low, but a recent high-level Revenue Symposium has paved the way for the introduction of a VAT.
- Private sector development has remained high on the authorities' policy agenda, but progress has been slow in implementing the necessary structural reforms. More recently, however, four of the five governments have approved the AsDB's Private Sector Development Program, which aims to address some of the structural constraints to private sector investment.
- Improvements in fiscal transparency and accountability have also been advocated. In light of the stringent financial reporting requirements under the new Compact, the authorities are giving these issues increased attention.
- Despite some improvements, statistical deficiencies continue to hamper economic assessment and management. The authorities intend to strengthen their statistical capacity and have sought technical assistance from the Fund.

reform and steps to initiate the PSDP, however, little has been done in the past two years to prepare the economy for Compact II. Indeed, the underlying fiscal position has weakened further, with an attendant loss of reserves; the present economic situation would thus have called for strong adjustment efforts even without the prospect of reduced financing. With it, the required adjustment has become more urgent and severe. The authorities broadly agreed with this assessment and attributed the country's limited progress to several factors: the policy autonomy of the FSM's four states; the availability of bump-up Compact funds that provided ready financing for government spending; expectations of a more favorable outcome of the Compact II negotiations; and the country's weak implementation capacity.

12. **To frame its discussions, the mission discussed two alternative medium-term scenarios with the authorities** (Annex I).

- Under a "**reform**" scenario, the impact of fiscal adjustment would be attenuated by some pick-up in private sector investment fostered by structural reforms. This could allow the economy to grow at about 2 percent per annum over time (broadly in line with the growth rate attained under Compact I), with a likely modest improvement in per capita income.

- Under the alternative "**current policies**" scenario, which highlights the serious potential costs of policy inaction, adjustment would come mainly through a depletion of the already low level of usable government assets and a reduction of capital outlays. Lower capital outlays will weaken the FSM's growth potential and lead to a major decline in real GDP and living standards. The government's failure to take the needed policy actions would, moreover, send a negative signal to potential investors and donors. Thus, economic activity would remain depressed even in the long run, with likely continuing declines in living standards.

13. **Looking beyond the Compact II period, the corpus of the Trust Fund to be built up over the twenty-year period is expected to provide in FY2024 an annual yield broadly in line with the level of grant assistance in the last Compact year** (Annex II). While the Trust Fund will indeed constitute a safety net for the FSM for the long run, annual revenue in real terms will suffer a decline compared with assistance provided under Compact I and even under Compact II. Thus, appropriate policies, as discussed above, are essential to prevent a significant reduction in living standards.

14. **The mission underscored the importance of political resolve and a broad base of internal support for the required policy actions, given the FSM's weak track record of recent years and the difficulty involved in taking these actions**. An early priority is thus to better disseminate information on Compact II and its economic implications as a first step to building consensus on the required policies. Moreover, while efforts to lobby the U.S. Congress for more favorable Compact II terms are understandable, undue optimism about the outcome risks further delay in adjustment. The mission also advised against postponing the needed actions owing to incipient pressures related to the upcoming national and state

government elections.[9] While agreeing with staff views, the authorities expressed concern about their ability to garner the necessary internal support, especially in view of the elections and the autonomy of the four states. Nevertheless, they felt that the FSM would have no choice but to undertake prompt fiscal adjustment, especially in response to the initial cutback in Compact funding; they foresaw more difficulty in sustaining the adjustment over the medium-term as required by the continuing declines in assistance. The authorities propose to disseminate widely the information on the Compact and its policy implications; they have distributed the staff's concluding statement to the National Congress and the state governments.

A. Fiscal Policy

15. **The FSM faces a dual challenge as it seeks to implement**: first, an adjustment to new terms for assistance in the first year of Compact II, FY2004; and second, a medium-term adjustment in response to anticipated declines in the real levels of Compact assistance resulting from an annual decrement in grant levels and less-than-full inflation indexation. The immediate priority is to strengthen the fiscal position of the national and state governments, starting in the current fiscal year. The main elements of Compact II that have a significant bearing on the budget are: the cutback (of \$6 million or about 2 ¾ percent of GDP) in assistance in FY2004 and the required contribution of \$30 million to the Trust Fund in that year. This estimated cutback assumes that the five governments will adhere to their pledge to set aside the bump-up funds in FY2003 for helping to finance the downpayment to the Trust Fund. The staff cautioned that, if the bump-up funds are used instead for spending in FY2003, the cutback will be much larger (\$23 million or 11 percent of GDP) and the required fiscal adjustment more daunting.

16. **The low level of usable government assets, as well as a stipulated restriction on the use of Compact II funds for securing borrowing, constrain the ability of the governments to run and finance deficits**. The authorities agreed that fiscal consolidation is crucial to help bolster the precarious reserve position and gradually build up a cushion for future contingencies.

17. **Fiscal adjustment will require both revenue and expenditure measures.** However, as revenue measures may take a few years to be fully implemented, expenditure cuts will have to bear the initial brunt of adjustment.

- **Current expenditures will need to be cut by about \$10–12 million (4 to 5 percent of GDP) during the first three years of Compact II, with most of this adjustment having to come from a reduction in the wage bill.** Public sector wages remain twice as high as those in the private sector. The staff recommended, therefore, that at a minimum the current freeze on nominal wages should be maintained, together with reductions in employment. The staff suggested that, more fundamentally, fiscal

[9] Elections for the national Congress will be held in March 2003, and the President and Vice President will be elected in April. Elections for governors of two states took place in November 2002.

retrenchment will benefit from an early comprehensive review of the structure, staffing, and compensation levels of the public sector—possibly with donor assistance. The authorities confirmed their intention, in the first instance, to keep nominal wages unchanged and to reverse the recent increase in work weeks. They agreed that a systematic civil service review would be useful, especially given the recent ad hoc adjustments in most of the states.

- **Other important sources of potential cost savings are cuts in travel outlays, discretionary spending for constituency-based projects, and subsidies.** To build an adequate reserve position, the National and Chuuk governments should consider not only imposing a freeze on new projects but also de-appropriating funds for low-priority projects. Another avenue for savings will be to minimize duplication of activities among the various levels of government. Further, a phased reduction of government subsidies to public enterprises could yield budgetary savings of at least \$3 million. Implicit subsidies to public utility companies through discounted fuel prices should also be eliminated.

- **Capital outlays and social spending should not bear the burden of fiscal retrenchment**, with priorities in such expenditure, however, being carefully reviewed. In the absence of a specific requirement for capital spending allocations under Compact II—unlike under Compact I—the government should ensure that spending for infrastructure, health, and education is safeguarded to enhance the economy's productive potential. Given the past pattern of high outlays and weak outcomes, efforts should also be made to improve the quality of social spending. In particular, the staff was of the view that a well-educated work force would enhance the country's economic potential and institutional capacity. At the same time, the growth of the private sector may not be sufficient to absorb the large number of people expected to enter the job market over the next five to ten years on the basis of the present demographics. Under these circumstances, the emphasis on education would provide the more skilled among them the option of seeking employment opportunities in the U.S. Further, given the advances in information technology, investment in human capital should help the FSM overcome its constraints of small size and remoteness. The authorities fully concurred with staff's views on these issues.

- **In view of the low tax ratio and the limitations of the present tax regime, the staff welcomed the recent steps toward introducing a VAT in place of import duties and the gross revenue tax (GRT).** The staff underscored that the new Steering Committee should press ahead with operationalizing the VAT. While the nature of the Federation has made it difficult to have a unified VAT structure, every effort should be made to minimize divergence in rates, coverage, and exemptions of the VATs in the four states; it would also be important to have a uniform administration (Customs and Unified Tax Administration) across the four states as endorsed by the Revenue Symposium. Consideration should also be given to measures for raising revenue from other sources in the near term. These actions could include a broadening of the wages and salaries tax to include non-wage income and an increase in the personal income tax rate for upper-income earners. Equally important will be strengthened tax administration. The authorities expressed their intention to proceed with the VAT expeditiously; they also saw a clear need to improve tax administration.

- **Non-tax receipts should be bolstered.** The government should give priority to identifying ways to reverse the decline in receipts from fishing license fees in recent years and to strengthen monitoring of illegal fishing. The authorities are considering steps to increase the FSM's attractiveness for fishing relative to neighboring countries.

18. **With regard to the serious financial situation of the Chuuk state**, the staff noted that the state's FY2003 budget failed to address adequately the large build-up of arrears and the past unsustainable growth in current expenditures, especially on payroll. The authorities agreed that fiscal discipline and governance had to be urgently strengthened in Chuuk, by repayment of the arrears and reduction of the wage bill at least to the levels achieved under the PSRP. While welcoming the creation of the new Chuuk Financial Control Commission to take control of Chuuk's expenditures, the staff expressed concern that its mandate may not be sufficient to achieve a turnaround in Chuuk's finances. The authorities indicated that, while the responsibility for corrective action rests primarily with Chuuk, the national government would closely monitor the situation and bring pressure to bear on the Chuuk authorities for early and significant adjustment.

19. **The importance of good governance and transparency in economic policy making cannot be over-emphasized.** The staff expressed concern about questions raised in U.S. Government Accounting Office reports about accountability in the use of Compact I funding, long lags in publishing the audit reports of the government accounts (the final accounts of FY2001 are still not available), and the failure to distinguish between revenue and financing items in the budget. Given these and other concerns, the stringent Compact II accountability requirements on audits and procedures governing fiscal transparency and reporting on the use of Compact funds are appropriate. These measures will also allow a clearer assessment of fiscal operations and help improve productivity of spending. The authorities agreed that, for compliance with these requirements, substantially improved accuracy and timeliness of reporting of fiscal and other macroeconomic data will be crucial.

20. **Public enterprise reform, long overdue, is essential for reducing budgetary subsidies but also for facilitating private sector development.** Most enterprises are operating with continuous losses or are defunct. While there is growing recognition that the government should not be involved in the productive sector of the economy, little progress has been made in privatizing or liquidating these ventures. The AsDB's PSDP calls for the preparation of a reform master plan, including the transformation of at least one public enterprise by each government, and should help carry forward reform. The recent efforts to reduce employment in public enterprises are welcome, but wage rates appear to remain even higher than in the rest of the public sector. To provide a level playing field, these enterprises should be required to pay the GRT. The authorities concurred on the early need for reform, but noted that it was politically difficult for the governments to accept the losses on their original investments that would be entailed in exiting from these ventures.

B. Structural Reforms to Promote Private Sector Growth

21. **Prospects for the dynamic development of the private sector are uncertain**, reflecting the FSM's narrow resource base and limited availability of viable investment opportunities—factors common to other small island economies. The mission emphasized that, nevertheless, the resolute implementation of structural reforms will be important for improving the climate for private sector investment and maximizing—within those limits—the potential for niche markets in tourism and some agricultural exports. The staff therefore encouraged the authorities to press ahead with the PSDP, which includes steps to improve the regulatory and legal framework, enhance access to finance for small businesses, and strengthen entrepreneurial skills. Moreover, given the considerable time required for structural reforms to bear fruit, the staff urged that these actions should be implemented without further delay.

22. **Bold action will also be needed to establish a transparent and less discretionary regime for foreign investment approvals**. However, it appears that difficulties encountered with some previous foreign ventures, as well as concerns about the competition that foreign investment would pose to locally-owned ventures, such as tourist hotels, may have slowed progress in this area. Still, the authorities expressed their interest in promoting foreign investment, including through some actions envisaged under the PSDP to simplify the foreign investment regime.

23. **The present land tenure system continues to limit the use of land for commercial purposes**. Earlier progress has included the change in land ownership from multiple to individual titles and the increase in the maximum lease length from 25 to 55 years.[10] But serious problems remain: titling and registration are slow, there is no commercial market for land, and foreigners are not permitted to own land. While the authorities recognize the constraints posed by the current land tenure system on private sector development, they noted that land reform was a difficult issue given the cultural importance of land in the FSM. Nevertheless, they intend to continue their efforts in this area.

24. **With only a modest increase in the FSM's real effective exchange rate, the country's link to the U.S. dollar—which has imparted much-needed monetary stability—does not appear to be a factor behind the weak performance of its external sector**. Improving competitiveness—which will be important as the country seeks to develop a more vibrant private sector—would be facilitated by a lowering of the domestic cost structure, including through the reduction of structural impediments.

C. Strengthening the Financial Sector

25. **Financial intermediation in the FSM will remain limited unless factors that constrain lending, such as the difficulties of using land as collateral, are addressed**. Thus, structural reforms are needed to enable the banking system to enhance its support for private sector development. The recent amendment to the Banking Act to bring it into line

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[10] Most states have submitted legislation to Congress to further extend this period to 99 years.

with the Basle Core Principles is welcome, and will help further strengthen prudential standards. As the recent increase in non-performing loans is largely attributable to the Chuuk fiscal crisis, the delinquent loans will decline once the Chuuk government repays its current arrears to wage earners and vendors.

26. **The FSM is not on the FATF money laundering list nor on the OECD tax haven list**. The staff welcomed the authorities' interest in strengthening their strategy for combating potential financial system abuse. In particular, the authorities are reviewing LEG's recommendations for strengthening the FSM's Anti-Money Laundering Law.

D. Other Issues

27. **The FSM continues to have a relatively open trade regime, rated "4" on the Fund's index of trade restrictiveness**. The import duty rates are 4 percent for general merchandize and 3 percent for food products, while a number of other items are subject to higher rates ranging from 25-100 percent.

28. **Weaknesses in the quality, coverage, and timeliness of statistics continue to hamper effective economic assessment and management** (see Annex VIII). Some welcome improvements have been made—such as the establishment of an IFS page in FY2000 and CPI indices for most states, and the recent introduction of the PC/Trade reporting system that has begun to help improve import data. However, major deficiencies remain, particularly in the areas of the national accounts, balance of payments, and fiscal accounts. The authorities attributed these problems to a lack of local expertise and resources for statistical functions, and requested technical assistance. While supporting this request, the staff recommended that the authorities should appoint qualified staff so as to ensure that capacity building and technical assistance are properly followed up.

IV. Staff Appraisal

29. **The FSM faces major policy challenges as it adjusts to reduced external assistance under Compact II**. Little headway has been made thus far in preparing the economy for this new reality. On the contrary, the country's fiscal position has continued to weaken, as earlier progress in government retrenchment has been partly eroded; usable government assets have dwindled; and the private sector remains largely a provider of services to the public sector. Even without the prospective reduction in assistance, sizable adjustment would have been essential; the expected cutback only heightens the urgency and scale of the needed adjustment. The country's prospects rest heavily on decisive policy action by the government. Only with fiscal prudence, reforms to stimulate private sector activity, and greater investment in human capital can the FSM look forward to macroeconomic stability and economic growth. In the absence of timely adjustment, the outlook is bleak, with significant and protracted output losses and a corresponding slide in living standards.

30. **The FSM's structure as a loose federation of autonomous states and the upcoming elections are two factors that could impede efforts to garner the political consensus for needed policy actions**. Such factors have hampered policy action in the past, but the difficult funding situation under Compact II leaves little room for maneuver. It is thus

vital that the authorities spare no effort in mobilizing broad support, by widely disseminating information on the likely economic consequences of Compact II and the imperative of remedial action. A number of the required policy actions, especially those in the fiscal area such as reducing the wage bill, addressing Chuuk's fiscal problems, and strengthening tax administration should, and can, be implemented in the near term. Actions to initiate the implementation of the PSDP and the VAT should also be on the forefront of the authorities' agenda. For some other policy actions, notably structural reforms, securing a political consensus may prove more time-taking; here too, however, given the implementation lags, policies should be set in train as soon as possible.

31. **The immediate priority is to strengthen the fiscal position significantly**. Given the dearth of financing options and the urgent need to rebuild reserves, fiscal consolidation is crucial. The actions required will differ among the national and four state governments; Chuuk faces the most serious problems and requires the most stringent measures. Bold fiscal measures should be introduced in the FY2004 budget—the political consensus for which would be facilitated by the completion of elections in April 2003.

32. **Adjustment in the initial years of Compact II will have to come mainly from cuts in government current expenditure, focused on the wage bill.** The need for sustained public sector retrenchment and wage rationalization calls for a comprehensive review—possibly with donor assistance—of the compensation levels and structure of the civil service. Non-wage outlays should also be thoroughly reviewed with a view to reducing the large travel budget and discretionary spending on constituency-based projects. Cost savings will be especially essential to finance the new budgetary demands expected under Compact II—notably, those related to the stringent accountability requirements and to the possible scaling back of benefits from some U.S. government programs such as disaster assistance.

33. **Tax revenues remain very low, and additional revenues must be mobilized**. The proposed VAT is welcome; and resolute efforts are needed for its early implementation. Differences in VAT law among the four states should be kept to a minimum, while it should be administered on a uniform basis. Other measures, including better tax administration, will also have to be undertaken to boost revenues in the near term. Early action is equally needed to reverse the declining trend in fishing license fees, a key source of non-tax revenue.

34. **Reduced current spending, along with tax reform, will help minimize the need for cuts in capital expenditure**. To enhance the country's productive potential and economic growth, the FSM should safeguard spending on infrastructure as well as outlays for health and education. Better educated Micronesians can contribute to improved prospects for the FSM but will also be well placed to seek employment opportunities in the United States.

35. **Efforts are needed to improve transparency and accountability in the government's fiscal operations**. These efforts will benefit from the stringent new reporting and auditing requirements and strengthened oversight of U.S. assistance under Compact II.

36. **Private sector development can help sustain growth in the medium term and mitigate the likely declines in living standards resulting from fiscal adjustment**. The country's link to the U.S. dollar has imparted much-needed monetary stability and does not

appear to have had an adverse impact on competitiveness. However, given its narrow resource base and remote location, the FSM no doubt faces stiff challenges in developing the private sector. Prospects are therefore uncertain. Nevertheless, harnessing the limited potential for private sector development is essential, and will require, at a minimum, structural reforms in land tenure, the foreign investment regime, and the public enterprise sector. These reforms will also help address current constraints on bank lending.

37. **Despite progress, statistical deficiencies continue to hamper economic assessment and management**. Further efforts are needed to improve data compilation and coverage as well as data provision to the Fund. The authorities' intention to enhance the FSM's statistical capacity, through better recruitment and training as well as technical assistance, is strongly endorsed.

38. **It is proposed that the next Article IV consultation with the Federated States of Micronesia take place on the current 24-month cycle.**

Table 1. Federated States of Micronesia: Basic Data, FY1997-2003 1/

Nominal GDP (2001/02):	$232 million
Population (2001/02):	107,513
GDP per capita (2001/02):	$2,158
Quota:	SDR 5.1 million

	FY1997	FY1998	FY1999	FY2000	FY2001 Est.	FY2002 Est.	FY2003 Proj.
Real sector							
Real GDP (percent change)	-4.6	-2.8	0.3	4.4	1.1	0.8	2.4
Consumer prices (percent change) 2/	2.7	1.6	1.9	1.8	2.0	0.0	1.5
Consolidated government finances (in percent of GDP)							
Revenue and grants	66.6	73.6	71.2	66.4	59.8	69.1	67.9
Revenue	23.4	27.1	25.5	23.3	18.0	19.9	20.1
Grants	43.2	46.5	45.7	43.1	41.8	49.2	47.8
Expenditure	66.3	80.4	78.8	73.2	65.8	66.7	66.2
Current	59.8	60.8	60.3	59.1	54.5	55.6	54.2
Capital	6.5	19.6	18.5	14.0	11.2	11.1	12.0
Overall balance	0.4	-6.9	-7.6	-6.7	-5.9	2.4	1.7
Stock of domestic arrears (in millions of U.S. dollars) 3/	12.4	1.2	--	--	9.0	15.0	13.0
National and state governments' usable financial assets							
(in millions of U.S. dollars; end of period) 4/	35.2	35.3	48.0	42.5	34.6	43.6	48.8
(in percent of government expenditure)	25.5	21.3	29.0	26.0	22.8	28.2	30.6
Commercial banks (in millions of U.S. dollars)							
Foreign assets 5/	74.2	78.3	75.9	77.0	77.8	75.3	...
Loans 5/	42.9	48.0	50.0	52.4	52.1	44.9	...
Total deposits 5/	109.3	120.1	119.0	120.8	121.5	114.6	...
Interest rates (percent per annum)							
Consumer loans	15.0	15.0	15.2	15.3	15.3	15.3	...
Commercial loans	10.8	10.4	10.3	11.0	5.9	6.8	...
Balance of payments (in millions of U.S. dollars)							
Trade balance	-83.1	-82.4	-88.7	-96.0	-87.1	-88.1	-89.3
Net services and income	-9.5	-13.0	-7.3	-6.3	-15.6	-15.5	-13.2
Private and official transfers	72.1	83.5	85.6	87.0	85.3	99.4	117.6
Current account including official transfers	-20.5	-11.9	-10.4	-15.3	-17.4	-4.3	15.1
(in percent of GDP)	-9.9	-5.8	-5.0	-6.9	-7.5	-1.8	6.3
Current account excluding official transfers	-91.0	-93.5	-93.9	-100.1	-100.5	-101.4	-100.2
(in percent of GDP)	-43.7	-45.5	-44.7	-44.9	-43.7	-43.7	-41.6
Overall balance	-4.2	18.4	-8.8	22.0	-13.0	6.2	6.0
(in percent of GDP)	-2.0	9.0	-4.2	9.9	-5.7	2.7	2.5
External debt (in millions of U.S. dollars; end of period) 6/	97.8	94.4	83.5	66.5	57.6	57.6	53.1
(in percent of GDP)	47.0	45.9	39.8	29.8	25.0	24.8	22.0
External debt service (in millions of U.S. dollars) 6/	22.6	20.8	19.4	23.0	11.0	2.4	2.4
(in percent of exports of goods and services)	65.3	65.5	60.7	68.3	31.4	6.7	4.9
Exchange rate							
Exchange rate regime			The U.S. dollar is the domestic currency				

Sources: Data provided by the FSM authorities; AsDB Outlook 2002; and staff estimates.

1/ Fiscal year ending September 30.
2/ A price index for the FSM has been available only since FY2000, and data shown are for the FSM from FY2000 onward. For previous years, the U.S. CPI is used.
3/ Estimated stock of domestic arrears in Chuuk and Pohnpei in FY1998, and in Chuuk in FY2001-2003; end of period.
4/ Cash and other liquid investments not reserved for specific uses.
5/ Data for FY2002 are for end March 2002.
6/ Government and public enterprise debt.

Table 2. Federated States of Micronesia: Consolidated General Government Finances, 1997-2003 1/

(In millions of U.S. dollars)

	FY1997	FY1998	FY1999	FY2000	FY2001 Est.	FY2002 Est.	FY2003 Proj.
Total revenue and grants	138.7	151.2	149.4	148.2	137.7	160.3	163.7
Total revenue	48.7	55.6	53.4	52.0	41.5	46.1	48.4
Tax revenue	20.6	26.1	25.3	27.1	27.8	28.4	28.5
Nontax revenue	28.1	29.5	28.2	24.9	13.7	17.8	19.9
Of which : Fishing access revenue	14.4	13.5	16.0	14.1	12.0	11.2	12.4
Dividend and interest income	8.7	8.9	7.4	5.2	-2.3	1.7	2.5
Grants from abroad	90.0	95.6	96.0	96.2	96.2	114.2	115.3
Current grants	66.0	71.0	70.9	70.4	69.9	81.1	81.8
Of which : Compact Total	56.0	56.1	55.7	54.7	55.3	65.9	66.6
Capital grants	24.0	24.6	25.1	25.8	26.2	33.1	33.5
Of which : Compact CIP	22.0	23.3	23.7	24.6	25.0	31.8	32.2
Total expenditure and net lending	137.9	165.3	165.3	163.2	151.3	154.8	159.6
Total expenditure	137.9	165.3	165.3	163.2	151.3	154.8	159.6
Current expenditure	124.4	124.9	126.6	131.9	125.5	129.1	130.7
Expenditure on goods and services	113.6	109.1	114.3	119.7	119.0	122.1	124.2
Wages and salaries	58.5	50.1	50.2	52.2	55.1	57.6	58.2
Travel	6.9	6.8	7.7	8.4	8.4	8.4	8.5
Other	48.2	52.2	56.4	59.1	55.5	56.1	57.4
Interest payments	4.8	3.6	2.9	1.9	0.0	0.0	0.0
Subsidies	3.9	3.4	4.3	5.9	3.0	3.0	3.1
Transfers	1.9	8.8	5.2	4.5	3.5	3.9	3.5
Capital expenditure	13.5	40.4	38.8	31.3	25.9	25.7	28.9
Net lending (domestic)	--	--	--	--	--	--	--
Overall Balance	0.8	-14.1	-15.9	-15.0	-13.6	5.5	4.1
Current Balance	-9.7	1.7	-2.3	-9.4	-14.0	-1.8	-0.5
Financing	-0.8	14.1	15.9	15.0	13.6	-5.5	-4.1
Domestic financing	33.7	-11.9	23.0	17.8	...	...	...
External financing	-34.5	25.9	-7.1	-2.8	...	...	...
	(In percent of GDP)						
Total revenue	23.4	27.1	25.5	23.3	18.0	19.9	20.1
Tax revenue	9.9	12.7	12.0	12.1	12.1	12.2	11.8
Nontax revenue as percent of GDP	13.5	14.4	13.4	11.2	6.0	7.7	8.3
Grants	43.2	46.5	45.7	43.1	41.8	49.2	47.8
Total expenditure and net lending	66.3	80.4	78.8	73.2	65.8	66.7	66.2
Current	59.8	60.8	60.3	59.1	54.5	55.6	54.2
Of which : Wages and salaries, as percent of GDP	28.1	24.4	23.9	23.4	24.0	24.8	24.1
Capital	6.5	19.6	18.5	14.0	11.2	11.1	12.0
Overall balance	0.4	-6.9	-7.6	-6.7	-5.9	2.4	1.7
Current balance	-4.7	0.8	-1.1	-4.2	-6.1	-0.8	-0.2
Memorandum items (in millions of U.S. dollars):							
Compact	78.0	79.4	79.4	79.3	80.2	97.7	98.8
(in percent of GDP)	37.5	38.6	37.8	35.6	34.9	42.1	41.0
Total government financial assets 2/	204.5	198.6	205.9	189.5	163.4	171.8	182.0
Usable government financial assets 3/	35.2	35.3	48.0	42.5	34.6	43.6	48.8
Of which : excluding Yap	18.1	16.4	23.5	11.0	-0.9	3.7	4.8
Outstanding stock of domestic arrears	12.4	1.2	--	--	9.0	15.0	13.0

Sources: Data provided by the FSM authorities; and staff estimates.

1/ Fiscal year ending September 30. The consolidated government fiscal accounts cover the national and four state governments.
2/ This number comprises the sum of the holdings of foreign assets of each of the five governments, and their holdings of shares in public enterprises. The latter are of little value given that most of these enterprises are loss-making.
3/ Cash and other liquid investments not reserved for specific uses.

Table 3. Federated States of Micronesia: Balance of Payments, FY1997-2003 1/

(In millions of U.S. dollars)

	FY1997	FY1998	FY1999	FY2000	FY2001 Est.	FY2002 Est.	FY2003 Proj.
Trade balance	-83.1	-82.4	-88.7	-96.0	-87.1	-88.1	-89.3
Exports and reexports, f.o.b.	15.0	16.0	14.5	12.9	16.3	16.1	16.5
Imports, f.o.b. 2/	-98.1	-98.5	-103.2	-108.9	-103.4	-104.2	-106.2
Petroleum products	-11.3	-10.9	-11.1	-15.4	-14.4	-14.6	-14.0
Services account	-30.5	-34.4	-30.7	-27.9	-27.1	-28.5	-30.7
Receipts	19.6	15.7	17.4	20.7	18.7	20.1	21.9
Travel	17.7	14.5	16.0	19.5	16.8	18.2	19.9
Communications (net)	0.8	1.1	1.1	1.1	1.8	1.8	1.8
Other	1.1	0.1	0.3	0.1	0.1	0.1	0.1
Payments	-50.2	-50.1	-48.1	-48.6	-45.8	-48.6	-52.6
Freight and insurance	-17.3	-17.4	-18.2	-19.2	-18.3	-18.4	-21.8
Transportation	-12.8	-9.9	-10.1	-10.7	-11.1	-11.2	-11.2
Travel	-4.9	-4.8	-5.0	-5.3	-5.5	-5.5	-5.5
Other	-15.1	-18.0	-14.8	-13.3	-11.0	-13.5	-14.1
Income, net	21.0	21.4	23.4	21.5	11.5	13.0	17.5
Receipts	29.3	28.6	29.6	26.6	15.0	16.1	21.2
Fishing rights fees	14.4	13.5	15.9	14.1	12.0	11.2	11.7
Interest and dividend income	14.9	15.1	13.7	12.5	3.0	4.9	9.5
Payments	-8.3	-7.1	-6.2	-5.1	-3.5	-3.1	-3.7
Interest payments	-6.7	-5.6	-4.6	-3.7	-2.1	-1.7	-3.7
Dividends	-1.6	-1.5	-1.6	-1.4	-1.4	-1.4	0.0
Unrequited transfers	72.1	83.5	85.6	87.0	85.3	99.4	117.6
Private	1.7	1.9	2.1	2.2	2.2	2.3	2.3
Inflows	4.0	4.2	4.4	4.6	4.7	4.8	4.9
Outflows	-2.3	-2.3	-2.3	-2.5	-2.5	-2.6	-2.6
Official	70.5	81.6	83.5	84.8	83.1	97.1	115.3
Compact funds	53.6	54.4	54.4	54.7	55.3	65.9	98.8
Other	16.9	27.1	29.1	30.1	27.9	31.2	16.5
Current account							
Including official transfers	-20.5	-11.9	-10.4	-15.3	-17.4	-4.3	15.1
(in percent of GDP)	-9.9	-5.8	-5.0	-6.9	-7.5	-1.8	6.3
Excluding official transfers	-91.0	-93.5	-93.9	-100.1	-100.5	-101.4	-100.2
(in percent of GDP)	-43.7	-45.5	-44.7	-44.9	-43.7	-43.7	-41.6
Capital and financial account	23.1	25.8	19.7	12.2	19.7	36.9	34.8
Capital Transfers, Official	30.2	24.0	24.5	24.5	24.6	31.8	32.2
Capital Transfers, in-kind	0.0	3.9	6.3	4.8	1.9	5.0	2.5
Short term, net	-2.9	1.3	-0.2	-0.1	2.1	0.1	0.1
Medium term, net	-4.2	-3.4	-10.9	-17.0	-8.9	0.0	0.0
Inflows	11.7	11.8	3.8	2.2	0.0	0.0	0.0
Medium-term note issues	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other borrowing	11.7	11.8	3.8	2.2	0.0	0.0	0.0
Outflows	-15.9	-15.2	-14.7	-19.2	-8.9	0.0	0.0
Medium-term note amortization	-8.3	-11.3	-11.0	-18.5	-8.2	0.0	0.0
Other amortization, excluding IMF	-7.6	-3.9	-3.7	-0.7	-0.7	0.0	0.0
Overall balance 3/	-4.2	18.4	-8.8	22.0	-13.0	6.2	6.0
Errors and omissions 4/	6.8	-4.5	18.1	-25.2	15.4	26.5	43.9

Sources: Data provided by the FSM authorities; and staff estimates.

1/ Financial year ending September 30. The figures in the table are based on an updated methodology used by the authorities.

2/ Based on import tax collections.

3/ Reflects changes in total government foreign assets.

4/ Includes valuation changes.

Table 4. Federated States of Micronesia: External Vulnerability Indicators, FY1997–2002

	FY1997	FY1998	FY1999	FY2000	FY2001	FY2002 Est.
Financial indicators 1/						
Commercial bank deposits (12 month percent change)	-2.7	9.9	-0.9	1.5	0.6	-5.7
Private sector credit (12 month percent change)	-13.0	11.9	4.2	4.8	-0.6	-13.8
Foreign assets/total assets (percent)	59.6	57.3	53.7	57.4	56.8	54.0
Nonperforming loans (in percent of total loans) 2/	7.6	3.8	4.0	5.0	4.8	9.8
External indicators						
Exports (percent change)	-17.4	7.0	-9.7	-10.7	26.0	-1.2
Imports (percent change)	-4.3	0.4	4.8	5.6	-5.0	0.8
Current account balance (in percent of GDP)						
Including official transfers	-9.9	-5.8	-5.0	-6.9	-7.5	-1.8
Excluding official transfers	-43.7	-45.5	-44.7	-44.9	-43.7	-43.7
Capital and financial account balance (in percent of GDP)	11.1	12.6	9.4	5.5	8.6	15.9
Total government foreign assets (in millions of dollars) 3/	85.8	101.6	92.7	113.0	98.3	104.4
Total government foreign assets (in months of imports of goods and services)	6.9	8.2	7.3	8.6	7.9	8.2
Total external debt (in percent of GDP)	47.0	45.9	39.8	29.8	25.0	24.8
Total external debt (in percent of exports of goods and services)	282.6	297.2	261.8	197.7	164.7	159.2
External debt service (in percent of exports of goods and services)	65.3	65.5	60.7	68.3	31.4	6.7

Source: Data provided by the FSM authorities; and staff estimates.

1/ Figures for FY2002 are based on end-June 2002 estimates.

2/ Defined as loans with arrears in excess of 90 days.

3/ Based on Gross Official Reserves data reported in the IFS. The figure for FY2002 is the end-August observation.

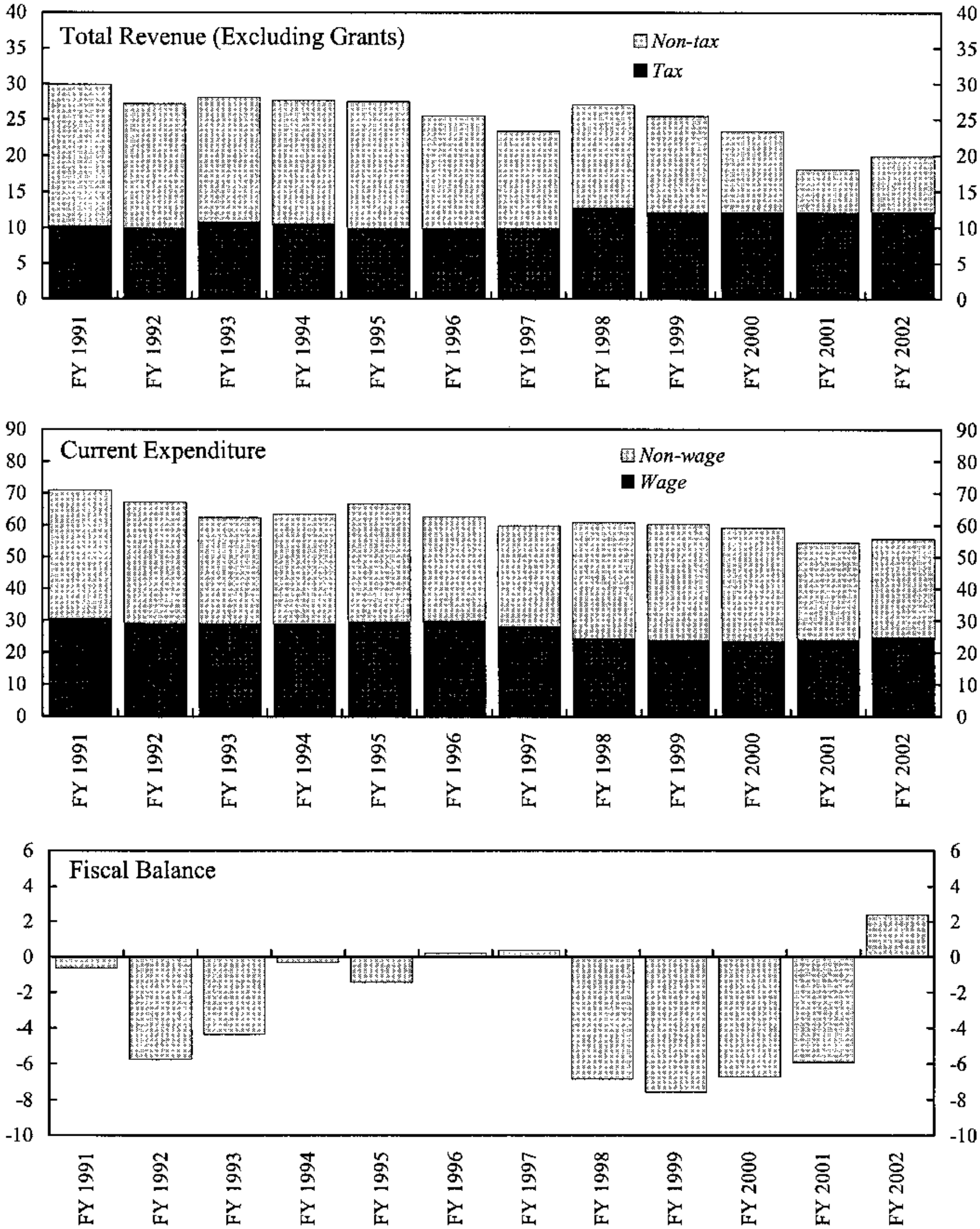
Table 5. Federated States of Micronesia: Social Indicators 1/

	Micronesia	Same Region/Income Group East Asia and Pacific	Same Region/Income Group Lower-middle Income
Population			
Total population, mid-year (millions)	0.11	1,853	2,046
Growth rate (percent annual average)	0.2	0.9	0.9
Urban population (percent of population)	29.7	35.2	42.0
Total fertility rate (births per woman)	4.4	2.1	2.1
GNI per capita (in U.S. dollars)	2,110	1,060	1,130
Human poverty index	26.7	...	...
Current public expenditure			
Health (in percent of GDP)	7.6	5.1	5.1
Education (in percent of GNP)	13.4	2.9	4.9
Gross School enrollment (percent of school age population)			
Primary school	83.0	107.0	106.4
Female	83.0	107.8	106.6
Secondary school	61.0	62.0	63.0
Female	43.0	58.7	60.2
Access to safe water (percent of population)	41.0	80.2	74.4
Immunization rate (percent under 12 months)			
Measles	74.0	85.4	89.1
Diphtheria/Pertussis/Tetanus (DPT)	75.0	85.2	88.8
Life expectancy at birth (years)			
Total	67.2	69.1	69.5
Male	66.6	67.3	67.4
Female	67.7	70.9	71.7
Mortality			
Infant (per thousand live births)	19.5	35.5	32.6
Under 5 (per thousand live births)	24.0	44.7	40.6

Sources: 2002 World Development Indicators, World Bank; FSM Country Brief, Asian Development Bank.

1/ FY2000 or latest available year prior to FY2000.

Figure 1. Micronesia: Consolidated General Government Finances
(In percent of GDP)



Source: Data provided by FSM authorities.

FEDERATED STATES OF MICRONESIA—ILLUSTRATIVE LONG-TERM FISCAL ADJUSTMENT SCENARIOS

The FSM's prospects rest heavily on decisive policy action by the government. In particular, fiscal adjustment in response to the expected cutback in Compact assistance and reforms to stimulate private sector activity are essential to achieve macroeconomic stability and economic growth. This is the outcome envisaged under the "reform" scenario discussed below. On the other hand, without timely adjustment, the outlook is bleak, with significant and protracted output losses and declines in living standards, as illustrated under the "current policies" scenario.

Basic assumptions

- Compact II will cover the twenty-year period, FY2004-2023, with annual assistance from the U.S. totaling $92 million,[1] split between a sector-specific grant and a contribution to a Trust Fund.[2] Annual grants will start at the level of $76 million per year for 3 years, and then decrease by $0.8 million per year, with the decrement being added to the annual U.S. contribution to the Trust Fund (Table).
- As in Compact I, both annual grants and contributions to the Trust Fund are adjusted for inflation at two-thirds the level of inflation in the U.S., with a cap of 5 percent. The present analysis assumes inflation in the U.S. and the FSM to be 3 percent and 2 percent, respectively.[3]
- The FSM will make an up-front contribution of $30 million to the Trust Fund in FY2004 financed by drawing down its government assets. No revenue or expenditure reform measures will be undertaken in FY2003; hence, government assets, together with the bump-up funds in FY2003, will be used to cover the fiscal shortfall in FY2003.
- The Trust Fund and the income from it are not available for use or as collateral until FY2024.

Reform Scenario

In the "reform scenario", comprehensive fiscal--in particular, civil service--reform will bring about the required adjustment in the initial years under Compact II (see Figure 2). After this initial adjustment, the fiscal position will broadly stabilize and a pick-up in private sector

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[1] Fiscal year ending September 30.

[2] The key assumptions for the long-term fiscal adjustment scenario analysis are based on the May 2002 U.S. proposal, which is the final U.S. offer. The analysis also assumes that no other new external assistance will be available during the Compact II period.

[3] Although the FSM is heavily dependent on imports from the U.S., its inflation rate has historically been below that of the U.S.

activity—fostered by broad-based structural reforms—is expected to support long run annual growth of about 2 percent.

Specifically, on the expenditure side, the government wage bill will be cut by 5 percent each year beginning in FY2004 for 5 years, and will grow in line with the rate of inflation after 2008. In addition, travel expenses will be cut by 5 percent annually between FY2004 and FY2008, and stay flat afterwards. Government subsidies are also expected to be phased out over three years beginning in FY2004. Consequently, current expenditure as a percent of GDP will drop from 55 percent in FY2004 to 37 percent in FY2023, while the wage bill as a percent of GDP will decline from 24 percent to 14 percent. Capital expenditures, on the other hand, will experience a sharp decline initially, being cut by 8 percent annually in the first three years of Compact II before recovering at the growth rate of nominal GDP.

On the revenue side, improved tax administration, a modest increase in tax rates, and the introduction of a VAT are expected to increase tax revenue by 6 percent annually for the first five years of Compact II and by 8 percent annually thereafter. Other sources of tax revenue are projected to grow at the rate of nominal GDP. As a result, tax revenue as a percent of GDP is projected to increase from the current 12 percent to 15 percent at the end of the Compact II period.

These wide-ranging expenditure control and revenue generation measures are expected to shift the consolidated fiscal position into a small surplus in FY2007 following the large deficits experienced in the first three years under Compact II. In step with these developments, usable government assets are initially run down significantly to finance the fiscal deficits before being gradually re-built—albeit to reach a much lower level than that attained at the end of Compact I.

Compact II Funding for the FSM[1]
(In millions of dollars)

Fiscal Year	Grant	Trust Fund	Total
2004	76.0	16.0	92.0
2005	76.0	16.0	92.0
2006	76.0	16.0	92.0
2007	75.2	16.8	92.0
2008	74.4	17.6	92.0
2009	73.6	18.4	92.0
2010	72.8	19.2	92.0
2011	72.0	20.0	92.0
2012	71.2	20.8	92.0
2013	70.4	21.6	92.0
2014	69.6	22.4	92.0
2015	68.8	23.2	92.0
2016	68.0	24.0	92.0
2017	67.2	24.8	92.0
2018	66.4	25.6	92.0
2019	65.6	26.4	92.0
2020	64.8	27.2	92.0
2021	64.0	28.0	92.0
2022	63.2	28.8	92.0
2023	62.4	29.6	92.0

[1] In FY2004 prices.
Source: U.S. Compact proposal, May 17, 2002.

Current Policies (Alternative) Scenario

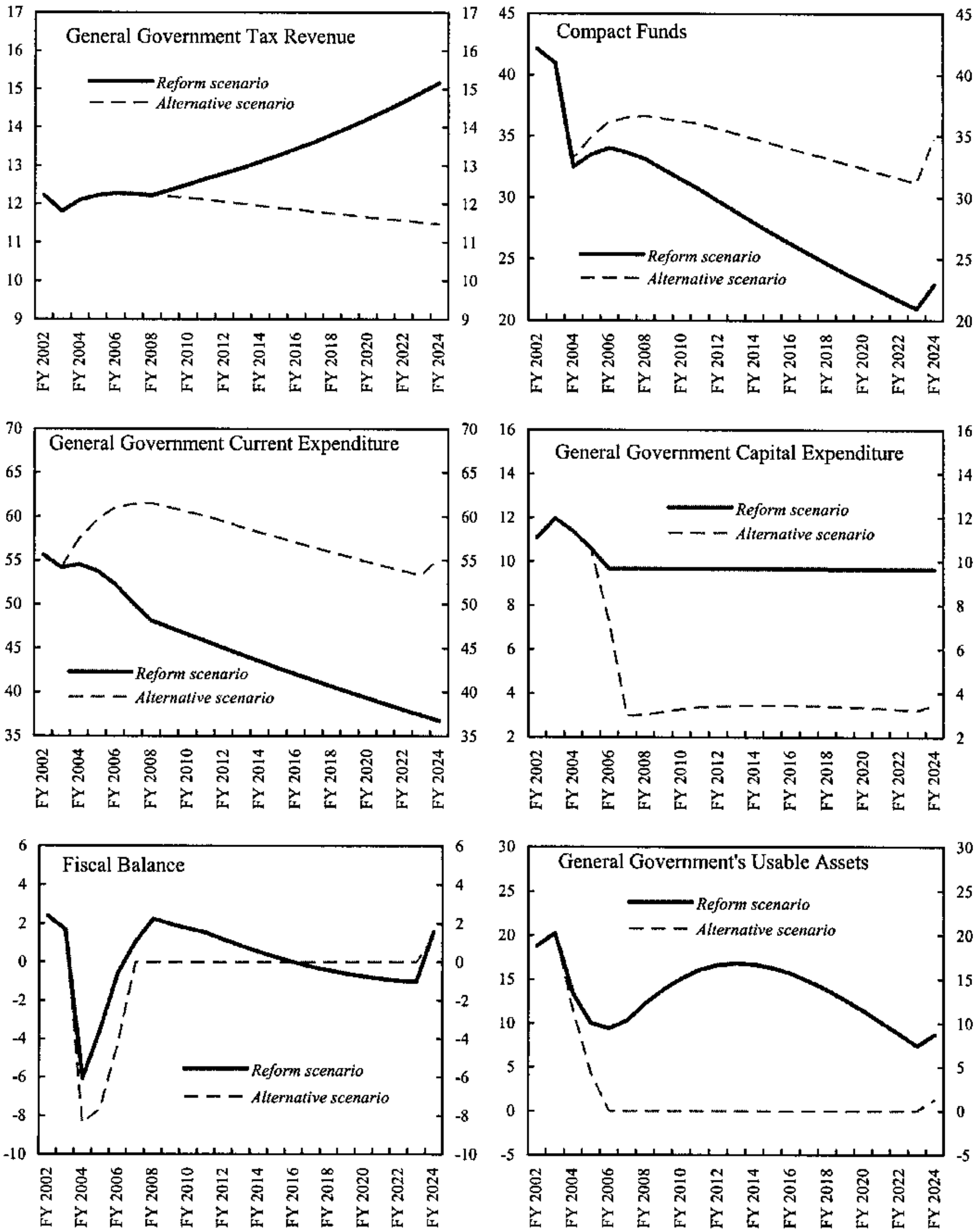
The "current policies" scenario illustrates the serious economic costs of policy inaction. Under this scenario, the authorities do not undertake the needed measures to increase revenue and reduce expenditures, especially in the area of civil service reform. As a result, the required adjustment to lower Compact assistance would come mainly through a depletion of usable government assets and a reduction in capital outlays, with adverse consequences for growth and living standards.

Specifically, the tax revenue to GDP ratio is expected to remain below 12 percent, and current expenditure is expected to remain at more than 50 percent of GDP. Since government usable assets will be depleted by FY2006, most of the adjustment to the reduced levels of Compact assistance would have to come from compression of capital expenditures. Therefore, capital expenditure will fall more sharply, to around 3 percent of GDP, compared with the drop to about 10 percent of GDP in the reform scenario.

The lower level of capital expenditure would have significant negative implications for growth. In addition, the government's failure to take the needed policy actions would send a negative signal to potential investors and donors. The economy is, therefore, projected to contract more sharply in the initial years of Compact II than under the reform scenario, and will be unable to achieve any real growth in the long run. Depending on population growth (net of migration), real GDP per capita may stagnate or even decline over time.[4]

[4] Migration from the FSM could intensify if the FSM economy shrinks in real terms.

Figure 2. Micronesia: Long-Term Fiscal Adjustment Scenarios, 2002-24
(In percent of GDP)



Source: Data provided by FSM authorities; and IMF staff estimates and projections.

FEDERATED STATES OF MICRONESIA—ANALYSIS OF THE COMPACT II TRUST FUND

The economic package of Compact II entails a Trust Fund to be built up mainly from U.S. contributions over the twenty-year period FY2004–2023, plus an up-front $30 million payment in FY2004 by the FSM.[1] The Trust Fund is expected to provide a stream of earnings broadly sufficient to replace the annual U.S. grant assistance after Compact II ends.

Based on the U.S. proposal, key assumptions of the Trust Fund analysis are:

- During the growth phase of the Trust Fund (years 1–20), annual U.S. appropriations plus the initial FSM contribution would be invested in growth and income-oriented investment assets, and no withdrawals would be allowed.
- For the first 20 years, a real rate of return of 6 percent is assumed; after the twenty year period, a real rate of return of 4.1 percent is used. These rate assumptions are consistent with the historical long-term average real returns (1900–2001) for growth of income-oriented investment assets.
- The annual U.S. contribution to the Trust Fund is adjusted each fiscal year for two-thirds of the inflation rate in the U.S., assumed at 3 percent.

On this basis, the total value of the Trust Fund at the beginning of FY2024 is projected to reach about $1.5 billion in nominal terms, with an annual yield of $103 million (16 percent of GDP), which is higher than the grant assistance in the last year of Compact II of $91 million. However, the Trust Fund would not build up any buffer funds that could be used during years of low or negative Trust Fund earnings. Further, if earnings from the Trust Fund are not reinvested into the Fund in the post-FY2023 period, the real value of the income stream will likely decline over time.

[1] The Trust Fund will be governed by a Trust Fund Committee with the U.S. holding a majority interest for the twenty-year Compact II period, but the composition of the Committee thereafter will need to be agreed by the parties concerned.

Federated States of Micronesia—Fund Relations
(As of November 30, 2002)

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

II. General Resources Account:	SDR Million	Percent Quota
Quota	5.10	100.00
Fund holdings of currency	5.10	100.00
Reserve position in Fund	0.00	0.01

III. SDR Department:	SDR Million	Percent Allocation
Holdings	1.18	n.a.

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangement**:

The U.S. dollar is legal tender and the official currency. The Federated States of Micronesia (FSM) maintains an exchange system that is free of restrictions on international payments and transfers for current and capital transactions.

VIII. **Article IV Consultation**:

The FSM is on the 24-month consultation cycle. The 2000 Article IV consultation discussions were held during September 4–12, 2000. The Executive Board discussed the staff report (SM 00/267) and concluded the consultation on January 5, 2001.

IX. **Technical Assistance, 1997–2001**:

STA, MAE, FAD, LEG, and PFTAC have provided technical assistance on statistics, banking supervision, tax policy and administration, budget management, and combating of financial crime and financial system abuse.

X. **Resident Representative**: None

FEDERATED STATES OF MICRONESIA—
TECHNICAL ASSISTANCE FROM HEADQUARTERS

	Activities	Date
FAD	Reform of the Tax System: the mission discussed a proposal for changes in the system of indirect taxes on income and suggestions for the appropriateness of tax holidays.	June 1994
MAE	Banking Supervision: an expert was sent to (i) assist in drafting the first annual report, (ii) review staffing requirements, (iii) review current reporting quality of banks, and (iv) provide on site training and support the Commissioner.	February 1997
	Financial Systems, Supervision, and Savings Mobilization: the mission examined (i) the scope of monetary policy within the FSM institutional arrangements, (ii) mobilization of savings by the banking system for economic development, (iii) supervision of the banking system, (iv) procedures for banking system reports to the Banking Board, and (v) the functioning of the Banking Board.	August 1992
STA	Money and Banking: the mission helped (i) review the current procedures for compiling monetary data in light of the new Monetary and Financial Statistics Manual, and (ii) finalize the establishment of the FSM IFS page.	March 2000
	An expert helped with the development of CPI data for each state and for the country as a whole.	
	An expert helped with the assessment of the statistical compilation issues in light of the then recently established Central Statistics Office.	April 1999
	Money and Banking Statistics: the mission helped (i) assist in developing monetary statistics and trained the staff of the Banking Board on the methodology and procedures for compiling monetary data, and (ii) compiled a banking survey with expanded institutional coverage.	November 1998 May 1996
LEG	Anti-Money Laundering: the mission provided technical assistance in designing, developing, and implementing a more effective strategy for combating financial crime and financial system abuse, especially with respect to money laundering. The mission was sent to assess the legal and institutional framework and provide recommendations on amendments to the current AML law, and the establishment of an FIU.	July 2002

FEDERATED STATES OF MICRONESIA—RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTER (PFTAC)[1]

The Center's assistance to the FSM since 1996 has included 33 advisory missions, mostly in the area of banking supervision and tax policy and administration. The FSM has also sent officials to various regional seminars and workshops organized by PFTAC.

Public Financial Management

The most recent mission took place in July 2001 to assess current practices in fiscal transparency against the *Code of Good Practices on Fiscal Transparency*. A performance-oriented budget system has been introduced (partly to comply with reporting obligations under the Compact), but implementation has been difficult as some building blocks are still missing. A mission is planned to review progress made with past recommendations and to impress upon the authorities the urgent need for fiscal reform.

Tax Administration and Policy

The most recent mission took place in October 2002. One of the main objectives of the mission was to discuss a revenue strategy, with particular focus on the introduction of a VAT in the context of a five-day high-level Revenue Symposium. This mission followed up on several earlier missions on tax reform, which had focused on various issues related to the introduction of a VAT and the establishment of a single National tax and customs administration. The PFTAC has provided considerable policy and technical support in this area, including for the Revenue Symposium. The other main objective of the October 2002 mission was to assist with the implementation of the new customs clearance automated system (PC-Trade). The establishment of this system is a key achievement for the FSM, conceived with the help of the PFTAC, developed by the Statistics New Zealand (SNZ), and financially supported by New Zealand Aid.

Financial Sector Regulation and Supervision

The last mission took place in September 2000, and a short-term peripatetic adviser assigned by MAE in collaboration with the PFTAC provides hands-on training for onsite and offsite supervision. While there have been no recent visits, close contacts have been maintained from Suva and advice provided regularly as needed / requested, particularly on the issues related to the closure of the Bank of Hawaii in the FSM. A three-week onsite examination program at the Reserve Bank of Fiji was arranged for the new examiner of the FSM Banking Commission. Plans are being initiated for a Basel Core Principles assessment by 2003.

Economic and Financial Statistics

The last mission, in July 2001, followed up on previous work to fill gaps and help develop comprehensive BOP statistics. With information now available for public enterprises and diplomatic missions, and also for imports and exports (PC Trade), PFTAC has helped in assessing data, summarizing results, and preparing adjusted entries. A resident adviser has been appointed with AusAID funds.

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[1] The Pacific Financial Technical Assistance Centre (PFTAC) in Suva, Fiji is a multi-donor technical assistance institution, financed by the IMF, AsDB, AusAID and NZAID, with the IMF as Executing Agency. The Center's aim is to build skills and institutional capacity for effective economic and financial management that can be sustained at the national level. Member countries are: Cook Islands, the Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tokelau, Tonga, Tuvalu, and Vanuatu. This annex is prepared on the basis of input from PFTAC staff.

Federated States of Micronesia—Relations with the World Bank Group[1]

Total Commitments: None

IFC Investments: None

Recent Reports: Embarking on a Global Voyage: Trade Liberalization and Complementary Reforms in the Pacific (Draft), June 27 2002.

Non Communicable Diseases in Pacific Island Countries–Disease Burden, Economic Cost and Policy Options (FY2001).

Cities, Seas and Storms: Managing Change in Pacific Island Economies, November 2000.

Enhancing the Role of Government in the Pacific Island Economies, October 1998.

Pacific Island Economies: Building a Resilient Economic Base for the Twenty-First Century (No. 13803-EAP), June 1995.

The Federated States of Micronesia (FSM) joined the World Bank Group on June 24, 1993. To date, no loans have been extended to the FSM. The main thrust of the World Bank's work in the FSM has been regionally focused economic and sector work and country-specific work in the fisheries sector.

The Bank approved a grant of about $140,000 in 1995 through the Institutional Development Fund to help improve the institutional capacity for coordinating fisheries development policies across the four states and to improve the performance of fisheries parastatals, including through privatization.

More recently, the World Bank has been collaborating with the Asian Development Bank (AsDB), the Forum Fisheries Agency, and the Secretariat of the Pacific Community in estimating the economic importance of fisheries to key Pacific Island countries, including the FSM. The study presents new estimates of the economic importance of fisheries in these countries that takes into account volume and value of fish harvested (including commercial and subsistence fisheries), export and import data, access fees, and levels of fish consumption. The study will be published by the AsDB as a joint publication with the World Bank.

The World Bank's most recent biennial Regional Economic Report looks at the issue of regional trade agreements in the Pacific and the complementary reforms needed to maximize the benefits that can flow from trade liberalization.

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[1] Prepared on the basis of input from the World Bank staff.

FEDERATED STATES OF MICRONESIA—RELATIONS WITH THE ASIAN DEVELOPMENT BANK[1]

Since becoming a member in 1990, the FSM has received substantial assistance from the AsDB. As of August 2002, cumulative AsDB assistance to the FSM consisted of six loans and 31 TA prospects.[2] During the period 1997–1999, the AsDB successfully launched the Public Sector Reform Program (PSRP), achieving important reductions in public sector payroll costs and employment through the Early Retirement Program with significant budgetary savings.

Currently, three loans are active: one focused on basic social services, and two on the development of the private sector. The AsDB approved a Private Sector Development Program (PSDP) at the end of 2001, with two loans totaling $13.0 million. The PSDP aims at promoting small and medium business, enhancing the regulatory and policy framework, and improving factor markets. Measures are also planned to mitigate any adverse social impact of these adjustment polices. At present, the program has been approved by all states except Chuuk. It is expected to be completed by early 2005.

The AsDB signed a Poverty Partnership Agreement (PPA) with the FSM Government on 14 June 2002. The PPA seeks an active collaboration to better assess the extent of poverty in the FSM and design appropriate strategies for poverty reduction, consistent with local priorities that could be incorporated into the country's development plan.

The AsDB has been also assisting the FSM public sector with Technical Assistance projects to strengthen capacity building for economic policy formulation and financial management, such as the Economic Policy Reform and Capacity Building Project and the Implementation of Performance-based Budget Management.

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[1] Prepared on the basis of information from the AsDB staff.

[2] The six loans are in the five following areas: (i) Fisheries Development; (ii) Public Sector Reform; (iii) Water Supply and Sanitation; (iv) Basic Social Services; and (v) Private Sector Development.

Table 1. Asian Development Bank: Loans to the Federated States of Micronesia by Sector

(In millions of dollars; as of end-July 2002)

Sector	Number	Amount
Agriculture and natural resources	1	6.5
Energy	0	0.0
Industry and nonfuel minerals	0	0.0
Transportation	0	0.0
Communications	0	0.0
Finance	3	31.0
Social infrastructure	1	10.6
Multisector	1	8.0
Other	0	0.0
Total	6	56.1
Memorandum item:		
Technical assistance	35	19.6

Source: Data provided by the Asian Development Bank.

Table 2. Asian Development Bank: Loan Approvals and Disbursements to the Federated States of Micronesia, 1990–2001

(In millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Total
Loan approvals	0.0	0.0	0.0	6.5	0.0	0.0	10.6	18.0	0.0	0.0	8.0	13.0	56.1
Loan disbursements	0.0	0.0	0.0	0.0	0.0	0.3	0.1	11.3	6.2	4.9	4.4	2.5	29.7
Undisbursed balance at the end of the year	0.0	0.0	0.0	6.5	6.5	6.2	16.7	23.4	17.2	12.3	14.2	23.3	
Memorandum item:													
Technical assistance approvals	0.3	0.5	0.8	1.7	1.3	3.4	1.2	2.4	4.9	1.3	0.8	1.2	19.6

Source: Data provided by the Asian Development Bank.

Federated States of Micronesia—Statistical Issues

The Office of Planning and Statistics is responsible for the compilation of national statistics, and the first *Statistical Yearbook* was published in July 1999. There have been a number of improvements in data compilation recently, reflecting substantial assistance provided by the Economic Management Policy Advisory Team (EMPAT)[1] and other donors; but major weaknesses remain, particularly in the areas of national accounts, fiscal data, and balance of payments statistics.

Real Sector

The last official GDP estimate is for FY1996. This estimate was based on a virtual census of businesses. However, updated estimates were not produced, largely due to the lack of specialized expertise within the Statistics Division. No unemployment or aggregate production indicators are available. To meet the needs of policy formulation, recent GDP estimates have been developed outside the Statistics Division, using administrative data (tax and social security records). The authorities have published a quarterly consumer price index for the nation as a whole and for each state except Chuuk from the first quarter of FY1999, based on the first *Household Income and Expenditure Survey* conducted for 1998.

Government Finance

The National and state governments and public sector enterprises publish annual audit reports detailing their fiscal operations, and are now available in GFS format. However, there are long publication lags. Further improvements in the quality of the fiscal data will require more timely and accurate reporting of data by the state governments to the Office of Planning and Statistics.

Monetary Accounts

An IFS country page was established in 2000. The Banking Commissioner sends updated data to STA on a monthly basis. The reported data comprise the accounts of the commercial banks and the FSM Development Bank, as well as the banking survey.

Balance of Payments

The authorities compile annual estimates of the balance of payments and external debt statistics. The authorities have installed the PC-trade system in customs, which has facilitated an updated and improved methodology for BOP data.

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[1] The Economic Management Policy Advisory Team (EMPAT) is financed by donors including the AsDB, and is attached to the Ministry of Economic Affairs.

Core Statistical Indicators
(As of October 31, 2002)

Country: **Federated States of Micronesia**

	Exch. Rates	International Reserves[1]	Reserve / Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Gov. Balance	GDP/ GNP	External Debt
Date of latest observation	11/12/02	Oct. 2002	N/A	N/A	N/A	Sept. 2002	June Qtr 2002	FY2002	FY2002	FY2001	FY2002	FY2002
Date received	11/12/02	Oct. 2002	N/A	N/A	N/A	Sept. 2002	Oct. 2002	Oct. 2002	Oct. 2002	Oct. 2002	Oct. 2002	Oct. 2002
Frequency of data[2]	D	M	N/A	N/A	N/A	M	Q	A	A	A	A	A
Frequency of publication[2]	D	M	N/A	N/A	N/A	M	Q	A	A	A	A	A
Frequency of reporting[3]	D	M	N/A	N/A	N/A	M	V	V	V	V	V	V
Source of data[4]	P	A	N/A	N/A	N/A	A	A	A/O	A/O	A	A/O	A
Mode of reporting[5]	E	E	N/A	N/A	N/A	E	E	E	E	E	E	E
Confidentiality[6]	C	C	N/A	N/A	N/A	C	C	C	C	C	C	C

[1] Approximated by government holdings of financial assets.
[2] A-annually; D-daily; Q-quarterly; M-monthly
[3] D-daily; V-staff visits.
[4] P-publicly released information; A-direct reporting by the authorities; O-staff estimates.
[5] E-electronic data transfer; V-staff visits.
[6] C-unrestricted use; A-for use of staff only; B-embargoed for a specified period and thereafter for unrestricted use.

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IMF Concludes 2002 Article IV Consultation with the Federated States of Micronesia

On January 24, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Federated States of Micronesia.[1]

Background

The economy of the Federated States of Micronesia is largely supported by the United States financing provided under the Compact of Free Association. The first Compact (Compact I), covered the 15-year period FY1987–2001, with two stepdowns in funding; a second Compact (Compact II), covering the 20-year period FY2004–23, is nearly finalized. Compact II will entail declining levels of U.S. grant assistance, a Trust Fund to provide revenue after the cessation of such assistance, and strict procedures/audits/reporting requirements for the use of Compact funds. For FY2002 and FY2003, Compact I provided for funding to continue at the average level of the previous 15 years, resulting in a substantial increase in assistance—or "bump-up funds"—in these two years relative to FY2001.

Economic activity is dominated by the public sector; the private sector, while progressively increasing in importance, remains largely a provider of services to the public sector. Fiscal adjustment was postponed following the first stepdown in FY1992, as expenditure levels were

[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. 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. This PIN summarizes the views of the Executive Board as expressed during the January 24, 2003 Executive Board discussion based on the staff report.

sustained by external commercial borrowing secured against future Compact funding. However, following the second and larger stepdown in FY1997, and in the face of an already high external debt burden, significant fiscal retrenchment was undertaken with the help of an Asian Development Bank (AsDB)-supported Public Sector Reform Program. Real GDP declined by an average rate of 3.6 percent per annum during FY1996–98, but rebounded by FY2000 reflecting the implementation of a number of infrastructure projects and some pick-up in private sector activity.

More recently, economic activity is estimated to have slowed. Despite the use of the bump-up funds by some of the FSM's four state governments to boost spending during FY2002, GDP is estimated to have grown only by 0.8 percent. The fiscal stimulus appears to have been mostly offset by an emerging fiscal crisis in Chuuk and a "wait and see" attitude of the private sector in the face of uncertainty associated with the new Compact. Inflation declined to close to zero in FY2002.

After years of large deficits, the underlying consolidated fiscal position of the National and the state governments continued to deteriorate in FY2002, with little prospect for improvement in FY2003. The estimated small surpluses in these two years resulted entirely from the availability of the bump-up Compact grants. Excluding these funds, a consolidated fiscal deficit—of about US$11 million–US$12 million (5 percent of GDP)—is projected for these two years. Fiscal performance across the National and four state governments has varied considerably, with the National government and the Chuuk state accounting entirely for the deficits in recent years; the Chuuk state is estimated to have built up arrears of US$15 million.

The external current account position has remained weak in recent years as the trade deficit has widened and transfers have declined with the stepdowns in Compact funding. Export volumes have been stagnant and tourism receipts have remained subdued. Further, interest and dividend earnings from the sizable investment of government assets in U.S. equities have decreased significantly since FY2001 owing to the rundown of government assets to finance the deficits of recent years and the downturn in the U.S. equity market. On the other hand, since FY2000, imports have recovered in step with the increase in government expenditure and the rise in oil prices.

The external debt position has improved significantly with the full repayment of the earlier commercial borrowing. With the outstanding debt wholly on concessional terms, the debt service ratio fell sharply to 6 percent of exports of goods and services, and the external debt ratio to 23 percent of GDP, in FY2002.

Policy reforms—especially structural measures to promote private sector activity—have advanced little in the past few years, but some initial steps are now under way. In recent months, the requisite approval for an AsDB-supported Private Sector Development Program loan has been granted by all governments except Chuuk. In the area of tax reform, a high-level Revenue Symposium recommended the introduction of a VAT in October 2002, with support from the Pacific Financial Technical Assistance Center.

Executive Board Assessment

Directors welcomed the expected pick-up in economic activity and continued low inflation in the Federated States of Micronesia (FSM), as well as the recent improvement in the external debt position with the repayment of the earlier commercial borrowing. However, they expressed concern about the country's weakening fiscal position and the decline in usable government assets, as the significant fiscal retrenchment achieved earlier under the Public Sector Reform Program had been partly reversed in recent years. They also noted that significant progress is yet to be made in strengthening the legal and institutional framework for private sector development.

Directors agreed that the FSM faces major policy challenges, as it has to adjust to reduced external assistance under the second Compact of Free Association (Compact II) covering the fiscal years 2003-2023. In this regard, Directors noted that little headway had been made in preparing the economy for the required adjustment. They stressed that only with strong fiscal adjustment, structural reforms to stimulate private sector activity, and greater investment in human capital can the FSM look forward to macroeconomic stability and economic growth. Directors recognized, however, that, given the FSM's structure as a loose federation of autonomous states, difficulties might be faced—as in the past—in garnering the political consensus for needed policy actions. In the view of Directors, this made it all the more important that the authorities spare no effort in mobilizing broad support, by widely disseminating information on the likely consequences of Compact II and the imperative of corrective action.

Directors called for bold fiscal measures in the FY2004 budget. They agreed that fiscal adjustment in the initial years of Compact II will have to come mainly from cuts in government current expenditure, focused on the wage bill. Directors therefore welcomed the authorities' intention to keep nominal wages unchanged and to reverse the recent increase in working hours in several of the states. Directors underscored the need for a comprehensive review—with possible donor assistance—of the compensation levels and structure of the civil service to sustain public sector retrenchment and wage rationalization. They also emphasized the need to review non-wage outlays with a view to reducing the large travel budget and discretionary spending on constituency-based projects. In view of the need to enhance the country's productive and economic growth potential, Directors agreed that the FSM should safeguard spending on infrastructure and on health and education, while improving the efficiency of such expenditures.

As tax revenues remain very low, Directors highlighted the crucial need to mobilize additional revenues. They welcomed the proposed VAT and called for its early implementation. Directors attached considerable importance to minimizing differences in VAT laws among the four states and to administering the tax on a uniform basis. They also stressed the urgency of strengthening tax administration.

Directors underscored the need to improve transparency and accountability in the government's fiscal operations. These efforts will benefit from the stringent new reporting and auditing requirements and the strengthened oversight of U.S. assistance under Compact II.

Directors concurred that private sector development is essential to help sustain growth in the medium term and mitigate the likely declines in living standards resulting from fiscal adjustment. They recognized, however, that the FSM's narrow resource base and remote location and other structural constraints pose difficult challenges for developing the private sector. Nevertheless, Directors called for actions to harness the limited available potential in agriculture, fishing, and tourism, including through structural reforms in land tenure, the foreign investment regime, and the public enterprise sector. They urged the authorities to press ahead with the actions envisaged in these areas in the context of the Private Sector Development Program.

Directors noted that the banking system in the FSM is well regulated and supervised. They welcomed the recent passage of legislation that brings existing bank regulations into line with the Basle Core Principles to further strengthen prudential standards. Directors commended the authorities' intention to strengthen the anti-money-laundering law, and recommended that they submit a Self-Assessment Questionnaire on Terrorist Financing to the Financial Action Task Force.

Directors noted that statistical deficiencies continue to hamper meaningful economic assessment and management and called for further improvements in data compilation and coverage. They, therefore, supported the authorities' intention to strengthen the FSM's statistical capacity through better recruitment and training as well as sustained technical assistance. A few Directors saw a larger role for Fund technical assistance on a more general basis.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2002 Article IV Consultation with the Federated States of Micronesia is also available.

Federated States of Micronesia: Selected Economic Indicators

	FY1998[1]	FY1999	FY2000	FY2001 Est.	FY2002 Est.	FY2003 Proj.
Real Sector						
Real GDP (percent change)	-2.8	0.3	4.4	1.1	0.8	2.4
Consumer prices (percent change) 2/	1.6	1.9	1.8	2.0	0.0	1.5
Consolidated government finances (in percent of GDP)						
Revenue and grants	73.6	71.2	66.4	59.8	69.1	67.9
Revenue	27.1	25.5	23.3	18.0	19.9	20.1
Grants	46.5	45.7	43.1	41.8	49.2	47.8
Expenditure	80.4	78.8	73.2	65.8	66.7	66.2
Current	60.8	60.3	59.1	54.5	55.6	54.2
Capital	19.6	18.5	14.0	11.2	11.1	12.0
Overall balance	-6.9	-7.6	-6.7	-5.9	2.4	1.7
Stock of domestic arrears (in millions of U.S. dollars) 3/	1.2	...	...	9.0	15.0	13.0
National and state governments' usable financial assets (in millions of U.S. dollars; end of period) 4/	35.3	48.0	42.5	34.6	43.6	48.8
Commercial banks (in millions of U.S. dollars)						
Foreign assets 5/	78.3	75.9	77.0	77.8	75.3	...
Loans 5/	48.0	50.0	52.4	52.1	44.9	...
Total deposits 5/	120.1	119.0	120.8	121.5	114.6	...
Balance of payments (in millions of U.S. dollars)						
Trade balance	-82.4	-88.7	-96.0	-87.1	-88.1	-89.3
Net services and income	-13.0	-7.3	-6.3	-15.6	-15.5	-13.2
Private and official transfers	83.5	85.6	87.0	85.3	99.4	117.6
Current account including official transfers	-11.9	-10.4	-15.3	-17.4	-4.3	15.1
(in percent of GDP)	-5.8	-5.0	-6.9	-7.5	-1.8	6.3
Current account excluding official transfers	-93.5	-93.9	-100.1	-100.5	-101.4	-100.2
Overall balance	18.4	-8.8	22.0	-13.0	6.2	6.0
(in percent of GDP)	9.0	-4.2	9.9	-5.7	2.7	2.5
External debt service (in percent of exports of goods and services) 6/	65.5	60.7	68.3	31.4	6.7	4.9
Exchange rate regime	The U.S. dollar is the domestic currency					

Sources: Data provided by the FSM authorities; AsDB Outlook 2002; and IMF staff estimates.

1/ Fiscal year ending September 30.

2/ A price index for the FSM has been available only since FY2000, and data shown are for the FSM from FY2000 onward. For previous years, the U.S. CPI is used.

3/ Estimated stock of domestic arrears in Chuuk and Pohnpei in FY1998, and in Chuuk in FY2001-2003; end of period.

4/ Cash and other liquid investments not reserved for specific uses.

5/ Data for FY2002 are for end March 2002.

6/ Government and public enterprise debt.

Statement by Diwa Guinigundo, Alternate Executive Director
for the Federated States of Micronesia
January 24, 2003

Key Points

- The key challenge facing the FSM is to be able to adjust to significantly reduced grant assistance from the US and overcome the constraints to expanding private sector activity.

- Staff and authorities agree on what needs to be done but there is difficulty in gaining the necessary political support for reforms given the forthcoming elections and the autonomy of the states of the Federation.

- FSM has managed to show positive growth since 1986 and generally stable inflation, but the external payments position has been weak, bank lending limited and public financing the most difficult challenge. In the case of the fiscal difficulties, the experience of the Yap state illustrates the benefits of sound financial management.

- While fiscal consolidation is important, we are concerned about how this is really going to translate into accelerated private sector activity because, as the staff admits, "it will curtail economic activity" in the short-run. FSM may also need a roadmap on how to absorb the large number of people joining the labor force in the next 5-10 years.

- The Fund may have to give more time and resources to small island member countries to make periodic surveillance more fruitful and more convincing.

- The authorities have consented to publication of the staff report.

We thank the staff for their thorough analysis of recent economic and policy developments in the Federated States of Micronesia. The Staff Report and Selected Issues Paper outline some of the unique challenges faced by small and geographically isolated constituent members.

As the staff clearly showed, the Federated States of Micronesia is next only to Palau as the smallest member of the Fund in terms of its voting power, which reflects its small economic size. Through the Compact of Free Association with the United States in 1986, FSM became a Freely Associated State, no longer subject to US administration, in an effort to: (i) secure self-government; (ii) assure certain national security rights; and (iii) advance economic self-sufficiency. While the first two objectives have been achieved, the task of becoming economically self-reliant is extremely challenging. US direct financial payments continue to cover general government and capital expenditures. Additional allocations have been used in specific sectors including energy, communications, maritime surveillance, health and education.

But this 15-year funding provision came to an end in 2001, with amounts decreasing every five years. A new 20-year Compact Agreement was signed in November 2002 providing for declining levels of annual US grants, pre-determined sectoral allocation, strict procedures and audits to ensure accountability and transparency and a Trust Fund to provide revenues after 2023.

Herein lies, and we agree with staff, the key challenge for the FSM. Namely, the need to adjust to significantly reduced grant assistance from the United States and overcome the constraints to expanding private sector activity posed by a small, geographically isolated island economy with a population of only about 110,000. Towards this end, fiscal consolidation, reducing impediments to an expansion of private sector activity, strengthening the financial system and improvement of institutional capacity are the overriding agenda for the authorities. There is no disagreement between the staff and the authorities as to what needs to be done. However, the practical reality is the difficulty in gaining the necessary political support for the required reforms given the forthcoming elections and the autonomy of the states. In this regard, a number of other Fund members, many considerable larger than the FSM, face similar challenges in building the necessary consensus in support of difficult reforms.

Where FSM is Coming From

Since independence in 1986, FSM has shown an average growth rate of 1.8 percent despite higher migration of the population to the United States and, with geographic isolation, limited private sector activity. Institutional capacity remains severely limited. While growth has slowed in 2001-2002 due to the impact of natural calamity in one of the states of the Federation, an expansion of some 2.4 percent is forecast this year due to the expected $8 million in US assistance in the calamity areas and the activation of the new Compact funds which is expected to normalize economic activity. As the staff reported, the inflation rate has remained stable due to favorable price trends in the domestic components of consumer prices.

Public finance has been most challenging in the last two years. While FSM achieved some success in its initial efforts to streamline the bureaucracy, the fiscal performance of the national government and the most populous state, went off track. With a large public sector, and a loose federation, decisions on reducing working hours and other expenditure cuts to achieve fiscal discipline, has become more political. It is easy to appreciate the comments of the US Chair two years ago during the last Article IV consultation with FSM: it is not always the case that small economies with small populations should have simple processes. Achieving agreement between the national government and the states is indeed as difficult as in large economies.

The external payments position of FSM has been quite weak in the past two years due to the persistent trade deficit. This reflected the limited export base consisting of fish and some agricultural commodities. As a small island economy, FSM is heavily dependent on imports. With the temporary bump-up in funds from the US, the current account position is anticipated to show some improvement, although the observed real exchange rate appreciation coming from the strong US dollar could reduce FSM's external competitiveness. The external debt service ratio fell from 31.4 percent in FY 2001 to 6.7 percent in FY 2002 after FSM fully repaid its commercial borrowing. Gross international reserves increased from $98.3 million in FY 2001 to $104.4 million in FY 2002, representing an increase in import coverage from 7.9 months to 8.2 months.

One could only expect that bank lending will remain limited in the next few years because there are very few business options in FSM. Business infrastructures are limited. There is little incentive to produce domestically because: (i) the market is small; and (ii) most domestic consumption and production items are imported, mainly from the US. However, the experience in the State of Yap does indicate the benefits that can come from good financial management. Yap has the best fiscal performance of the five governments, the lowest differential between public and private sector wages and has had the greatest success in generating private sector growth and employment.

The Economic Agenda for FSM

The FSM authorities fully realize that under the framework of the new Compact, there will be greater expectations for self-reliance and fiscal responsibility. The last 15 years of Compact I were to be a period of building institutional capacity, when there was practically none, and of financing the cost of governance immediately after independence.

Some Political and Institutional Problems. It has been an uphill battle for the FSM authorities to implement the Fund's policy advice from the 1998 and 2000 Article IV consultations. With limited growth in economic activity in the islands, growth in tax revenue has remained low, even though the VAT was recently introduced following the Revenue Symposium. The process of government in FSM is expensive due to some existing difficulties in public administration. For instance, political elections are not synchronized. Elections are held separately for members of Congress, President/Vice President and local officials. The federation is a loose one with the federal government having very little control over the four autonomous states on public finance. The authorities have indicated they recognize the need for political re-engineering in the Federation if the major source of fiscal excesses were to be plugged and governance were to be rationalized for better and more effective delivery of public service. Another major obstacle is, of course, the lack of adequate institutional capacity for reforms in the FSM.

Areas for Reform

1. <u>Getting Fiscal Policy Right</u> These institutional limitations in FSM should also help put into perspective staff's major recommendations for fiscal consolidation. Our authorities realize the importance of increasing revenues and curtailing expenditures. But it is important for private sector activity to be expanded by providing much-needed infrastructures and other components of a robust investment climate. This will require time as well as high levels of public spending. Tightening expenditures is essential to achieve fiscal sustainability, but this should be limited to those that do not translate into higher levels of productive capacity. We

agree with staff that, under Compact II, the axe should fall on public sector wages and/or the number of work weeks, travel outlays, discretionary spending for constituency-based projects and public subsidies. Capital expenditures and spending on social safety nets should be maintained to keep the productive potential of FSM at least at present levels. This Chair is therefore interested to know how the dynamics of the staff proposal for FSM to undertake fiscal consolidation "which will curtail economic activity" in the short-run, translates into acceleration in private sector activity. It will also be useful to have some hard numbers on the amount of private sector growth necessary to absorb the large number of people joining the labor force in the next 5-10 years.

The authorities have agreed to Compact II with the full understanding that it needs to prepare to cut the fat and keep itself lean and cost-effective. One way the authorities have approached this issue is to intensify public information on the new order in FSM and to broaden public support for fiscal consolidation. In fact, the authorities circulated to the members of Congress, local governments and the press, the closing statement of the IMF Article IV mission. This essentially contains the message of fiscal discipline contained in the Staff Report to help ensure public awareness and support for the impending fiscal adjustments starting this year, the beginning of the Compact II agreement. In this connection, we are pleased to inform the Board that the authorities have consented to the publication of the Staff Report for the 2002 Article IV consultation.

We reiterate that the authorities have taken the necessary initial steps by putting in place the VAT in lieu of import duties and gross revenue tax (GRT) and advancing this in an expeditious way. While the VAT will be revenue neutral in the initial phase, the authorities consider this as a prerequisite for eventual gains in tax effort. We also agree with staff, and the authorities will work to this end, that no stone should be left unturned to minimize divergence in rates, coverage and exemptions of VATs in the four states. VAT administration will also be made uniform. The authorities also agree with staff in respect to bolstering non-tax receipts from fishing license fees by, among other things, strengthening the monitoring of illegal fishing and enhancing the fishing grounds of the Federation.

Greater focus would be given to the Chuuk State. Decisive action will be undertaken in terms of repayment of state arrears and reduction of the state wage bill to levels suggested by the staff. To complement the work of the new Chuuk Financial Control Commission, the national government would do its share of monitoring of the finances of the Chuuk State.

Finally, public enterprise reform shall be undertaken consistent with the calls of the Asian Development Bank. The size of the public sector remains large but the authorities will look at the possibility of rationalizing public wage rates relative to the private sector. The authorities are convinced that in view of Compact II, it is important for government to eliminate its losses from state-owned enterprises and to be able to pay gross receipts tax. We should realize, however, that in larger and more developed economies, this problem was not solved overnight.

2. Revitalizing the Private Sector With the reduction in US grants, the growth plank is now to be increasingly covered by higher contributions from the private sector. The authorities

realize that this is the only way of sustaining growth for the Federation. As the staff stressed, FSM's resource base is narrow, while viable investment opportunities are limited. The authorities agree that structural reforms are necessary to develop tourism and key agricultural exports. These will include a better legal and regulatory framework, transparent and less distortionary approvals of foreign investments and greater flexibility in the use of land for commercial purposes. However, cultural considerations should be taken into account in moving forward with the structural reform agenda. For instance, land is an important cultural issue in FSM and land reform might not be the best way to immediately revive business and commerce in the Federation.

3. Strengthening the Financial Sector A strong banking system will buttress any effort to expand private sector activity. In this regard, the FSM authorities are to be commended for the recent amendment of the Banking Act to move it closer to the Basle Core Principles. The authorities have advised that the Chuuk Government will be repaying its outstanding arrears to both wage earners and vendors.

4. Statistical Issues The FSM authorities recognize that there is further room for improvement in public sector statistics. They have continued improving the statistical system, particularly on matters involving quality, coverage and timeliness. Late last year, the authorities signified their interest in seeking more sustainable forms of technical assistance in statistical compilation, including those on public sector account, national income data, and monetary sector and balance of payments. We are pleased to acknowledge the interest of PFTAC to assist, however, their resources are severely limited.

Concluding Remarks

FSM is small and geographically isolated group of small islands in the Pacific. Its resource based is narrow and its growth potential is quite limited. For many years, the Federation has relied on US grants to run the government and to deliver public services like education and medical health. There is a need for the international community to extend key assistance in re-engineering the government to reduce costs. The delay in the implementation of many staff recommendations from earlier Article IV consultations derived not entirely from the authorities' lack of political will and concern for public welfare. Rather, we also need to consider the impact of the serious lack of institutional capacity in the FSM bureaucracy. The FSM, like the other small island economies, is in urgent need of sustainable technical assistance and capacity building. More frequent staff visits than the current 24-month cycle may be appropriate. Fund staff recommendations are all well taken, but wisdom dictates that the Fund itself may have to give more time and resources, this time in favor of FSM and other small island economies. For instance, we need to see more research on cross-country comparisons among small economies with respect to their growth experiences. This is one important way of making Fund surveillance more fruitful and more convincing.