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# Federated States of Micronesia: 2004 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Federated States of Micronesia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2004 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 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on October 28, 2004, 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 February 25, 2005. 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 February 25, 2005 discussion of the staff report that concluded the Article IV consultation.

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

The document listed below has been or will be separately released.

Selected Issues and Statistical Appendix Paper

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

**To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.**

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INTERNATIONAL MONETARY FUND

FEDERATED STATES OF MICRONESIA

**Staff Report for the 2004 Article IV Consultation**

Prepared by the Staff Representatives for the 2004 Consultation
with the Federated States of Micronesia

(in coordination with other departments)

Approved by David T. Coe and Michael Hadjimichael

December 28, 2004

- A staff team comprising Messrs. Kramer (head), Komori, Ginting (all APD), and Mr. Christensen (OTM) held the Article IV discussions in Pohnpei during October 18–28, 2004. The mission overlapped with visits by a PFTAC team and an MFD expert.
- The team met with President Urusemal, Vice President Killion, Secretary of Finance and Administration Andon, Secretary of Foreign Affairs Anefal, and other senior officials. It also met with representatives of Pohnpei state government.
- The mission conducted a number of outreach activities, meeting with representatives of the National Congress, the banking and business communities, a local research institute, and a newspaper.
- In concluding the prior consultation in January 2003, Directors agreed that the Federated States of Micronesia (FSM) faced major challenges in adjusting to reduced external assistance under the second Compact of Free Association with the United States. They stressed that only with strong fiscal adjustment, structural reforms to stimulate private sector activity, and greater investment in human capital could the FSM look forward to macroeconomic stability and economic growth. Directors recognized that, given the FSM's structure as a loose federation of autonomous states, the authorities should spare no effort in garnering the needed political and community consensus for reforms.
- 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.

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## EXECUTIVE SUMMARY

### Economic Setting

- **The Federated States of Micronesia (FSM) relies heavily on U.S. grants under the Compact of Free Association.** These grants, which are currently sizeable, have been declining and are set to fall further and expire in FY2024. Reflecting large grants, the public sector dominates economic activity.

- **Success in adjusting to past declines in Compact grants has been mixed.** The wage bill was reduced in the 1990s but it remains high relative to GDP. Fiscal discipline has been uneven across the four states, which have budgetary autonomy.

- **Output contracted in FY2004 with a stepdown in Compact grants but is expected to grow slightly in FY2005.** The drop in grants also precipitated deteriorations in the fiscal and external balances. Employment is stagnant, and inflation remains low, notwithstanding rising fuel prices.

### Key Policy Issues

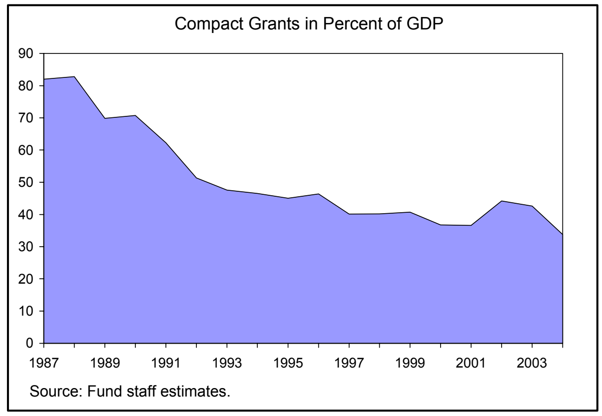
- **Fiscal and structural reforms are needed for the FSM to achieve self-sufficiency.** The large government sector will be increasingly unsustainable given coming declines in grants. A sizeable budgetary adjustment is needed to curb fiscal vulnerabilities as well as to build up sufficient assets as a buffer against future shocks. In addition, structural reforms are needed to promote private sector development and employment.

- **The authorities agree on these priorities, but progress in fiscal and structural reforms may well remain slow.** This situation reflects a highly decentralized fiscal system, a lack of understanding among stakeholders of the policy challenges, and capacity limitations.

- **Fiscal adjustment will need to comprise both expenditure cuts and revenue measures.** There is room to rein in current spending, although core health, education and infrastructure spending must be preserved given its importance to growth. The best option to increase revenue remains comprehensive tax reform and the introduction of a VAT; the government is discussing this option but agreement is not likely soon.

- **Structural reform priorities should include improvements to the legal framework for land use, foreign investment, and lending.** Public enterprise reforms could both reduce crowding-out of private firms and yield budgetary savings.

## I. ECONOMIC SETTING




1. **The Federated States of Micronesia (FSM) is a small Pacific island country that is highly dependent on external assistance.** Since independence in 1986 it has relied heavily on U.S. grants, first under an initial Compact of Free Association covering FY1987–2001 and then under an amended Compact covering FY2004–23 (Box 1).[1] Compact grants have been on the decline and are set to fall further and expire in FY2024; currently, they amount to about a third of GDP or about $700 per capita. Starting in 2024, the FSM will be able to draw on a trust fund established with its own contributions as well as those of the United States. The trust fund will invest in U.S. stocks and bonds (see Box 1).

2. **The country comprises four states in a loose federal structure.** Each state has its own administration and legislature; there is a national government as well. Presidents are selected by the National Congress from the four at-large Congressmen, and serve four-year terms; the current president took office in May 2003. The states formulate their own budgets, which are a significant share of the consolidated budget, and levy taxes, thus limiting the national government's influence on the overall direction of fiscal policy.

3. **Success in adjusting to past reductions in Compact funds has been mixed.** During FY1996–99, the public wage bill was cut substantially in the context of a Public Sector Reform Program supported by the Asian Development Bank (AsDB), but these cuts were partly reversed, and the wage bill remains high. Modest recent surpluses partly reflected a temporary increase in grants and compression of investment, while fiscal discipline has been uneven across states.

4. **Reflecting the size of Compact grants, the public sector dominates the economy.** Notwithstanding past declines, public expenditure is over 60 percent of GDP while government accounts for half of formal employment. Moreover, high public sector wages—around double those in the private sector—exacerbate structural impediments to private sector development. While the private sector has grown modestly over time, many firms mainly serve the government and its employees. Export-oriented sectors—tourism, commercial agriculture, and fisheries—account for only 6 percent of employment.

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[1] The fiscal year runs from October to September (e.g., FY2004 ended in September 2004).

### Box 1. Renewed Compact of Free Association with the United States

**The economic assistance provisions of the original Compact covered FY1987–2001.** It provided annual cash grants of $97.9 million during FY1987–91, $91.1 million during FY1992–96, and $79.2 million during FY1997–2001. The funds were to cover general government and capital expenditures, with the latter to comprise a minimum of 40 percent of grants. During the FY2002–03 interim, while the Compact was being renegotiated, grants were provided at the average level of the initial Compact period—a sizeable increase.

**The renewed Compact covers FY2004–23 and features declining grants assistance, a trust fund, and enhanced accountability and monitoring:**

- *Total funding*: Total funding of $92.7 million per year comprises grants, audit funds ($0.5 million), and trust fund contributions. Grants are $76.2 million during FY2003–05, after which they decline by $0.8 million per year in nominal terms. Grants and trust fund contributions are indexed at the lesser of two-thirds the increase in the U.S. GDP deflator or 5 percent.

- *Trust fund*: Trust fund contributions rise from $16 million in FY2004 to $29.6 million in FY2023. In addition, the FSM made a $30.2 million contribution in FY2004 (of which $30 million was required under the Compact). The trust fund cannot be used to finance spending or as collateral for borrowing before 2024. The fund is administered by a five-member committee (three U.S. and two FSM appointees), and can invest in U.S. stocks and bonds and other instruments as approved by the committee.

- *Accountability and monitoring*: A US-FSM Joint Economic Management Committee (JEMCO) approves grant allocations and reviews performance outcomes and audits. The committee is comprised of three U.S. and two FSM members.

- *Sectoral allocations*: Funds are to be allocated to six priority sectors—health, infrastructure, education, capacity building, environment, and private sector development. There are no explicit formulas for allocation by sector, but JEMCO has resolved that infrastructure spending should rise towards at least 30 percent of annual Compact grants and achieve that level in FY2006.

**Other key provisions of Compact II include:**

- Disaster assistance from the U.S. Federal Emergency Management Agency is to be phased out over time and replaced by assistance administered through the U.S. Department of State.

- Funding under certain U.S. educational programs is to be replaced by the Supplemental Education Grant (about $12 million in FY2005).

- Immigration provisions were tightened (for instance, visitors now must show a passport).

5. **A lack of domestic job opportunities appears to have driven significant emigration,** particularly following the late 1990s government restructuring and the subsequent economic slump (the Compact allows FSM citizens to readily emigrate to and work in the United States). According to unofficial estimates, emigrants comprise 10 to 25 percent of the population, most of whom live in the United States or in its territories such as Guam. As a result of increased emigration, since the mid-1990s annual population growth has slowed from about 2 percent to about 0.2 percent. Micronesians living overseas probably send substantial amounts of income home, increasing the resilience of the domestic economy. While official data put net remittance inflows at only 1 percent of GDP, these estimates are based on a household survey from the 1990s, and the subsequent pickup in emigration has likely boosted remittances.

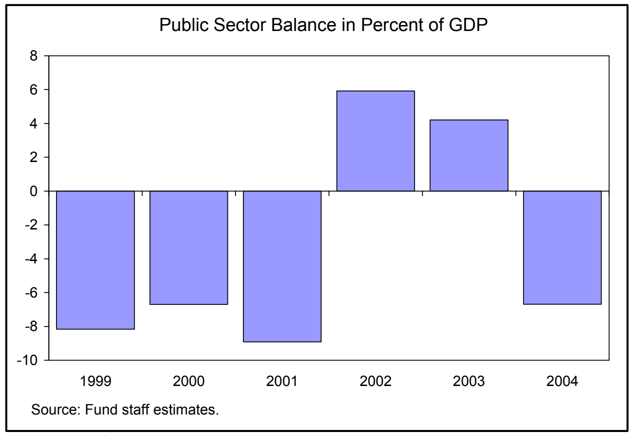
6. **The authorities recognize the need for fiscal and structural reforms, but implementation has been slow.** The authorities have made some progress in addressing problems highlighted by Directors at the conclusion of the 2003 Article IV consultation: fiscal accountability has been enhanced under the amended Compact, and modest headway has been made in some areas of structural reforms under the AsDB-supported Private Sector Development Program. In addition, the FSM's third Economic Summit held in early 2004 highlighted the benefits of a sustained-growth development strategy and identified key policy challenges, and disseminated information to the public on the need for reforms. However, much remains to be done: fiscal imbalances remain sizeable; the wage bill is high, including by regional standards; revenues remain low; a VAT is still under discussion; and key structural reforms have not moved forward. The limited progress reflects the difficulty of reaching agreement among the states on national fiscal priorities, as well as a lack of understanding among stakeholders of the challenges facing the FSM and policy options for dealing with them. In addition, weak capacity continues to hamper policy implementation.

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

7. **Real output contracted in FY2004** (Table 1). In FY2003, government spending rose, while private sector activity recovered owing to reduced uncertainty as Compact negotiations ended. In FY2004, however, economic activity was adversely affected by a stepdown in Compact grants and a typhoon. Employment growth has been stagnant the past two years, with falling public employment broadly offset by rising private employment, while wage growth has been modest. Inflation has remained low despite higher oil prices.

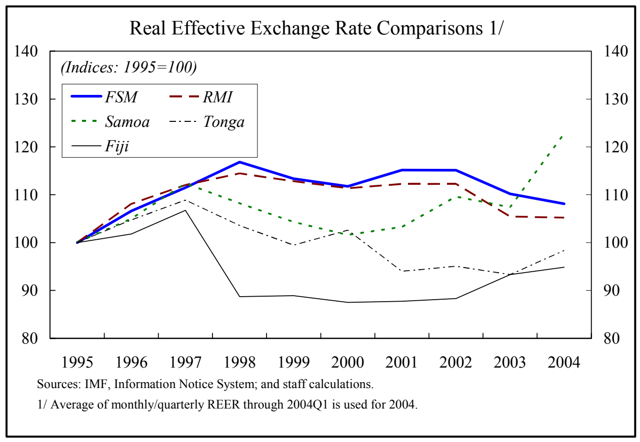
8. **The fiscal position swung sharply to deficit in FY2004** (Table 2). This deterioration after two years of surpluses reflected both a programmed drop in Compact grants and the withholding of Compact infrastructure grants disbursements owing to delays in preparing a required infrastructure development plan. Domestic revenues continued falling

[2] The Selected Issues paper accompanying this report covers recent economic developments in greater detail, and also analyzes medium-term prospects and options for tax reform.




relative to GDP. State fiscal performances varied, with Chuuk state accumulating arrears. Reflecting the consolidated deficit and a $30 million trust fund contribution, uncommitted government financial assets fell sharply from 21½ percent to 8¼ percent of GDP.

9. **The external position also worsened.** The trade deficit widened as the petroleum import bill rose with oil prices and as exports fell, partly due to the typhoon.[3] The trade imbalance drove the current account sharply into deficit (Table 3). Gross reserves declined slightly to 5½ months of imports (official capital-account data are incomplete and likely omit significant inflows). With the U.S. dollar the official currency, the real exchange rate has depreciated in recent years, although it remains somewhat appreciated compared with other Pacific island currencies. However, structural difficulties, rather than exchange rate competitiveness, seem to be the main cause of the FSM's weak export performance. External debt has remained low, including by regional standards (Box 2). Debt service is about 6 percent of exports, and about half of debt is owed to the AsDB, on concessional terms.




10. **Domestic credit continues to shrink.** The FSM's two commercial banks are well capitalized and highly liquid, with low nonperforming loans.[4] However, owing to limited domestic lending opportunities and shortcomings in the legal framework, the financial sector mainly invests in U.S. securities markets, rather than lending to domestic businesses and households. In the recent period, private sector credit has been contracting owing to weak economic prospects, and the loan/deposit ratio has declined to record lows.

11. **For the near term, output should grow slightly in FY2005** as public investment rises and private-sector activity picks up. Inflation is expected to remain low. The fiscal

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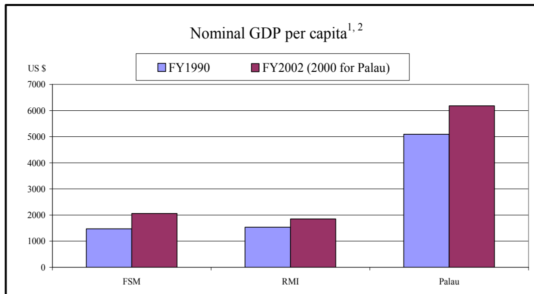
[3] Key exports are primarily tuna fish and agricultural produce.

[4] One bank is a branch of a foreign-headquartered bank; the other is mostly owned by the FSM government and has a small share of foreign ownership.

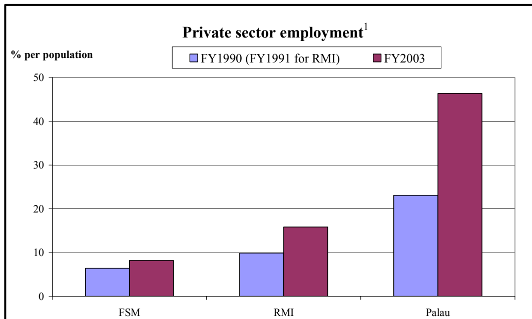
## Box 2. The FSM Economy: Comparison with Other Compact Countries

The FSM, the Republic of the Marshall Islands (RMI), and the Republic of Palau (all formerly part of the Trust Territory of the Pacific Islands) currently have Compact of Free Association agreements with the United States. These three countries have similar characteristics, with heavy reliance on official grants and dollarization. Nonetheless, cross-country comparisons highlight notable differences among them.



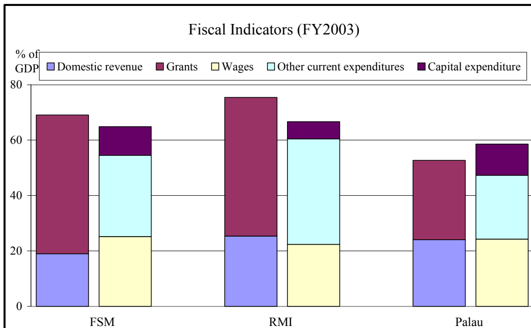

Sources: Data provided by the FSM authorities; and IMF staff estimates.
[1]Although reliable GDP deflators for long periods are not available, inflation in the FSM does not seem to be higher than those in the other countries for these years.
[2]Data for Palau are for calendar year.

Compared with the RMI, the FSM has experienced higher GDP growth and enjoys higher GDP per capita at present. However, both the FSM and the RMI have lagged Palau in terms of economic development, and a large part of their population is still in the subsistence sector. Furthermore, growth in paid private-sector employment has been modest. The differing economic performances might be partly attributed to geography: Palau is the closest to large Asian countries and receives the greatest number of international visitors. All three countries have enjoyed price stability during recent years, thanks to the U.S. dollar's use as the domestic currency.

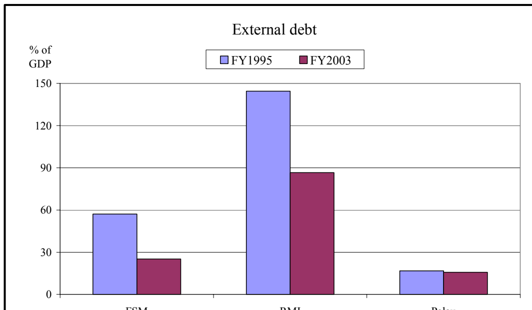



Sources: Data provided by the FSM authorities; and IMF staff estimates.
[1]Data for Palau are for calendar year.

Regarding fiscal performance, the three countries are characterized by low domestic revenue, high dependence on grants, and large current expenditures. As a share of GDP, the FSM has the lowest domestic revenue, the highest grants, and the largest wage expenditures. That said, its government debt, along with Palau's, is at comfortably low levels, thanks to large grants and relatively prudent past fiscal policies.




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




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

deficit should narrow to 2 percent of GDP if grants withheld in FY2005 are disbursed as anticipated. The external current account would remain in significant deficit owing in part to the pending closure of a garment factory. Steady emigration is likely to continue owing to limited job opportunities, although the attendant increase in remittance inflows would partly offset its effects on income. Downside risks to the outlook include a sustained increase in oil prices and a global slowdown that could dampen exports. Adverse weather conditions are another risk, which could worsen over time with global climate change.[5]

## III. Policy Discussions

### A. Medium-Term Framework

12. **The discussions revolved around medium-term prospects, and particularly the need for fiscal and structural adjustments to adapt to reduced Compact funding** (Annex I). The mission stressed that growth is likely to be sluggish in the medium term—around 1 percent a year—unless fiscal and structural reforms are undertaken. In addition, the large government sector will be increasingly unsustainable given coming declines in grants. Slow or partial reforms would entail mounting fiscal vulnerabilities and a continued drag on private sector activity, while a prolonged lack of private-sector opportunities could spur more rapid emigration that would reduce human capital and economic potential. To be sure, the FSM's remoteness, small size, and limited resource base continue to pose obstacles to development. However, strong private-sector growth in Yap state and higher per-capita GDP and employment in nearby Palau suggest that such obstacles are not insurmountable. The mission also stressed that fiscal and structural reforms could complement one another: for example, structural reforms would aid the fiscal effort by stoking growth in the tax base.

13. **The authorities agreed on the need for policy adjustments, but highlighted the difficulty of mobilizing public support and implementing policies.** In particular, the states account for a large proportion of the overall fiscal imbalance, and thus must undertake a significant share of the measures to correct it. Moreover, while the states and Congress are exploring options for adjustment, they are not convinced of the need for a VAT. The authorities continue their outreach and coordination efforts in the context of the Economic Summit and an Economic Policy Implementation Council (comprising the leaders of the five governments, including Congressional representatives). The mission recognized these efforts and encouraged the authorities to build upon them, but stressed the urgency of launching adjustments in earnest to promote medium-term fiscal and economic sustainability.

### B. Fiscal Adjustment

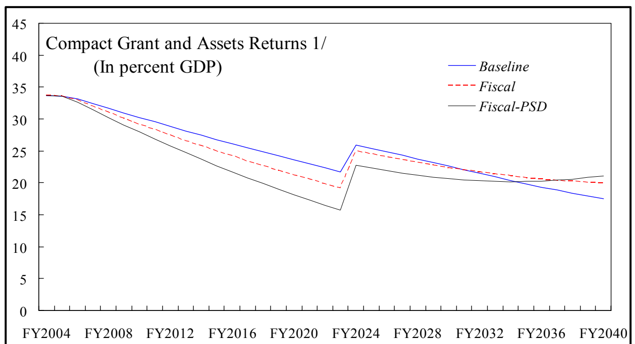
14. **The authorities noted that the FY2005 budget incorporated expenditure restraint.** Wage freezes and hiring ceilings would remain in place, holding down the wage

[5] Under the Compact, the FSM is eligible for U.S. disaster relief, which mitigates weather-related risks.

bill. While expressing concerns that states might experience pressure on service delivery given Compact restrictions on how grants can be spent, the authorities nevertheless thought that each state should be able to trim other current expenditure, including on wages and travel. On the revenue side, customs administration has improved with the recent introduction of an automated clearance system. However, the revenue impact has been small, and audits and penalties need strengthening.

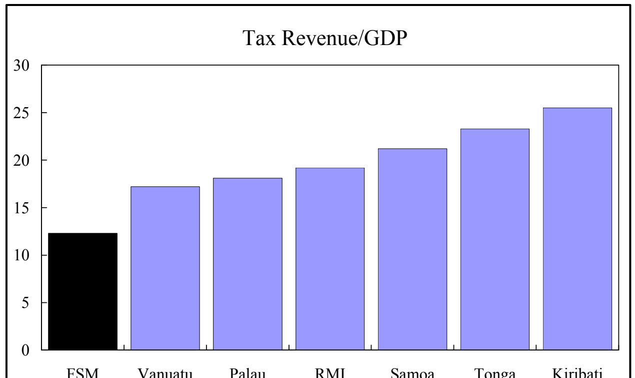
15. **The mission supported steps to restrain expenditure but stressed the need for immediate fiscal consolidation.** Based on the FY2005 budget, the mission estimated that current expenditures would remain broadly unchanged, while capital expenditure would recover with the release of Compact grants held back in FY2004. Tax revenues would remain low, while grants would rise substantially. Overall, the deficit would narrow but would remain large. To reduce this imbalance, immediate cuts in the wage bill and other current expenditures are needed. Efforts are also warranted to stem the decline in tax revenues by further improving administration, although the initial payoff would be modest. Delays in reducing the deficit would worsen fiscal vulnerabilities through further erosion of government financial assets and buildups of arrears—which was particularly a risk in Chuuk state. Alternatively, prompt consolidation would signal commitment to stabilizing the public finances and streamlining expenditure, and thereby bolster public support for tax reforms.

16. **The mission stressed that a sizeable fiscal adjustment would be required in the medium term.** Medium-term surpluses of around 3 percent of GDP would be needed to accumulate assets sufficient to absorb shocks and supplement trust fund income after 2023, as well as to stabilize assets relative to GDP in the long run. This would entail an adjustment of 5 percentage points of GDP from FY2005. With such an adjustment, complemented by reforms to spur private sector development, income on assets would stabilize relative to GDP in the long run.



Source: Staff estimates.

1/ Compact grants 2004-23 and Compact Trust Fund and other assets returns from 2024.



Source: Staff estimates.

17. **A more decisive fiscal strategy is needed to achieve this adjustment.** As significant revenue measures would take several years to implement, continued reductions in current expenditures would be needed. Indeed, the structure of expenditures could benefit from a broad review. However, as core expenditures on health, education, and infrastructure

should be preserved, given their crucial importance to growth and to meet Compact requirements, revenue efforts should contribute significantly to fiscal adjustment over time. This would include further strengthening administration to boost tax revenue, which remained low by regional standards, as well as aid with implementation of future tax policy measures. Beyond this, however, more fundamental tax reforms are needed to reduce distortions and improve compliance while bolstering revenue. In this connection, the mission expressed concern that piecemeal measures introduced by Congress, such as increasing duties, would divert attention from fundamental tax reforms and could even undercut revenue gains by worsening compliance. The authorities noted that a high-level Task Force that includes representatives of the five governments and the National Congress is reviewing options for comprehensive tax reform.

18. **The staff argued that the best option for tax reform remains introduction of a VAT, similar to those introduced in a number of other Pacific island countries.** Properly planned and implemented, this could yield 2 to 3 percentage points of GDP in revenue. Moreover, it would reduce distortionary tax cascades—taxes levied upon taxes—as well as conform with plans for trade liberalization and improve compliance. The administrative burden could be managed by setting an appropriately high sales threshold for selecting the firms that would be required to comply with the VAT (other firms would be covered by a presumptive tax similar to the existing gross revenue tax). The authorities noted that the Task Force saw the VAT as an important option. However, implementation would require the cooperation of the states, which have constitutional jurisdiction over consumption taxes (a proposed constitutional amendment to allow a national VAT failed in 2002). A VAT could be implemented through the introduction of four state VATs, although coordinating the tax schemes would be challenging. The mission recognized these difficulties but noted that other options, such as expanding the income tax base, were unlikely to yield as much revenue. Thus, absent a VAT, larger expenditure cuts would be needed.

19. **The mission and the authorities concurred that reforms of public enterprises are needed to reduce their budgetary burden and avoid crowding out private firms.** Heavy government involvement in commercial activities, notably in agriculture and fishing, has failed: some public enterprises are defunct, while others depend on subsidies. The public enterprise sector remains significant in size, accounting for 5 percent of employment—roughly the same size as all the main export-oriented sectors combined. The authorities' strategy going forward is to facilitate private sector development by creating a fertile business environment, rather than undertaking commercial activities. The mission welcomed this aim, but noted the need to expeditiously close inessential enterprises and strengthen essential but weak ones.

20. **The financial situation of the Social Security Administration warrants attention.** While the Administration currently runs a small surplus and is unlikely to be a drain on the budget soon, its unfunded future liability remains very high at $203 million (90 percent of GDP). This situation mainly reflects an unsustainably high rate of return on contributions: for most participants, the present value of benefits is 300 to 400 percent higher than the present

value of contributions. Accordingly, it was agreed that measures will be needed to address the unfunded liability—perhaps by increasing the retirement age or reducing benefits.

21. **Budgetary management needs to be strengthened.** Progress has been made toward compliance with the Fiscal Procedures Agreement (FPA) under the renewed Compact, but capacity limitations risked further delays in meeting FPA requirements that could hold up disbursements. Thus, the mission considered that efforts to meet the Compact's accountability and oversight requirements needed to be intensified. The authorities noted that the planned implementation of a unified financial management information system should improve financial control and reporting, as well as timeliness in completing audits (final accounts for FY2002 are still unavailable).

22. **Draft legislation would allow foreign corporations to pay corporate income tax in the FSM, thus exempting them from paying tax at home and creating a tax haven.** The authorities stressed that they opposed the legislation, which was pushed by members of Congress. The mission and PFTAC advisors strongly advised against the measure, which would likely bring few if any economic benefits to the FSM but would be viewed unfavorably by the international community. The President vetoed the legislation but the veto could be overridden by Congress. (The FSM is not now on the OECD list of tax havens.)

## C. Structural Reforms

23. **It was agreed that structural reforms are needed to encourage private sector development and employment.** Structural problems include periodic power outages in some parts of the country, obstacles to foreign ownership of land and to the use of land as collateral for loans, and an intransparent and lengthy review process for foreign investments. The authorities' priorities to resolve these problems, as reflected in the Private Sector Development Program (PSDP; Box 3) and the third Economic Summit, include:

- infrastructure enhancements to reduce the cost of doing business;
- measures to ease the use of land for production and for investment and collateral; and
- steps to make the foreign investment regime more efficient and transparent by reducing bureaucratic discretion and shortening the review process.

24. **The mission concurred with these priorities but noted that progress in reforms has been slow.** Approval of PSDP loans was delayed for over two years, reflecting limited capacity and a lack of a sense of urgency about reforms. As a result, considerable reform momentum has been lost, with little or no legislative action in most areas. The mission stressed the need for prompt and concrete progress, noting the risks and costs of further delays, and encouraged the authorities to intensify their dialog with stakeholders on the importance of timely reforms.

**Box 3. Private Sector Development Program**

Since 2003, the FSM has been implementing the Private Sector Development Program (PSDP) with $13 million in financial support from the Asian Development Bank (AsDB). The PSDP complements the late 1990s Public Sector Reform Program, which helped to cut government payroll costs (though the progress was partly undone later).

The goal of the PSDP, which is to be completed in 2006, is to promote economic growth by expanding the private sector, thereby raising domestic employment and incomes and reducing dependence on external assistance. To attain this goal, the PSDP's objectives are to: (i) improve the policy and legal environment for private sector development, and (ii) strengthen capacity to manage land, labor, and capital resources. Its key performance targets and required actions are the following:

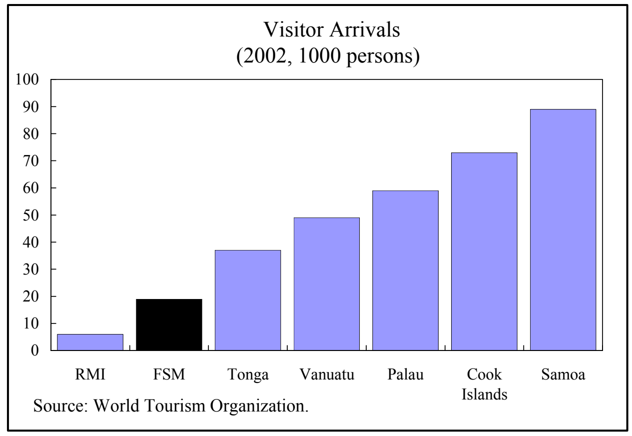
- **Public sector reforms:**

  - Maintaining balanced budgets (in terms of current revenues and expenditures);
  - Setting aside the FY2002–03 increase in Compact grants for the trust fund;
  - Maintaining government payroll levels; and
  - Reforms of at least one public sector enterprise by each national and state government.

- **Economic and legal reforms** to enact or revise laws in the areas of long-term land leases, mortgages, foreign investment, and bankruptcy.

**Progress in implementation has been generally limited.** The FSM satisfied prior conditions for the first tranche of the program loan, which was disbursed in 2003. To receive the second tranche disbursement ($2.5 million) slated for 2005, however, AsDB staff consider that much needs to be done, particularly on economic and legal reforms. Progress in economic and legal reforms has been as follows:

- *Public sector enterprise*s. Reforms have been delayed. These reforms are seen as the biggest hurdle to disbursement of the second tranche.
- *Long-term land lease laws and new foreign investment laws*. Local and national governments have prepared relevant model legislation.
- *Mortgage laws*. Only Chuuk passed the law, while other states submitted legislation.
- *Bankruptcy law.* A draft law has been prepared.




25. **The authorities described their policy goals in the sectors of tourism, fisheries, and agriculture.** Tourism is seen as having potential to develop. While neighboring islands were more competitive and advanced, especially in mass tourism, with vigorous promotion the FSM could develop niche tourism in areas such as diving. In fisheries and agriculture, commercial production is at a nascent stage. The government's priorities are to privatize public fishing enterprises and encourage FSM-based fishing fleets, with due attention to marine resource sustainability; and to increase agricultural production and reduce reliance on imports for food security purposes.

## D. Other Issues

26. **The banking system remains well supervised and regulated but lends little domestically.** The 2002 Banking Act amendment brought supervision and prudential standards closer in line with the Basle Core Principles. However, the mission and the authorities agreed that reforms to improve the lending environment are still needed to better support the domestic economy. The authorities noted that drafts of a bankruptcy code and secured transaction legislation have been prepared, but were not yet taken up by Congress. The mission saw these elements of the legal framework as key priorities.

27. **The banking system also includes a development bank, which accounts for half of domestic credit.** It has a slightly larger nonperforming loan rate than the commercial banks and received total capital contributions of around $2 million from the National Government over the past three years. The authorities saw the bank's competition with private banks as limited, as it deals mainly with loans that commercial banks considered too risky to underwrite, and viewed the associated fiscal risks as modest. The mission nevertheless noted that the development bank should avoid competing with the commercial banks and should contain possible budgetary implications of its operations.

28. **Efforts have been under way to strengthen the AML/CFT framework.** Money laundering legislation was put in place in 2001 and bank staff have received AML/CFT training. A 2003 Legal Department mission provided assistance in upgrading AML legislation to conform with international standards and advice on establishing a financial intelligence unit (FIU), which has recently been created. (The FSM is not on the FATF's list of countries that are noncooperative in AML/CFT.)

29. **The authorities intend to pursue trade liberalization.** The mission saw the strategy of engaging in regional trade agreements as a prelude to broader liberalization as appropriate;

ratification of the Pacific Island Countries Trade Agreement (PICTA) would be a step forward in this regard.[6] The FSM is a member of the Pacific Agreement on Closer Economic Relations, which is a framework for negotiation of regional trade agreements, and participates in Economic Partnership Agreement negotiations with the EU (which are at an early stage). The FSM has a relatively open trade regime, rated “4” on the Fund’s index of trade restrictiveness. A few items are subject to import duties of 25 percent but rates for food and general merchandise are 3 percent and 4 percent, respectively. There are no quantitative restrictions on imports and no significant nontariff barriers to trade. While the government maintains a monopoly on copra exports, such exports are at negligible levels.

30. **Domestic capacity to produce economic statistics remains weak,** hampering economic monitoring and policy evaluation. The mission welcomed ongoing efforts, based on a 2003 PFTAC plan, to strengthen the capacity of local staff and reduce reliance on external experts. It also encouraged the authorities to participate in the General Data Dissemination System (GDDS) to complement enhancements in capacity and define a framework for further improvements to statistics.

## IV. Staff Appraisal

31. **The medium term outlook is worrisome.** Given anticipated declines in external assistance the large government sector will be increasingly unsustainable. In addition, minimal progress has been made towards rectifying fiscal imbalances or undertaking structural reforms needed to promote private sector development. Without steps to remedy these problems, the medium-term outlook is for weak growth and mounting fiscal vulnerabilities, with a significant risk of more rapid outward migration.

32. **The main policy challenge is thus to foster fiscal and economic self sufficiency.** Reforms will be difficult, particularly given the states’ policy autonomy, and the country’s remote location and small size will continue to pose obstacles to development. Nevertheless, starting comprehensive reforms in earnest is the only option to ensure medium-term sustainability. Further dialog with public and private stakeholders will be essential to raise awareness of the choices facing the country and to build the needed consensus for reform.

33. **Given declining assistance, fiscal adjustment is unavoidable and should start right away.** In the context of the FY2005 budget, efforts to restrain the wage bill through a continued wage freeze and hiring ceilings are welcome. The authorities should build on these efforts by making immediate cuts in the wage bill as well as reductions in other current expenditure. Prompt consolidation would both reduce fiscal vulnerabilities and usefully signal the commitment to stabilizing the public finances and rationalizing expenditure.

[6] PICTA entails phased elimination of tariffs vis-à-vis other Pacific island countries by 2012. Given the limited trade between these states, little or no trade diversion would result. The process may provide an introduction to the mechanics of trade liberalization, which could prove useful for liberalization at the multilateral level.

34. **In the medium term, a sizeable adjustment will be needed.** Because necessary comprehensive tax reforms will take time to implement, expenditure cuts will need to continue beyond FY2005. However, fiscal adjustment should preserve core expenditures on health, education, and infrastructure, given their importance to growth and Compact requirements to target them. In addition, revenue administration and budgetary management should be strengthened.

35. **To safeguard core expenditures, revenue measures should contribute significantly to the medium-term adjustment.** The best option remains comprehensive tax reforms centered around introduction of a VAT, which would eliminate tax cascades, conform with plans for trade liberalization, and improve compliance. Implementation will be challenging given the decentralized fiscal system. However, viable alternatives are lacking: absent a VAT, significantly larger expenditure cuts that would imperil core social spending would be needed.

36. **As the public sector shrinks with falling assistance, structural reforms can encourage private sector growth and employment.** In this connection, the authorities' strategy to facilitate business by creating a fertile business environment and avoiding commercial activities is welcome. Priorities should include improvements to infrastructure and to the legal frameworks for land use, foreign investment, and lending. Also, public enterprise reforms could reduce crowding out of private firms, as well as yielding fiscal savings. With regard to trade policy, the strategy of using PICTA as a stepping stone to broader liberalization is appropriate.

37. **Economic monitoring and policy evaluation remain hampered by the limited domestic capacity to produce economic statistics.** Efforts to move compilation from outside experts to local staff are welcome and should continue. Participation in the GDDS would complement capacity enhancements and guide further improvements to statistics.

38. **It is recommended that the next Article IV consultation take place on the 24 month cycle.** The authorities expressed interest in a staff visit during 2005, possibly focusing on tax reform.

Table 1. Federated States of Micronesia: Basic Data, FY1999-2005 1/

| | |
|---|---|
| Nominal GDP (FY2004): | $226 million |
| Population (FY2004): | 108,021 |
| GDP per capita (FY2004): | $2,096 |
| Quota: | SDR 5.1 million |

| | FY1999 | FY2000 | FY2001 | FY2002 | FY2003 | FY2004 Est. | FY2005 Proj. |
|---|---|---|---|---|---|---|---|
| Real sector | | | | | | | |
| Real GDP (in percentage change) | -3.1 | 8.4 | 0.3 | 1.1 | 5.1 | -3.8 | 0.3 |
| Consumer prices (in percentage change) 2/ | 1.9 | 2.0 | 1.3 | -0.1 | -0.2 | 1.4 | 2.0 |
| Consolidated government finance (in percent of GDP) | | | | | | | |
| Revenue and grants | 76.6 | 69.0 | 64.4 | 72.4 | 69.1 | 52.1 | 60.9 |
| Revenue | 27.4 | 24.4 | 20.7 | 20.9 | 19.0 | 19.0 | 19.3 |
| Grants | 49.2 | 44.6 | 43.7 | 51.5 | 50.1 | 33.0 | 41.6 |
| Expenditure | 84.8 | 75.7 | 73.3 | 66.5 | 64.9 | 58.7 | 63.0 |
| Current | 64.9 | 61.2 | 59.2 | 56.5 | 54.5 | 53.2 | 52.1 |
| Capital | 19.9 | 14.5 | 14.1 | 10.0 | 10.4 | 5.6 | 10.8 |
| Overall balance | -8.2 | -6.7 | -8.9 | 5.9 | 4.2 | -6.7 | -2.1 |
| Stock of domestic arrears 3/ | ... | ... | 9.0 | 15.0 | 13.0 | ... | ... |
| National and state governments' usable financial assets | | | | | | | |
| (in millions of U.S. dollars; end of period) 4/ | 48.0 | 39.8 | 10.3 | 27.1 | 49.9 | 18.7 | 21.2 |
| (in percent of government expenditure) | 29.0 | 24.4 | 6.4 | 18.4 | 33.2 | 14.0 | 14.6 |
| Commercial banks (in millions of U.S. dollars) | | | | | | | |
| Foreign assets | 75.9 | 77.0 | 77.8 | 78.3 | 104.6 | 109.6 | ... |
| Loans | 50.0 | 52.4 | 52.1 | 39.1 | 23.7 | 20.0 | ... |
| Total deposits | 119.0 | 120.8 | 121.5 | 112.1 | 119.8 | 124.1 | ... |
| Interest rates (in percent per annum) | | | | | | | |
| Consumer loans | 15.2 | 15.3 | 15.3 | 15.0 | 15.0 | 15.0 | ... |
| Commercial loans | 10.3 | 11.0 | 5.9 | 4.8 | 7.0 | 6.8 | ... |
| Balance of payments (in millions of U.S. dollars) | | | | | | | |
| Trade balance | -76.6 | -82.7 | -88.1 | -76.8 | -100.7 | -113.8 | -118.7 |
| Net services and income | -9.1 | -10.0 | -20.4 | -17.5 | -19.3 | -17.4 | -20.2 |
| Private and official transfers | 90.3 | 93.4 | 96.7 | 110.6 | 122.3 | 106.8 | 102.5 |
| Current account including official transfers | 4.7 | 0.7 | -11.9 | 16.2 | 2.2 | -24.5 | -36.4 |
| (in percent of GDP) | 2.4 | 0.3 | -5.4 | 7.3 | 0.9 | -10.8 | -15.7 |
| Current account excluding official transfers | -83.4 | -90.5 | -106.3 | -92.0 | -117.8 | -128.8 | -136.5 |
| (in percent of GDP) | -42.8 | -42.0 | -48.5 | -41.6 | -50.8 | -56.9 | -58.9 |
| Overall balance 5/ | 23.0 | 13.7 | 8.1 | 52.2 | 25.0 | -24.3 | -17.5 |
| (in percent of GDP) | 11.8 | 6.4 | 3.7 | 23.6 | 10.8 | -10.8 | -7.5 |
| External debt (in millions of U.S. dollars; end of period) | 83.5 | 66.6 | 57.8 | 57.2 | 58.5 | 58.9 | ... |
| (in percent of GDP) | 42.8 | 30.9 | 26.4 | 25.8 | 25.2 | 26.0 | ... |
| External debt service (in millions of U.S. dollars) 6/ | 19.4 | 22.9 | 10.9 | 2.4 | 2.4 | 2.4 | ... |
| (in percent of exports of goods and services) | 62.8 | 60.8 | 27.8 | 5.5 | 5.9 | 6.0 | ... |
| Exchange rate | | | | | | | |
| Exchange rate regime | | | U.S. dollar is the official currency | | | | |

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

1/ Fiscal year ending September 30.
2/ A price index for the FSM has been only available since FY2000. Data shown are for FSM from FY2000 onward. Prior to this, the U.S. CPI is used.
3/ Estimated stock of domestic arrears in Chuuk and Pohnpei; end of period.
4/ Cash and other liquid investments not reserved for specific uses.
5/ Includes changes in reserves, valuation changes and errors and omissions.
6/ Government and public enterprise debt only.

Table 2. Federated States of Micronesia: Consolidated General Government Finances, FY1999-2005 1/
(In millions of U.S. dollars)

| | FY1999 | FY2000 | FY2001 | FY2002 | FY2003 | FY2004 | FY2005 |
|---|---|---|---|---|---|---|---|
| | | | | Est. | | Proj. | |
| Total revenue and grants | 149.4 | 148.8 | 141.1 | 160.2 | 160.2 | 117.9 | 141.1 |
| Total revenue | 53.4 | 52.6 | 45.4 | 46.3 | 44.0 | 43.1 | 44.8 |
| Tax revenue | 25.3 | 27.6 | 26.5 | 27.2 | 25.9 | 25.1 | 26.9 |
| Wages and salary tax | 5.6 | 6.4 | 6.1 | 8.0 | 7.3 | 7.1 | 7.1 |
| Gross revenue tax | 5.8 | 6.9 | 6.9 | 6.3 | 6.1 | 5.9 | 6.5 |
| Import tax: Fuel | 0.8 | 0.7 | 0.9 | 0.9 | 0.7 | 0.6 | 0.7 |
| Import tax: All others | 6.3 | 7.2 | 7.0 | 6.1 | 6.3 | 6.2 | 6.6 |
| All other tax (National) | 0.7 | 0.0 | 0.2 | 0.9 | 0.4 | 0.3 | 0.4 |
| State tax revenue | 6.0 | 6.4 | 5.5 | 5.1 | 5.1 | 5.0 | 5.6 |
| Nontax revenue | 28.2 | 24.9 | 19.0 | 19.1 | 18.1 | 18.0 | 17.9 |
| Fishing access revenue | 16.0 | 14.1 | 11.3 | 10.6 | 11.8 | 12.1 | 12.0 |
| Dividend and interest income | 7.4 | 5.2 | 2.1 | 2.0 | 1.1 | 1.3 | 1.3 |
| Other nontax revenues | 4.7 | 5.6 | 5.5 | 6.5 | 5.2 | 4.6 | 4.6 |
| Grants from abroad | 96.0 | 96.2 | 95.6 | 113.9 | 116.2 | 74.8 | 96.3 |
| Compact | 79.4 | 79.3 | 80.2 | 97.8 | 98.8 | 58.9 | 86.1 |
| Other | 16.6 | 16.9 | 15.4 | 16.1 | 17.4 | 15.9 | 10.2 |
| Total expenditure | 165.3 | 163.2 | 160.6 | 147.1 | 150.5 | 133.0 | 145.9 |
| Current expenditure | 126.6 | 131.9 | 129.7 | 124.9 | 126.4 | 120.4 | 120.8 |
| Expenditure on goods and services | 114.3 | 119.7 | 122.1 | 116.1 | 117.8 | 114.9 | 115.5 |
| Wages and salaries | 50.2 | 52.2 | 54.3 | 56.9 | 58.4 | 56.6 | 56.6 |
| Travel | 7.7 | 8.4 | 8.9 | 8.5 | 8.6 | 8.5 | 8.6 |
| Other | 56.4 | 59.1 | 58.9 | 50.6 | 50.8 | 49.8 | 50.3 |
| Interest payments | 2.9 | 1.9 | 0.6 | 0.0 | 0.0 | 0.0 | 0.0 |
| Subsidies | 4.3 | 5.9 | 3.6 | 4.2 | 4.3 | 1.3 | 1.1 |
| Transfers | 5.2 | 4.5 | 3.4 | 4.7 | 4.3 | 4.2 | 4.2 |
| Capital expenditure | 38.8 | 31.3 | 30.9 | 22.2 | 24.1 | 12.6 | 25.1 |
| Overall balance | -15.9 | -14.4 | -19.5 | 13.1 | 9.7 | -15.1 | -4.8 |
| Current balance | -2.3 | -8.9 | -13.8 | 3.5 | 0.7 | -2.5 | 6.2 |
| Capital balance | -13.6 | -5.6 | -5.7 | 9.6 | 9.1 | -12.6 | -11.0 |
| Overall balance, excluding grants | -111.9 | -110.6 | -115.2 | -100.8 | -106.5 | -89.9 | -101.1 |
| Current balance | -73.1 | -79.3 | -84.3 | -78.6 | -82.4 | -77.3 | -76.0 |
| Financing | 15.9 | 14.4 | 19.5 | -13.1 | -9.7 | 15.1 | 4.8 |
| Domestic financing | -7.0 | 4.5 | 6.2 | -7.3 | -12.7 | 13.1 | 4.0 |
| External financing | 22.9 | 9.9 | 13.2 | -5.8 | 3.0 | 2.0 | 0.7 |
| | | | | (In percent of GDP) | | | |
| Total revenue | 27.4 | 24.4 | 20.7 | 20.9 | 19.0 | 19.0 | 19.3 |
| Tax revenue | 13.0 | 12.8 | 12.1 | 12.3 | 11.2 | 11.1 | 11.6 |
| Nontax revenue | 14.4 | 11.6 | 8.7 | 8.6 | 7.8 | 7.9 | 7.7 |
| Grants | 49.2 | 44.6 | 43.7 | 51.5 | 50.1 | 33.0 | 41.6 |
| Total expenditure | 84.8 | 75.7 | 73.3 | 66.5 | 64.9 | 58.7 | 63.0 |
| Current | 64.9 | 61.2 | 59.2 | 56.5 | 54.5 | 53.2 | 52.1 |
| *Of which* : Wages and salaries | 25.7 | 24.2 | 24.8 | 25.7 | 25.2 | 25.0 | 24.4 |
| Capital | 19.9 | 14.5 | 14.1 | 10.0 | 10.4 | 5.6 | 10.8 |
| Overall balance | -8.2 | -6.7 | -8.9 | 5.9 | 4.2 | -6.7 | -2.1 |
| Current balance | -1.2 | -4.1 | -6.3 | 1.6 | 0.3 | -1.1 | 2.7 |
| Capital balance | -7.0 | -2.6 | -2.6 | 4.3 | 3.9 | -5.6 | -4.8 |
| Overall balance, excluding grants | -57.4 | -51.3 | -52.6 | -45.6 | -45.9 | -39.7 | -43.6 |
| Current balance, excluding grants | -37.5 | -36.8 | -38.5 | -35.5 | -35.5 | -34.1 | -32.8 |
| Memorandum items: | | | | (In millions of U.S. dollars, unless otherwise noted) | | | |
| Nominal GDP | 195.0 | 215.7 | 219.1 | 221.3 | 232.0 | 226.4 | 231.7 |
| growth rate | -1.3 | 10.6 | 1.6 | 1.0 | 4.8 | -2.4 | 2.4 |
| Compact | 79.4 | 79.3 | 80.2 | 97.8 | 98.8 | 58.9 | 86.1 |
| (in percent of GDP) | 40.7 | 36.8 | 36.6 | 44.2 | 42.6 | 26.0 | 37.2 |
| Total government financial assets | 205.9 | 189.4 | 146.3 | 154.9 | 170.0 | 162.9 | 193.4 |
| *Of which:* Compact Trust Fund Balances 2/ | ... | ... | ... | ... | ... | 30.3 | 63.5 |
| Usable government financial assets 3/ | 48.0 | 39.8 | 10.3 | 27.1 | 49.9 | 18.7 | 21.2 |
| Outstanding stock of domestic arrears | 0.0 | 0.0 | 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/ Including investment income.
3/ Cash and other liquid investments not reserved for specific uses.

Table 3. Federated States of Micronesia: Balance of Payments, FY1999-2005
(In millions of U.S. dollars)

| | FY1999 | FY2000 | FY2001 | FY2002 | FY2003 | FY2004 | FY2005 |
|---|---|---|---|---|---|---|---|
| Trade balance | -76.6 | -82.7 | -88.1 | -76.8 | -100.7 | -113.8 | -118.7 |
| (in percent of GDP) | -39.3 | -38.4 | -40.2 | -34.7 | -43.4 | -50.3 | -51.2 |
| Exports and reexports, f.o.b. | 15.5 | 19.0 | 22.4 | 23.8 | 21.6 | 19.6 | 17.8 |
| Imports, f.o.b. | -92.1 | -101.7 | -110.5 | -100.6 | -122.3 | -133.4 | -136.5 |
| Petroleum products | -11.1 | -13.7 | -15.9 | -12.5 | -11.0 | -17.3 | -18.2 |
| Services account | -30.4 | -28.8 | -29.1 | -28.0 | -30.5 | -30.9 | -30.9 |
| (in percent of GDP) | -15.6 | -13.3 | -13.3 | -12.6 | -13.1 | -13.6 | -13.3 |
| Receipts | 15.4 | 18.6 | 16.8 | 19.0 | 18.8 | 19.9 | 20.4 |
| Travel | 13.9 | 17.0 | 14.7 | 16.9 | 16.8 | 17.9 | 18.4 |
| Communications | 1.1 | 1.1 | 1.8 | 2.1 | 1.9 | 1.9 | 1.9 |
| Other | 0.3 | 0.5 | 0.3 | 0.1 | 0.1 | 0.1 | 0.1 |
| Payments | -45.7 | -47.4 | -45.9 | -47.0 | -49.3 | -50.8 | -51.3 |
| Freight and insurance | -16.2 | -18.0 | -19.5 | -17.7 | -21.6 | -23.5 | -24.1 |
| Transportation | -9.8 | -10.8 | -11.0 | -11.1 | -11.6 | -11.3 | -11.6 |
| Travel | -4.9 | -5.4 | -5.5 | -5.5 | -5.7 | -5.5 | -5.3 |
| Other | -14.8 | -13.3 | -10.0 | -12.7 | -10.4 | -10.3 | -10.3 |
| Income, net | 21.3 | 18.8 | 8.6 | 10.4 | 11.2 | 13.5 | 10.7 |
| (in percent of GDP) | 10.9 | 8.7 | 3.9 | 4.7 | 4.8 | 5.9 | 4.6 |
| Receipts | 30.0 | 26.5 | 14.8 | 16.1 | 17.9 | 20.1 | 17.3 |
| Fishing rights fees | 15.9 | 14.1 | 12.0 | 11.2 | 11.8 | 12.3 | 12.3 |
| Interest and dividend income | 14.1 | 12.4 | 2.8 | 4.9 | 6.1 | 7.8 | 5.0 |
| Payments | | | | | | | |
| Interest payments | -8.7 | -7.7 | -6.2 | -5.7 | -6.8 | -6.6 | -6.6 |
| Unrequited transfers | 90.3 | 93.4 | 96.7 | 110.6 | 122.3 | 106.8 | 102.5 |
| Private | 2.2 | 2.2 | 2.3 | 2.3 | 2.3 | 2.4 | 2.4 |
| Inflows | 4.4 | 4.6 | 4.7 | 4.8 | 4.9 | 5.0 | 5.0 |
| Outflows | -2.2 | -2.5 | -2.5 | -2.5 | -2.6 | -2.6 | -2.6 |
| Official | 88.1 | 91.2 | 94.4 | 108.2 | 120.0 | 104.3 | 100.0 |
| (in percent of GDP) | 45.2 | 42.3 | 43.1 | 48.9 | 51.7 | 46.1 | 43.2 |
| Compact funds | 54.4 | 54.7 | 55.3 | 65.9 | 66.6 | 58.9 | 54.6 |
| Other | 33.7 | 36.5 | 39.1 | 42.3 | 53.4 | 45.4 | 45.4 |
| Current account | | | | | | | |
| Including official transfers | 4.7 | 0.7 | -11.9 | 16.2 | 2.2 | -24.5 | -36.4 |
| In percent of GDP | 2.4 | 0.3 | -5.4 | 7.3 | 0.9 | -10.8 | -15.7 |
| Excluding official transfers | -83.4 | -90.5 | -106.3 | -92.0 | -117.8 | -128.8 | -136.5 |
| In percent of GDP | -42.8 | -42.0 | -48.5 | -41.6 | -50.8 | -56.9 | -58.9 |
| Capital and financial account | 18.3 | 13.0 | 20.0 | 36.0 | 22.8 | 0.1 | 18.9 |
| Capital Transfers | 29.0 | 29.9 | 31.0 | 37.4 | 37.5 | 5.2 | 19.3 |
| Short term, net | 0.2 | 0.1 | -2.1 | -0.8 | -16.0 | -5.5 | -0.8 |
| Medium term, net | -10.9 | -17.0 | -8.9 | -0.6 | 1.4 | 0.4 | 0.4 |
| Inflows | 3.8 | 2.2 | 0.0 | 0.0 | 2.0 | 1.1 | 1.1 |
| Medium-term note issues | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other borrowing | 3.8 | 2.2 | 0.0 | 0.0 | 2.0 | 1.1 | 1.1 |
| Outflows | -14.7 | -19.2 | -8.9 | -0.6 | -0.6 | -0.7 | -0.7 |
| Medium-term note amortization | -11.0 | -18.5 | -8.2 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other amortization, excluding IMF | -3.7 | -0.7 | -0.7 | -0.6 | -0.6 | -0.7 | -0.7 |
| Other net government flows | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Overall balance 1/ | 23.0 | 13.7 | 8.1 | 52.2 | 25.0 | -24.3 | -17.5 |

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

1/ Include changes in FSM reserves, valuation changes, errors, and omissions.

Table 4. Federated States of Micronesia: External Vulnerability Indicators, FY1999-2004

| | FY1999 | FY2000 | FY2001 | FY2002 | FY2003 | FY2004 Est. |
|---|---|---|---|---|---|---|
| Financial indicators 1/ | | | | | | |
| Commercial bank deposits (12 month percent change) | -0.9 | 1.5 | 0.6 | -7.7 | 6.9 | 3.6 |
| Private sector credit (12 month percent change) 2/ | 4.2 | 4.8 | -0.6 | -25.0 | -39.4 | -24.2 |
| Foreign assets/total assets (percent) | 56.6 | 56.2 | 55.8 | 61.0 | 76.4 | 78.8 |
| Nonperforming loans (in percent of total loans) 3/ | 4.0 | 5.0 | 4.8 | 7.7 | 2.5 | 3.1 |
| Return on assets 4/ | 2.5 | 2.7 | 2.3 | -0.2 | 0.3 | 0.8 |
| Return on equity 4/ | 12.3 | 13.0 | 10.8 | -1.1 | 2.2 | 5.8 |
| Loss allowance to loan and leases 4/ | 5.8 | 4.4 | 3.2 | 5.3 | 8.9 | 9.1 |
| Nonperforming assets to assets 4/ | 0.1 | 0.1 | 0.3 | 0.9 | 0.3 | 0.2 |
| Core deposits to total liabilities 4/ | 69.3 | 66.4 | 58.9 | 66.5 | 78.3 | 78.8 |
| Equity capital to total assets 4/ | 19.3 | 22.5 | 20.5 | 14.0 | 14.7 | 13.7 |
| Total capital to risk-weighted assets 4/ | 31.1 | 31.4 | 29.2 | 32.3 | 42.1 | 42.9 |
| External indicators | | | | | | |
| Exports (percent change) | -13.8 | 22.7 | 17.9 | 5.9 | -9.2 | -9.1 |
| Imports (percent change) | -3.0 | 10.5 | 8.6 | -9.0 | 21.6 | 9.1 |
| Current account balance (percent of GDP) | | | | | | |
| Including official transfers | 2.4 | 0.3 | -5.4 | 7.3 | 0.9 | -10.8 |
| Excluding official transfers | -42.8 | -42.0 | -48.5 | -41.6 | -50.8 | -56.9 |
| Gross official reserves (millions of dollars) | 97.7 | 113.0 | 98.3 | 117.4 | 89.6 | 83.5 |
| Gross official reserves (months of imports of goods and services) | 8.5 | 9.1 | 7.5 | 9.5 | 6.3 | 5.4 |
| Total external debt (percent of GDP) | 42.8 | 30.9 | 26.4 | 25.8 | 25.2 | 26.0 |
| Total external debt (percent of exports of goods and services) | 270.6 | 176.9 | 147.2 | 133.6 | 144.8 | 149.2 |
| External debt service (percent of exports of goods and services) | 62.8 | 60.8 | 27.8 | 5.5 | 5.9 | 6.0 |

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

1/ Calendar year basis.
2/ Data for FY2004 are for end of June 2004.
3/ Preliminary figures. Defined as loans with arrears in excess of 30 days.
4/ Data for Bank of FSM (accounting for around 50 percent of domestic commercial bank credit).

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 (in millions) | 0.11 | 1,839 | 2,633 |
| Growth rate (in percent annual) | 0.2 | 0.9 | 0.8 |
| Urban population (in percent of population) | 29.0 | 38.8 | 49.2 |
| Total fertility rate (in births per woman) | 3.5 | 2.1 | 2.1 |
| GNI per capita (in U.S. dollars) | 1,970 | 960 | 1,340 |
| Current public expenditure | | | |
| Health (in percent of GDP) | 5.6 | 1.9 | 2.6 |
| Education (in percent of GDP) | 7.0 | 3.2 | 4.0 |
| Gross primary enrollment | | | |
| (in percent of school age population) | 142 | 111 | 112 |
| Male | 136 | 111 | 113 |
| Female | 149 | 112 | 111 |
| Immunization rate (in percent under 12 months) | | | |
| Measles | 84.0 | 70.2 | 77.8 |
| Diphtheria/Pertussis/Tetanus (DPT) | 75.0 | 77.9 | 83.5 |
| Life expectancy at birth (in years) | | | |
| Total | 68.6 | 69.4 | 69.1 |
| Male | 66.6 | 67.7 | 66.9 |
| Female | 70.8 | 71.3 | 71.5 |
| Mortality | | | |
| Infant (in per thousand live births) | 20.0 | 32.4 | 32.1 |
| Under 5 (in per thousand live births) | 24.0 | 42.0 | 40.0 |

Sources: World Development Indicators 2004, World Bank; Key Indicators 2004, Asian Development Bank.

1/ FY2002 or latest available year prior to FY2002.

## FEDERATED STATES OF MICRONESIA—LONG-TERM FISCAL ADJUSTMENT

Coming declines in external Compact assistance will necessitate both fiscal adjustment and structural reforms if the FSM is to attain economic self-sufficiency. Illustrative calculations describe the possible outturn under baseline, fiscal reform, and comprehensive fiscal and structural reform scenarios. The results suggest that comprehensive reforms could foster both strong private-sector-led growth and a robust fiscal position over the long run.

**Basic assumptions**

- Compact grants and trust fund contributions will be disbursed as scheduled during FY 2004–23 (see the table), with adjustments for inflation as described in Box 1 (U.S. and FSM inflation are assumed to be 3 percent and 2 percent, respectively). No other new assistance is made available. Neither the trust fund nor the income from it are available to finance spending before FY2024.

- Except in the baseline scenario, capital expenditure is raised over the near term in line with Compact requirements to raise spending on infrastructure.

- No additional borrowing takes place (borrowing has been for development purposes rather than to finance deficits; no new loans are currently scheduled).

**Baseline Scenario**

*Assumptions*: Tax revenues are assumed to remain around the current level as a percentage of GDP, and capital spending bears the brunt of fiscal adjustment to accommodate declining external assistance. With capital spending insufficient to shore up the infrastructure, economic growth is about 1 percent.

*Outcome*: With the budget in balance, usable government assets remain low, leaving only a slim buffer to absorb fiscal shocks such as the end of Compact grants in 2023. Returns on the trust fund plus other assets would initially suffice to replace expiring Compact grants, but only for a few years, and the stock of assets would decline relative to GDP over time. As in the other scenarios, usable government assets rise relative to GDP in the long run because returns on assets exceed the growth rate of nominal GDP.

**Fiscal Reform Scenario**

*Assumptions*: On the revenue side, a VAT is introduced in FY2006, increasing revenues by 3 percent of GDP. From 2007 onwards (including beyond 2023), further improvements to tax administration foster a modest rise in taxes relative to GDP. On the expenditure side, wages are frozen up to FY2010, while travel and other current expenditures are cut by 10 percent over FY2006–08 and then indexed to inflation. Capital expenditure increases in line with Compact requirements through 2007 and grows by 4 percent thereafter. Higher capital expenditure facilitates private-sector activity, raising GDP growth to around 1¾ percent.

*Outcome*: The fiscal balance initially rises steeply after the introduction of the VAT, then declines to about 1 percent of GDP reflecting the fall in Compact funds. In the long run, returns on assets are too small to replace expiring grants, as assets fall relative to GDP. Assets are lower relative to GDP than under the baseline because GDP is higher.

**Comprehensive Reform Scenario (Fiscal-Private Sector Development)**

*Assumptions*: In addition to the above fiscal reforms, current expenditures other than wages are cut by a further 5 percent over FY2006–08. Also, structural reforms are undertaken that raise private-sector growth to 6 percent—in line with the growth rate of Yap state during the first Compact period. Overall GDP growth rises to 2¾ percent.

*Outcome*: Better fiscal performance permits both modestly increased capital expenditure and higher long-run surpluses. In the long run, assets stabilize relative to GDP and returns on the trust fund plus other assets suffice to replace expiring grants. Assets are lower relative to GDP than under the baseline or fiscal reform scenarios because GDP is higher.

Selected Indicators in FY2023
(In millions of U.S. dollars)

| | Reform Scenarios | | |
|---|---|---|---|
| | Baselin e | Fiscal | Fiscal-PSD |
| General government usable assets | 88 | 220 | 409 |
| Trust Fund | 1225 | 1225 | 1225 |
| Nominal GDP | 420 | 475 | 580 |
| Average annual growth over FY04-FY23 (in percent) | 1 | 1¾ | 2¾ |

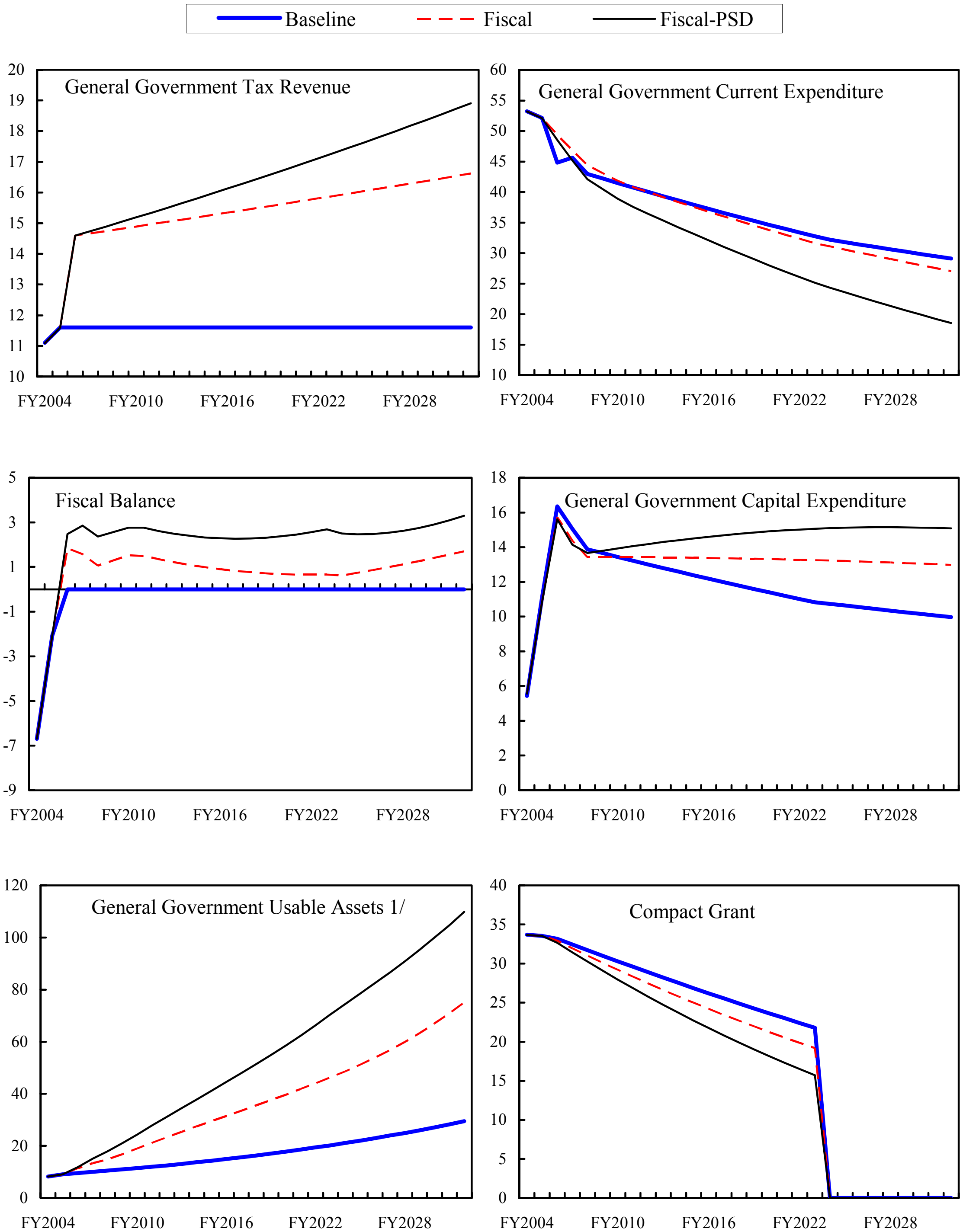
Source: IMF staff estimates and projections.

Compact II Funding for the FSM
(In millions of U.S. dollars)

| Fiscal Year | Annual Grants | Audit Grant | Trust Fund | Total |
|---|---|---|---|---|
| 2004 | 76.2 | 0.5 | 16.0 | 92.7 |
| 2005 | 76.2 | 0.5 | 16.0 | 92.7 |
| 2006 | 76.2 | 0.5 | 16.0 | 92.7 |
| 2007 | 75.4 | 0.5 | 16.8 | 92.7 |
| 2008 | 74.6 | 0.5 | 17.6 | 92.7 |
| 2009 | 73.8 | 0.5 | 18.4 | 92.7 |
| 2010 | 73.0 | 0.5 | 19.2 | 92.7 |
| 2011 | 72.2 | 0.5 | 20.0 | 92.7 |
| 2012 | 71.4 | 0.5 | 20.8 | 92.7 |
| 2013 | 70.6 | 0.5 | 21.6 | 92.7 |
| 2014 | 69.8 | 0.5 | 22.4 | 92.7 |
| 2015 | 69.0 | 0.5 | 23.2 | 92.7 |
| 2016 | 68.2 | 0.5 | 24.0 | 92.7 |
| 2017 | 67.4 | 0.5 | 24.8 | 92.7 |
| 2018 | 66.6 | 0.5 | 25.6 | 92.7 |
| 2019 | 65.8 | 0.5 | 26.4 | 92.7 |
| 2020 | 65.0 | 0.5 | 27.2 | 92.7 |
| 2021 | 64.2 | 0.5 | 28.0 | 92.7 |
| 2022 | 63.4 | 0.5 | 28.8 | 92.7 |
| 2023 | 62.6 | 0.5 | 29.6 | 92.7 |

Source: “Compact of Free Association, as Amended, Between the Government of the United States of America and the Government of the Federated States of Micronesia,” 2003.

Micronesia: Long-Term Fiscal Adjustment Scenarios, 2004-32
(In percent of GDP)




Source: IMF staff estimates.
1/ Excludes trust fund.

## FEDERATED STATES OF MICRONESIA—FUND RELATIONS

(As of October 31, 2004)

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 | 1.21 | 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 2002 Article IV consultation discussions were held during October 22–31, 2002. The Executive Board discussed the staff report and concluded the consultation on January 24, 2003.

IX. **Technical Assistance, 1999–2004**:

STA, MFD, LEG, and PFTAC have provided technical assistance on statistics, banking supervision, tax policy, 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 |
| MFD | *Banking Supervision*: a series of seven expert visits assisted with (i) developing a consolidated supervisory program, (ii) training in on-site examination, (iii) developing a standard format for reports and an on-site and off-site procedures manual, and (iv) strengthening the licensing regime. | January 2001–October 2004 |
| | *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 to the Commissioner. | February 1997 |
| | *Financial Systems, Supervision, and Savings Mobilization*: a 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 board, and (v) the functioning of the banking board. | August 1992 |
| STA | *Money and Banking*: two missions 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/October 2000 |
| | An expert helped with the development of CPI data for each state and for the country as a whole. | April 1999 |
| | An expert helped with the assessment of the statistical compilation issues in light of the then recently established Central Statistics Office. | November 1998 |
| | *Money and Banking Statistics*: a mission (i) helped assist in developing monetary statistics, (ii) trained the staff of the banking board on the methodology and procedures for compiling monetary data, and (iii) compiled a banking survey with expanded institutional coverage. | May 1996 |
| LEG | A mission helped upgrade AML legislation to conform with international standards and provided recommendations regarding the legislative basis for the financial intelligence unit (FIU) and in relation to the structure, resources, and functional responsibilities required for an operational FIU. | August 2003 |
| | A mission provided assistance in designing, developing, and implementing a more effective strategy for combating financial crime and financial system abuse, especially with respect to money laundering. | July 2002 |

## FEDERATED STATES OF MICRONESIA—RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTER (PFTAC)[7]

Since 1998, the Center's assistance to the FSM has included 34 advisory missions, mostly in the area of banking supervision and tax policy and administration. The FSM has also sent 13 officials to various regional seminars and workshops organized by PFTAC.

**Public Financial Management**

A July 2001 mission assessed fiscal transparency against the *Code of Good Practices on Fiscal Transparency*. A performance-oriented budget system has been introduced (partly to comply with Compact reporting obligations), but some building blocks are missing. A mission is planned for CY2004 to review progress and discuss further budget reforms.

**Tax Administration and Policy**

A Tax Reform Task Force has been established to review tax options, including recommendations of a PFTAC report. Depending on the outcome of the Tax Force's work, a mission will provide further TA, including designing an action plan to assist implementation.

PFTAC also designed a Customs Modernization project in 2002, which resulted in a sharp drop in the average time to clear goods, and also introduced electronic customs declarations (now more than 40 percent of the total); self-assessments; internationally accepted coding systems; a single identification number for income tax and customs duties; the metric system and the CIF value for customs forms; and standardized procedures for all four states. More training is proposed on risk management, post-clearance audit and valuation.

**Financial Sector Regulation and Supervision**

Since January 2001, a Fund peripatetic advisor has visited the FSM five times to provide technical assistance, focusing mainly on on-site examination. Further missions over the next twelve months will focus on off-site surveillance and prudential reporting. The Banking Commissioner has benefited from Fund and PFTAC seminars and workshops.

**Economic and Financial Statistics**

A March 2003 mission reviewed an earlier development plan for economic statistics. It recommended strengthening the statistics function and reducing reliance on external consultants by recruiting four economic trainee statisticians, extending the resident external adviser position for two years, and conducting a new Household Income and Expenditure Survey. Participation in the GDDS was also encouraged. The number of qualified staff increased in 2004, but other initiatives have yet to be implemented.

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[7] The Pacific Financial Technical Assistance Centre (PFTAC) in Suva, Fiji is a multi-donor technical assistance institution, financed by IMF, AsDB, AusAID and NZAID, with the IMF as Executing Agency. The Centre'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, 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 the input from the PFTAC staff.

## FEDERATED STATES OF MICRONESIA—RELATIONS WITH THE WORLD BANK GROUP[8]

| | |
|---|---|
| Total Commitments: | None |
| IFC Investments: | None |
| Recent Reports: | Embarking on a Global Voyage: Trade Liberalization and Complementary Reforms in the Pacific, 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 focus 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 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. It presents new estimates of the economic importance of fisheries in these countries that takes into account employment values, volume and value of fish harvested (including commercial and subsistence fisheries), export and import data, access fees, and levels of fish consumption. The study was published by ADB as a joint publication with the World Bank in 2002.

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

## FEDERATED STATES OF MICRONESIA—RELATIONS WITH THE ASIAN DEVELOPMENT BANK[9]

Since becoming a member in 1990, the FSM has received substantial assistance from the AsDB. As of August 2004, cumulative AsDB assistance to the FSM consisted of six loans and a number of TA prospects.[10] During the period 1997–99, the AsDB 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.

The AsDB continues to support the FSM with three pillars of the country strategy: (i) good governance, (ii) inclusive social development, and (iii) pro-poor economic growth. In addition, the AsDB's country strategy for 2005–06 will emphasize further the underlying themes; (i) promoting wider participation of civil society to development processes of the country, (ii) addressing hardship (poverty) issues more explicitly, and (iii) providing assistance with a long-term perspective, with a view to increase the effectiveness of its assistance.

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 sized businesses, enhancing the regulatory and policy framework, and improving factor markets. Measures are also planned to mitigate any adverse social impact of these adjustment polices. A new loan project for infrastructure development in power, water supply and waste water sectors is being processed with anticipation of AsDB approval in 2004.

The AsDB has been assisting the FSM to improve public sector efficiency and effectiveness since 1995 through TA in economic management and capacity building. The AsDB continues to support the government in increasing its institutional capacity in public sector management, administration and auditing through TA activities.

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

[10] The six loans are in the areas of: (i) fisheries development; (ii) public sector reform; (iii) water supply and sanitation; (iv) basic social services; and (v) private sector development.

Table 1. Loans to the Federated States of Micronesia by Sector
(In millions of dollars; as of end-August 2004)

| Sector | No. | Amount |
|---|---|---|
| Agriculture and Natural Resources | 1 | 6.5 |
| Energy | 0 | 0 |
| Industry and Nonfuel Minerals | 0 | 0 |
| Transportation | 0 | 0 |
| Communications | 0 | 0 |
| Finance | 3 | 31.0 |
| Social Infrastructure | 1 | 10.6 |
| Multisector | 1 | 8.0 |
| Other | 0 | 0 |
| Total | 6 | 56.1 |
| Memorandum Item: | | |
| Technical Assistance Provided | 42 | 21.8 |

Table 2. Loan Approvals and Disbursements
to the Federated States of Micronesia, 1993–2003
(In millions of dollars)

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Loan Approvals | 6.5 | 0.0 | 0.0 | 10.6 | 18.0 | 0.0 | 0.0 | 8.0 | 13.0 | 0.0 | 0.0 | 56.1 |
| Loan Disbursements | 0.0 | 0.0 | 0.3 | 0.1 | 11.3 | 6.2 | 4.9 | 4.4 | 2.5 | 1.4 | 2.7 | 33.8 |
| Undisbursed balance at the end of the year | 6.5 | 0 | 6.2 | 16.7 | 23.4 | 17.2 | 12.3 | 14.2 | 23.3 | 22.0 | 19.2 | ... |
| Memorandum Item: TA approvals | 1.7 | 1.3 | 3.3 | 1.2 | 2.4 | 4.9 | 1.3 | 0.8 | 1.2 | 1.0 | 1.2 | 21.8[1] |

[1] Includes 1990–92.

## 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, reflecting substantial assistance provided by the AsDB-financed Economic Management Policy Advisory Team (EMPAT) and PFTAC. However, major weaknesses remain, particularly in the area of national accounts.

**Real Sector**

The last official GDP estimate is for FY1996. No unemployment or aggregate production indicators are available. Recent GDP estimates are calculated by EMPAT from tax and social security data. The authorities have published a quarterly consumer price index for the nation as a whole and each state.

**Government Finance**

The national and the state governments and public sector enterprises publish annual audit reports detailing their fiscal operations, and are now available in GFS format. However, long publication lags exist. Further improvements in the quality of the fiscal data are dependent on greater cooperation between the national and state governments through timely and accurate reporting of data to the Division of Statistics in the FSM Department of Economic Affairs.

**Monetary Accounts**

An IFS country page was established in 2000. The Banking Commissioner sends updated data to STA on a monthly basis, with some need for improvement in timeliness. The reported data comprise interest rates, the accounts of the monetary authorities, commercial banks and the FSM Development Bank.

**Balance of Payments**

The authorities provide annual estimates of the balance of payments and external debt statistics.

Federated States of Micronesia: Core Statistical Indicators

(As of December 1, 2004)

| | Exchange 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't. Balance | GDP/ GNP | External Debt |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Date of latest observation | 8/31/02 | July 2002 | N/A | N/A | N/A | July 2004 | March Qtr 2002 | FY2001 | FY2001 | FY2001 | FY2001 | FY2001 |
| Date received | 8/31/02 | July 2002 | N/A | N/A | N/A | Sept. 2004 | Aug. 2002 | July 2002 | July 2002 | July 2002 | Aug. 2002 | July 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 | A | A/O | A |
| Mode of reporting[5] | E | E | N/A | N/A | N/A | P/E* | E | E | E | E | E | V |
| 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; M-monthly; V-staff visits.
[4] P-publicly released information; A-direct reporting by the authorities; O-staff estimates.
[5] P-postal delivery; E-electronic data transfer; V-staff visits.
Statistics Department (STA) of the IMF receives interest rates data from Banking Commission (the commission) of the Federal States of Micronesia (FSM) via postal delivery. STA also receives the interest rates data separately from the commission of FSM in an electronic file attached to e-mail that also contains the monetary and financial statistics for the monetary authorities, commercial banks, and FSM Development Bank. The interest rate data submitted via postal delivery often contains more current data.
[6] C-unrestricted use; A-for use of staff only; B-embargoed for a specified period and thereafter for unrestricted use.

**Statement by Michael Reddell, Alternate Executive Director for the Federated States of Micronesia and Evelyn Adolph, Advisor to Executive Director February 25, 2005**

**Key Points**

- The Federated States of Micronesia (FSM) is heavily dependent on a declining level of grant assistance.
- Substantial progress has been made in recent years to reduce the share of government expenditure in the economy, through wage restraints and cuts in subsidies.
- Substantial further adjustment will be required over the coming decades and the authorities recognize that tax reform, and higher overall domestic revenues, will have to be an integral part of that adjustment.
- Development partners, and agencies such as the Fund, have a significant role to play in helping provide the technical support for reform and in identifying the key effective barriers to securing a strongly-growing self-sustaining private sector in an isolated and very small economy.

Facing the substantial challenge of adjusting to the amended compact, the President and his administration welcomed the Article IV consultation's timely contribution to the active policy dialogue taking place in the Federated States of Micronesia (FSM). Staff's advice has, in many cases, helpfully served to reinforce the importance and urgency of many of the efforts they are currently pursuing. The staff team put considerable effort into understanding the country's particular economic developments and challenges and their work was appreciated.

***Economic Developments and Challenges***

The FSM economy remains heavily dependent on financial assistance under the Compact arrangements with the United States (with compact grants currently equivalent to a third of GDP). However, this assistance has been declining, and will continue to fall in the years ahead, and changes in compact assistance levels have been quickly mirrored in short-term fluctuations in the rate of GDP growth (the economy saw the sharpest declines in the two years of compact funding step-down, first in 1997, and again last year reversing the trend of positive economic growth since 2000).

The scale of adjustment already achieved, however, has been impressive. Since 1999, current government expenditure as a share of GDP has fallen by 13 percentage points (from 65 percent to 52 percent). The authorities have shown an impressive, and sustained, degree of fiscal discipline in bringing about this adjustment. Nominal wages in the public sector have been frozen since 1997, and subsidies to public enterprises, once a very large proportion of public spending, have been cut further from 4.3 percent of GDP in 1999 to 1.3 percent now (most of the operational public enterprises are now generating sufficient revenue to cover costs). These are substantial adjustments by any standards and the authorities deserve considerable credit for what has already been achieved. It is also encouraging that, as public sector employment has fallen, employment opportunities in the private sector have steadily increased, and the number of private sector employees now exceeds those in the public sector.

With a typhoon and delays in Compact-funded capital expenditure exacerbating the decline in output, 2004 was a challenging year for the authorities. The fiscal position is set to improve significantly in the 2005 budget as compact infrastructure grants resume and expenditure restraint is maintained. The overall fiscal balance is projected to be only 2.1 percent of GDP this year and, if anything, increasing capital expenditure suggests that there could be an upside risk to staff's rather cautious growth projections for 2005. As staff note, the government's usable reserves fell sharply last year from 21½ percent to 8¼ percent of GDP, but it is important to stress that the bulk of this fall represented FSM's investment in its own future, in the form of the $30 million contribution to the trust fund that is established under the Compact. Moreover, debt remains low, with 50 percent of it on concessional terms.

***Policies under the amended compact***

The amended Compact agreement with the United States reflects the shared objectives for the FSM economy: macroeconomic stability, sustainable growth, and ultimate self-reliance. To achieve these objectives, the amended compact incorporates the following features:

- declining annual grants;
- sectoral grant allocations with emphasis on health, education, and infrastructure;
- trust fund contributions; and
- enhanced accountability and monitoring[1].

Dealing with the far-reaching fiscal, political, and economic implications of the amended compact has been the biggest issue confronting the government for the last few years, and will remain so in the years ahead.

Looking ahead, the authorities agree that a comprehensive set of fiscal and structural reforms will be needed to promote medium-term fiscal and economic sustainability. Building on the substantial adjustment already achieved since the mid-1990s, these are important medium-

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[1] The requirements for greater oversight and accountability under the amended compact should facilitate improved financial management and reporting by all levels of government to facilitate greater transparency. For instance, whereas completion of the audited government accounts faced substantial delays in the past—FY2002 audited government accounts were completed in November 2004—the amended Compact requires submission of the audited government accounts by end-third quarter of the following fiscal year.

term challenges, and meeting them will require strong political leadership, continued efforts to build a consensus for reform, and ongoing support from FSM's international partners.

The road ahead will be difficult in places and many of the necessary changes are likely to occur only slowly. But progress in meeting the new challenges continues to be made. The 3rd FSM Economic Summit held last year was instrumental in building public awareness on the alternatives facing the country, illustrated by the three scenarios presented in the selected issues paper. The summit endorsed pursuing the third scenario of comprehensive fiscal consolidation and structural reforms. Reflecting the priorities that came out of the summit, the FSM Strategic Development Plan (SDP) was then drawn up providing an overall framework to guide the use of government resources, including compact grants[2].

The annual reduction in the operating grant featured in the compact is designed to ensure that a gradual shift away from compact grant to greater reliance on domestic revenue takes place. This will inevitably require on-going fiscal adjustments over the life of the amended compact. The authorities agree that, in the shorter-term, the expenditure side will have to bear the brunt of the fiscal adjustment (although would put less emphasis than staff on the need for "immediate cuts in the wage bill and other current expenditures"). However, given the magnitude of the adjustment over time, and the substantial adjustments already achieved in recent years, expenditure cutting will not be able to meet the medium- to long-term fiscal adjustment needs without severely compromising the government's ability to provide essential services. Also, as staff note, tax revenue remains low as a share of GDP by regional standards, although it is augmented by significant fishing access revenues which raise total domestic revenue to around 19 percent of GDP at present.

It is therefore widely accepted that in the medium-term revenue increases will be relied upon to meet some of the adjustment needs. Indeed, the action by congress in December 2004 to increase the rates on certain "sin taxes", reflect a growing awareness in FSM that revenue increases must be part of the adjustment effort. For the longer-term, the government has for some time been considering a comprehensive tax reform program, two main features of which, are the value-added-tax and improvements in tax and customs administration. Good progress has been made recently in improving the customs and tax administration, including the introduction of the an automated customs clearance system to modernize customs procedures, self-assessment has been introduced, and international codes and classifications have been put in place. The authorities have opted for a cautious approach to the VAT, and are somewhat constrained by the constitutional (and resulting practical) constraints outlined in the staff report. To reinvigorate the momentum on tax reform, a high-level task force on tax reform was officially established last month by a Presidential Order. To ensure consensus, the task force decided that it will now take a step back and consider all possible alternatives for reforming the tax system with the view to selecting one that is most suited for FSM's unique circumstances. It has invited PFTAC to give a presentation on the VAT in the next task force meeting scheduled for the coming month.

[2] Completion of the SDP is a requirement under the amended Compact.

The first round of fiscal consolidation, in preparation for the second compact funding step-down in 1997, had noticeable adverse economic impacts. The country saw a sharp rise in migration to the US in the period immediately following the government's implementation of its PRSP, which focused on retrenchment of government workers. That experience underscores to the authorities that any further fiscal consolidation in preparation for reduced compact assistance must be complemented by a more aggressive private sector development program. Against this background, the authorities are attaching more importance to pursuing private sector development.

To support private sector development, discussions on the allocation of annual compact sectoral grants has resulted in agreement to protect the infrastructure sector grant to a minimum of 30 percent of annual compact grants. To build on earlier progress to improve the investment environment, the authorities are now implementing an ADB-funded Private Sector Development (PSD) project/program loan. Under the on-going PSD project, progress has been made in improving the capacity and management of land administration offices in the state governments. Consistent with one of the policy conditions, the nation's first bankruptcy law was passed by the FSM congress last month. Further work in strengthening the legal and regulatory framework is expected under the program. My authorities are committed to taking the measures needed to ensure the success of this programme. More generally, they welcome sustained engagement with development partners and agencies, such as the Fund where the real pressure points might be that hold back the development of a truly self-sustaining private sector in a small isolated multi-island economy.

***Improving the pace of reform implementation***

Staff described in some detail the loose federation of government in the FSM, which has been one of the key factors in slowing down the pace of reform implementation. Indeed, while some countries are struggling to enhance the participatory nature of their decision making process, in the FSM the highly participatory nature of decision making is complicating the authorities' task of adjusting to the amended compact. Unfortunately, in the FSM there is no way around a time-consuming and resource-demanding process.

The reform process is now at a critical stage where agreement has been reached on the overall objectives. What is needed now is endorsement and implementation of specific measures (such as the VAT, further expenditure streamlining, and structural reforms) to effect the agreed objectives. To help political leaders sell the case for change, it is important that the authorities have available high level technical support, in their administration and from outside advisers. Consistently articulating the links between specific reform measures, such as the VAT and the longer-term objectives that the government has already agreed to, is vital to help move the reform and adjustment process forward. The government currently relies on technical assistance from the outside, including ADB and PFTAC advisors, to provide this critical support; and while extremely useful, occasional visits are not enough to meet demanding requirements of securing support for these important measures and seeing them through to implementation.

Against this background, interest has been expressed in staff's offer of an interim visit, in the off-year of the biennial surveillance cycle. This is an important initiative by APD, and in

FSM's case, such a visit, focused on tax reform issues, could help to strengthen the President and his administration in building consensus for change.

***Conclusion***

As we noted at the outset, our authorities appreciated the contribution this Article IV round has made. Nonetheless, as we have pointed out previously, the effectiveness of Article IV missions can benefit greatly from more continuity in the composition of missions, especially when full staff reports are done only every two years. We would also encourage future Article IV missions to FSM dedicate more time to **outreach**. Outreach is especially needed in the context of the decentralized decision making-process that exists in FSM.

In a decentralized system, with limited technical capacity, and a history of generous aid support, the progress of reform and adjustment is always likely to be slower than suggested by some abstract ideal. But material progress has been made in adjusting to the changing environment, and moving towards greater self-reliance, and my authorities are committed to confronting the challenges ahead. They continue to appreciate the support of all of their international partners, bilateral and multilateral alike. They continue to value the bi-ennial Article IV consultations and reiterate their interest in an interim staff visit. They have also indicated their consent to the publication of the staff report.

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# IMF Executive Board Concludes 2004 Article IV Consultation with the Federated States of Micronesia

On February 25, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Federated States of Micronesia.[1]

## Background

Economic developments in the Federated States of Micronesia (FSM) remain dominated by external assistance, particularly sizable U.S. grants under the Compact of Free Association. In FY2004 (ending September 30), a fall in Compact grants, along with a typhoon, precipitated a contraction in real output. Employment has been stagnant this year, and the public sector continues to account for half of formal employment. Wage growth has been modest, with a persistent wide differential between public and private pay. Inflation remained low despite higher oil prices.

The fiscal position swung sharply to deficit in FY2004, due to both a scheduled drop in Compact grants and delays in disbursements. With softening economic activity, domestic revenues continued to fall relative to GDP. Reflecting a loose federal system, the states' budgetary performances varied, with Chuuk state accumulating arrears. The fiscal deficit contributed to a decline in usable government financial assets to 8¼ percent of GDP.

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[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.

The external position also worsened, as the trade deficit widened due to rising oil prices as well as the typhoon's effects on agricultural exports. External debt has remained low, and debt service is around 6 percent of exports. With the U.S. dollar the official currency, the real exchange rate has depreciated modestly in recent years.

Domestic credit continued to shrink in FY2004. While the FSM's two commercial banks are sound, they mainly channel deposits overseas, rather than lending domestically. As a result, the loan/deposit ratio has reached record lows. This situation reflected continued uncertainty about economic prospects and shortcomings in the legal framework for lending, both of which continue to restrain private sector development.

**Executive Board Assessment**

Directors welcomed signs that the economy is recovering from the effects of the recent reduction in grants under the Compact of Free Association with the United States, and that inflation remains low. Directors noted with concern, however, that employment has been stagnant, the external and fiscal positions have recently worsened, and domestic credit has been contracting. Against this backdrop, limited private sector job opportunities have fostered steady emigration, undercutting the development of human capital within the country. Directors recognized that the Federated States of Micronesia's geographic remoteness and small size pose challenges to economic development. At the same time, they were of the view that following a prudent fiscal policy aimed at reducing reliance on grant assistance, combined with the implementation of structural reforms to foster private sector development and raise employment, would be the most effective way of confronting those challenges.

Directors observed that growth is likely to be sluggish over the medium term without fiscal and structural adjustments to promote stability and growth. Given the coming further reductions in Compact funding, the costs of the large government sector will be increasingly unsustainable, and the fiscal situation will deteriorate further. Directors therefore urged the authorities to make every effort to promote medium-term economic and fiscal sustainability and to build the needed political consensus for adjustment through greater outreach efforts.

Directors welcomed efforts by the authorities to restrain spending through a continued wage freeze and other means, but further efforts are needed to reduce the fiscal deficit, including cuts in the still-high wage bill and in other current expenditures. Directors stressed the need to deal with the unfunded liability of the social security system, including through cutbacks in benefits, if necessary. Comprehensive and timely reforms of the public enterprises could yield budgetary savings and improve prospects for private businesses. Directors encouraged the authorities to further strengthen budgetary management to meet the Compact's accountability and oversight requirements.

Directors emphasized the need to protect core expenditures on health, education, and infrastructure to underpin growth. Given the difficulties of making further spending cuts beyond those envisaged in other areas, and in light of fiscal adjustments previously undertaken by the authorities, the primary focus must be on raising revenues. In particular, greater efforts are needed to boost tax revenues, including through improvements in tax administration. Directors encouraged the authorities to move expeditiously in the context of the Task Force on Tax Reform to design and implement a comprehensive tax reform strategy. Some Directors saw a Value Added Tax as the best option for tax reform, especially if related constitutional issues can be resolved, but noted that it will need to be carefully designed and well-coordinated among the states.

A few Directors expressed concern about the passage of tax haven legislation by the Congress, which they viewed as harmful for the transparency of the tax system. They urged the authorities to work closely with relevant international groups to ensure that the tax haven scheme is not subject to abuse.

Directors stressed that structural reforms are needed to encourage private sector development and employment. In that connection, they broadly endorsed the authorities' priorities of enhancing infrastructure, easing restrictions on the use of land, and streamlining the foreign investment regime. They urged that measures to reach these objectives be accelerated. The authorities should also move ahead to develop the tourism, fisheries, and agriculture sectors, which could also help to improve the external imbalance. Directors considered appropriate the authorities' pursuit of regional trade liberalization as a prelude to broader liberalization.

Directors noted that domestic lending continues to decline, notwithstanding the banks' strong capital and liquidity positions. Enhancements to the domestic lending environment can help the private banking system to better support the domestic economy. In this connection, the Development Bank should avoid competing with commercial banks, and the budgetary impact of its operations should be limited. Directors commended the authorities for strengthening their effort to prevent money laundering and counter the financing of terrorism by establishing a financial intelligence unit.

Directors called on the authorities to strengthen economic statistics to improve their usefulness for economic monitoring and policy analysis. Domestic statistics-gathering capacity in particular needs to be enhanced. They encouraged the authorities to participate in the General Data Dissemination System.

***Public Information Notices (PINs)*** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report for the 2004 Article IV Consultation with the Federated States of Micronesia

**Federated States of Micronesia: Selected Economic Indicators, FY2000-04 1/**

| | FY2000 | FY2001 | FY2002 | FY2003 | FY2004 |
|---|---|---|---|---|---|
| Real sector | | | | | |
| Real GDP (in percentage change) | 8.4 | 0.3 | 1.1 | 5.1 | -3.8 |
| Consumer prices (in percentage change) 2/ | 2.0 | 1.3 | -0.1 | -0.2 | 1.4 |
| Consolidated government finance (in percent of GDP) | | | | | |
| Revenue and grants | 69.0 | 64.4 | 72.4 | 69.1 | 52.1 |
| Revenue | 24.4 | 20.7 | 20.9 | 19.0 | 19.0 |
| Grants | 44.6 | 43.7 | 51.5 | 50.1 | 33.0 |
| Expenditure | 75.7 | 73.3 | 66.5 | 64.9 | 58.7 |
| Current | 61.2 | 59.2 | 56.5 | 54.5 | 53.2 |
| Capital | 14.5 | 14.1 | 10.0 | 10.4 | 5.6 |
| Overall balance | -6.7 | -8.9 | 5.9 | 4.2 | -6.7 |
| Stock of domestic arrears 3/ | ... | 9.0 | 15.0 | 13.0 | ... |
| National and state governments' usable financial assets | | | | | |
| (In millions of U.S. dollars; end of period) 4/ | 39.8 | 10.3 | 27.1 | 49.9 | 18.7 |
| (In percent of government expenditure) | 24.4 | 6.4 | 18.4 | 33.2 | 14.0 |
| Commercial banks (in millions of U.S. dollars) | | | | | |
| Foreign assets | 77.0 | 77.8 | 78.3 | 104.6 | 109.6 |
| Loans | 52.4 | 52.1 | 39.1 | 23.7 | 20.0 |
| Total deposits | 120.8 | 121.5 | 112.1 | 119.8 | 124.1 |
| Interest rates (in percent per annum) | | | | | |
| Consumer loans | 15.3 | 15.3 | 15.0 | 15.0 | 15.0 |
| Commercial loans | 11.0 | 5.9 | 4.8 | 7.0 | 6.8 |
| Balance of payments (in millions of U.S. dollars) | | | | | |
| Trade balance | -82.7 | -88.1 | -76.8 | -100.7 | -113.8 |
| Net services and income | -10.0 | -20.4 | -17.5 | -19.3 | -17.4 |
| Private and official transfers | 93.4 | 96.7 | 110.6 | 122.3 | 106.8 |
| Current account including official transfers | 0.7 | -11.9 | 16.2 | 2.2 | -24.5 |
| (In percent of GDP) | 0.3 | -5.4 | 7.3 | 0.9 | -10.8 |
| Current account excluding official transfers | -90.5 | -106.3 | -92.0 | -117.8 | -128.8 |
| (In percent of GDP) | -42.0 | -48.5 | -41.6 | -50.8 | -56.9 |
| Overall balance 5/ | 13.7 | 8.1 | 52.2 | 25.0 | -24.3 |
| (In percent of GDP) | 6.4 | 3.7 | 23.6 | 10.8 | -10.8 |
| External debt (in millions of U.S. dollars; end of period) 6/ | 66.6 | 57.8 | 57.2 | 58.5 | 58.9 |
| (In percent of GDP) | 30.9 | 26.4 | 25.8 | 25.2 | 26.0 |
| External debt service (in millions of U.S. dollars) 6/ | 22.9 | 10.9 | 2.4 | 2.4 | 2.4 |
| (In percent of exports of goods and services) | 60.8 | 27.8 | 5.5 | 5.9 | 6.0 |
| Exchange rate | | | | | |
| Exchange rate regime | U.S. dollar is the official currency | | | | |

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

1/ Fiscal year ending September 30.

2/ A price index for the FSM has been only available since FY2000. Data shown are for FSM from FY2000 onward. Prior to this, the U.S. CPI is used.

3/ Estimated stock of domestic arrears in Chuuk and Pohnpei; end of period.

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

5/ Includes changes in reserves, valuation changes and errors and omissions.

6/ Government and public enterprise debt only.