INTERNATIONAL MONETARY FUND

2012 Staff Report with the Federated States of Micronesia

Concluding Statement of the IMF Mission

November 19, 2012

This statement summarizes the mission's preliminary views and policy recommendations based on discussions in Pohnpei.[1] The discussions focused on policies to ensure long-term sustainability through strengthening fiscal management and promoting the private sector. The economy is expected to continue to expand at a moderate pace, supported mainly by new construction activities and a growing fisheries sector, but faces headwinds over the medium-term from the gradual decline of Compact grants and the lack of a vibrant private sector. In that context, a comprehensive package of a medium-term fiscal consolidation plan with tax reforms and targeted expenditure cuts, as well as structural reforms to nourish private sector growth is essential to secure fiscal and economic sustainability.

I. BACKGROUND AND OUTLOOK

1. **Since the last IMF Article IV consultation in 2010, the economy continued on a steady growth path.** Following a recession in FY2006–08 due to delays in Compact grants utilization as well as high fuel and food prices, the FSM economy grew by 2–2½ percent for FY2010 and FY2011. The expansion was driven by new construction activities, such as the airport renewal projects funded by

Selected Economic Indicators

	FY2009	FY2010	Est. FY2011	Est. 1/ FY2012	Proj. FY2013
			(year-on-year changes)		
Real GDP	1.0	2.5	2.1	1.4	0.8
Consumer price index	7.8	6.3	4.6	5.6	4.2
			(in percent of GDP)		
Consolidated fiscal balance	1.6	0.5	0.6	1.2	0.8
Current account balance	-18.5	-16.6	-18.9	-15.0	-14.3

Source: RMI Authorities and Fund staff estimates.
1/Data For FY2012 are preliminary.

[1] The mission met with government officials, political leaders, donors, and private sector representatives in Pohnpei from November 9 to 19, 2012. The Regional Resident Representative for the Pacific Island Countries, representatives from the Executive Director's Office, the Asian Development Bank and World Bank also joined discussions. Numbers and estimates contained in this statement may be revised in the forthcoming Article IV Consultation Staff Report as pending data are received.

the US Federal Aviation Authority (FAA), and by growth of the fishery sector helped by good fishing conditions and high prices. The economy remains dependent on the large public sector (40 percent of GDP, including public enterprises), although there are signs of a further growth pick up in the fisheries and agriculture sectors.[2]

2. **Inflation moderated from its FY2009 peak, and fluctuations are largely driven by commodity prices.** After reaching 7.8 percent in FY2009, inflation has declined to 4.6 percent in FY2011. However, the last quarter of 2011 recorded a 6.5 percent increase (year-on-year) reflecting the rise in international food and fuel prices, which compose about 46 percent of the consumption basket.

3. **The overall fiscal balance of the consolidated government recorded modest surpluses for three straight years through FY2011, with an uneven distribution of outcomes across states.** In FY2011, the overall consolidated fiscal balance was $1.9 million (0.6 percent of GDP) in surplus, helped by economic growth and fishing fee revenue. However, the surplus of the national government masks an aggregate deficit at the state government level.[3] While Chuuk and Yap turned in a surplus in FY2011 with better revenue administration, Kosrae and Pohnpei each recorded deficits equivalent to about 1 percent of state GDP.

4. **Public debt remains at a relatively low level, but underfunding in the Compact Trust Fund (CTF) assets and declining balance of the social security fund pose long-term challenges.** Gross public debt is relatively low at $87.1 million (below 30 percent of GDP) in FY2011, mostly owed to Asian Development Bank (AsDB) on concessional terms. Amount of the gross public debt is dwarfed by the size of financial assets held in the CTF which is equivalent in value to $257 million (83 percent of GDP) as of end-FY2012.[4] However, the trajectory of the CTF asset accumulation is insufficient for the long-term budget self-reliance (see paragraph 9 and Box 1). In addition, net assets of the social security fund declined from $42.4 million in 2010 to $40.4 million in 2011 with benefit payments still exceeding contribution revenue, continuing to raise concerns over the viability of the system (see paragraph 13).

5. **Despite some deterioration of the current account balance (from -12 percent of GDP for FY2006–8 to -18 percent for FY2009–11 on average), external balance is sustained by a stable flow of official transfers.** The majority of the overall current account deficit (19 percent of GDP in FY2011) is financed through capital transfers from official sources (13 percent of GDP). Given their contractual nature, they can be considered a stable source of funding. Similarly, imbalances within the current account balance (a trade and services deficit of 58 percent of GDP) are largely offset by a stable surplus in the income and transfer balances from Compact current grants and remittances (40 percent of GDP). Given the dedicated official funding sources, the level of gross international reserves (about 3½ months of imports) is not as much a critical indicator for the external sustainability as in other countries. The current account deficit widened in FY2011, with an increase in exports (mainly fish) more than offset by that in imports driven by construction materials and fuels. Visitor arrivals declined significantly in FY2011 to 20 percent below the FY2009 peak, while

[2] Annual data refer to the fiscal year ending on September 30.

[3] The overall consolidated fiscal balance is calculated by aggregating that of national government and fiscal balances of four state governments (Chuuk, Kosrae, Pohnpei and Yap).

[4] It should be noted, however, that the use of trust fund assets are stipulated by the Compact agreement between the FSM and the United States.

higher inflation than in trading partners has kept the real effective exchange rate at an appreciated level.

6. **Financial conditions have remained tight.** There are large spreads between deposit rates (around 1 percent) and loan rates (about 14 percent for consumer loans, about 7 percent for commercial loans), partly reflecting high risks involved in lending in the FSM, given limited availability of land as collateral. Commercial loan growth has been stagnant in recent years, while consumer loans saw some pick up. The ratio of consumer loans to household income is relatively high (about 24 percent in 2011).

7. **Economic growth will likely slow in the near term, as the private sector falls short of offsetting the declining public sector demand from Compact grants reduction.** Growth in FY2012 is estimated at 1.4 percent as recent construction projects financed through FAA grants are winding down. A modest consolidated fiscal surplus of 1¼ percent of GDP is expected in FY2012, mainly due to a sharp increase in fishing access fee revenue by $7.6 million. While the fishery sector is expected to continue its healthy expansion, lackluster wholesale and retail activities will remain a drag on the private sector growth.

8. **Beyond the near-term, growth is weighed by the scheduled reduction in Compact grants disbursement.** In addition, the 2010 census shows that the population has been shrinking, and significant outward migration continues despite the reasonably good economic performance in recent years. Staff expects growth to stay low at about ½ percent over the medium term, with limited private sector growth failing to offset the effects of a decline in Compact sector grants ($0.8 million per annum before adjusting for inflation).

9. **Risks to the outlook are on the downside.** While there are certain upside risks from upgrading of the U.S. military base in Guam and possible acceleration in release of delayed infrastructure grants, larger risks are that further deterioration in the external environment and volatile commodity prices hold back growth, leading to further delays in fiscal adjustment, and thus elevating concerns over fiscal sustainability. Long-term risks include failure to fully prepare for the expiry of the Compact grants, continued outward migration of working age population, and climate change and the associated shore erosion of limited farmland.

II. POLICIES TO SECURE ECONOMIC AND FISCAL SUSTAINABILITY

A. Fiscal Policy

10. **The projected amount of government assets in the CTF under the current policies is unlikely to generate sufficient investment returns to replace the Compact grants that will expire in FY2023 (Box 1).** Notwithstanding the benign investment performance in FY2012, projected investment returns from the CTF in FY2024 will fall short of the Compact grants to be replaced by as much as $16 million in FY2011 prices (about 5 percent of GDP). To achieve the long-term fiscal sustainability, the FSM needs a steady and decisive fiscal strategy. In this regard, the establishment of the "2023 Planning Committee" (the Committee) under the leadership of President Mori to develop a realistic action plan for addressing the looming budgetary shortfall in FY2024 and beyond is a welcome development.

11. **The following four points should serve as the guiding principles for the Committee to meet its objectives.**

- *Develop a realistic macroeconomic framework.* Budget documents should cover general government (include contingent liabilities from public enterprises or social security fund) and long-term fiscal projections should use conservative assumptions on growth and asset returns while providing an appropriate expenditure trajectory. The IMF can share its long-term fiscal projection framework to assist the government in preparation of their own projections.

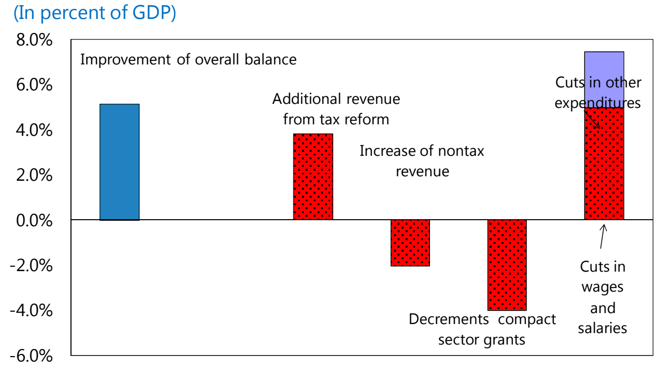
- *Devise a balanced fiscal adjustment path.* The adjustment path should strike an appropriate balance between the need to preserve assets for future generation, current developments needs (for instance for infrastructure), and short-term growth implications of fiscal reforms.

  The government is committed to securing fiscal self-sufficiency by FY2023 when the Compact grants are scheduled to expire. Based on a 6 percent rate of return assumed in an earlier GAO study, it requires financial assets of $1.1 billion in FY2023 (in FY2011 prices). This target could be achieved by increasing fiscal surplus to about 6.4 percent of GDP by FY2016, and then maintaining the surplus at that level until FY2023, before returning to a small surplus budget. Alternatively, the government could accumulate fiscal surpluses more gradually over a longer period; though with the higher risk of reform fatigue, the higher overall level of fiscal surplus required to achieve fiscal sustainability, and the shorter time left before FY2023 to re-adjust the fiscal trajectory in the event of setbacks (see Box.1). The considerable growth impact of fiscal consolidation would need to be partly offset by accelerating structural reforms (see section B below).

- *Build in policy buffers*. Given the long implementation period, the absence of monetary policy, and the susceptibility of the economy and the poor to external shocks, the FSM needs to build fiscal policy space for the resilience of its medium-term plan. Possible policy actions include allocating part of expenditures to fund an emergency transfer program. In designing these arrangements, however, care should be taken that they do not undermine the long-term fiscal consolidation efforts, possibly by requiring that the amount should be recovered by other savings within a limited length of years once the temporary shocks subsided.

- *Secure buy-in of the public and state governments*. The long-term fiscal consolidation cannot be carried out and sustained without broad public support. In addition, given the significant size of state governments in the FSM, their contributions to the fiscal adjustment are essential. It is thus imperative for the national government to engage these stakeholders into the discussion of needed fiscal reforms. From this viewpoint, the continuous enhancement of audits and the reflection of their results in fiscal management are also important.

Accumulated Changes in Expenditure and Revenues under the Alternative Adjustment Scenario 1/
(In percent of GDP)



1/ Cumulative change between FY 2012–16.
Source: IMF staff estimates.

12. If the fast fiscal adjustment scenario (see Box.1) is to be pursued, the government needs to implement fiscal reforms immediately; setting clear targets on both expenditure and revenue sides (see text chart). The approval and implementation of the long-term fiscal framework would be an important step. Significant gains can be made by improvements in operational efficiency on both current and capital expenditure. Beyond such gains, there is room for reducing current expenditure as public sector payroll in the FSM ranks high among the region as share of GDP and public wage rates for governments are on average 2.1 times higher than for the private sector. Those for public enterprises have even higher ratio of 2.8

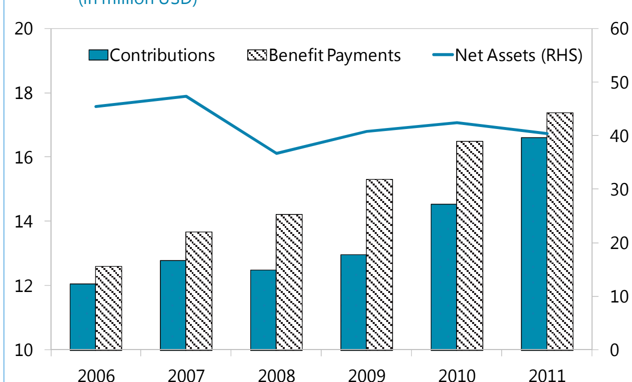
times. Containment of public sector wages (reduction by 3 percent of GDP) could also help improve competitiveness of the FSM economy over the medium term through containing inflation and by raising labor supply for the private sector.

13. In parallel, the planned comprehensive tax reform should be swiftly implemented. Enhancing revenue is imperative to put the public finance on a more sustainable path. A set of bills, including ones to create the Unified Revenue Authority (URA) and to introduce a net profits tax and a value added tax to remove a bias against industries with relatively high fixed costs and distortions from different rates of tax across goods and services, were approved by the national government as well as two out of the four state governments. Given the urgency of the tax reform, the government should step up its efforts to engage state governments and the general public for swift consideration of the tax reform bill in the remaining states. Further efforts to strengthen the tax administration through staff training and upgrading the IT system will also be necessary.

14. To complement and protect the benefits of expenditure and tax reforms, it is essential to improve the public financial management. Ongoing efforts to strengthen the public financial management with support from the Pacific Financial Technical Assistance Center (PFTAC) should be accelerated in this respect. Under the current system, fiscal surpluses in one year are freely appropriated to finance next year's expenditure. The mission encourages the authorities to devise a fiscal rule requiring fiscal surpluses to be transferred to the CTF. Given the nature of the FSM as federated states, the long-term fiscal consolidation also requires strengthening the fiscal discipline at state governments to contain expenditures, including through tighter fiscal rules on their use of the expenditure carry-over between annual budgets. Budget documents should reflect the whole activities of the government financed by domestic revenues and foreign grants as well as those of state governments.

15. The social security system of the FSM remains in a challenging financial situation. It is financed by employer/employee contributions at a rate of 7 percent each paid to the system and funds benefit payments for the old-age, surviving spouses of deceased workers, and disabled. Despite some efforts in recent years to strengthen collection, total benefit payments ($17.4 million) were still in excess of total contributions ($16.6 million) in 2011. Although the contributions rate was raised from 6 to 7 percent in 2010 and will be further increased to 7.5 percent in 2013, it is unlikely to reverse the trend of assets erosion permanently. Further efforts in both tax collection and system design are needed to correct the accumulated imbalances in the past and reduce delinquent accounts so as to bring the system into long-term sustainability. Given that it will take time to carry out comprehensive reforms, contributions from the general budget will still be needed in the meantime to protect the value of the social security fund.

Social Security Finances
(in million USD)



Sources: Audit Reports
Note: Unfunded accrued liability is 245 million USD as of Jan. 1, 2011.

16. Public enterprises pose another important fiscal risk. They have significant economic presence accounting for 8.6 percent of GDP. Some public enterprises not only crowd out precious financial and human resources from other sectors of the country, but also constrain productivity growth of the entire economy through inefficient or costly services. Though budget transfers to public enterprises are currently limited, their sheer size of operations implies considerable contingent liabilities for public finance in the event of deterioration of financial positions of public enterprises that could be triggered by surge in commodity prices. While simply promoting competition may have only limited effect due to the small scale of the economy, it is critical to strengthen the oversight and accountability of public enterprises, in particular in the essential service areas such as electricity and telecommunication.

B. Private Sector Development

17. **Sustainable growth will require a vibrant private sector.** The structure of the FSM economy has changed little over the last decade—the share of the public sector stands at 38 percent, the private sector at 22 percent, and the household at 31 percent.[5] The key bottlenecks for private sector development include difficulties in obtaining secure long-term land leases, reliance on a single carrier operating high-priced flights, poor infrastructure, and lack of skilled labor.[6] While some key infrastructure projects are underway, the government could further support private sector growth by accelerating infrastructure investments and providing a more business-friendly environment.

18. **Reforms to attract inward FDI could have an immediate impact as part of an overall development strategy.** Given the FSM's competitive advantage in some niche tourism markets, a more focused approach on improving inward FDI in these areas could generate immediate benefits. In particular, addressing issues regarding obtaining longer-term land leases and burdensome procedures of approval for foreign investment would help facilitate tourism FDI. Other measures to improve business environment include: committing long-term government support for the College of the FSM in training future workers; keeping public wages in check to reduce the large public-private sector wage gap; and advancing the public enterprises reform to encourage new entrants for more competition in the provision of infrastructure services including through increasing private sector participation in public enterprises, where feasible. The FSM's first Development Partners Forum, held in early November to discuss economic and development challenges for the FSM, provided an excellent opportunity for representatives from national and local governments, private sector, civil society and international partners to sit together and explore possible paths to the future growth. It is essential to keep the momentum and ensure the forum is followed by concrete action plans with strong engagement by stakeholders.

C. Financial Sector

19. **The banking sector is well capitalized and with sufficient liquidity, but renders little support to the private sector with a low loan-to-deposit ratio (33 percent at end-FY2011).** While deposits are steadily increasing over the past three years, majority of them are invested by banks in safe financial assets rather than being lent to the private sector, apparently due to lack of bankable projects. The introduction of the Secured Transactions Act in 2006 has facilitated taking immovable property as collateral and did help banks to extend loans to those customers they would not have been able to lend to before, but it has not so far led to boosting commercial lending.

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[5] The rest is indirect taxes.

[6] Doing Business (2013) ranks the FSM at 150th out of 185 countries. The ratings are particularly low in registering property (185th), protecting investors (177th), and resolving insolvency (166th).

Increasing availability of consumer loans may have contributed to pick up in inflation in recent years, and while NPLs remain relatively low at just over 3½ percent, careful monitoring of credit quality is warranted.

20. The FSM Development Bank, originally focused on commercial lending, continues to be engaged in consumer lending, in direct competition with private banks. The Development Bank should return to its intrinsic role of fostering new businesses to complement private banks. Moreover, it lacks sufficient risk assessment capacity and provisioning against consumer loans. Appropriate supervision of the Development Bank, together with credit unions, in line with international best practices, is key to the financial stability. The mission urges that capacity of the regulatory authorities should be enhanced to include the supervision of lending activities by the Development Bank and credit unions. In the area of insurance, strengthening the regulatory and supervisory capacity is a priority in view of the increasing activities of captive insurance companies.

D. Exchange Rate and External Sustainability

21. The FSM's real exchange rate has been appreciated since the global downturn. The real effective rate appreciated by 9 percent in FY2009 due to a hike in the inflation rate driven by food and fuel prices, and remained appreciated. The goods trade balance worsened over the same period, with an increase in exports (mainly fish) more than offset by that in imports. The exchange rate level could be reversed as inflationary pressures subdue, although the authorities noted the tendency of the price level to keep elevated in the FSM.

22. Despite the appreciation, the risks to external stability are currently limited. The current account deficits are expected to remain wide in the medium term, but financed through foreign assistance. Compact-related financial flows dominate external balances and will continue to provide a stable source of funding over the next decade, while external debt is expected to decline in terms of GDP. It should be stressed, however, that fiscal and structural reforms are essential for securing external stability after the expiry of Compact grants. The use of the U.S. dollar as the official currency is appropriate given the small size of the economy and its close financial and trade linkages with the United States.

E. Other Issues

23. Improving the reliability, coverage, and timeliness of economic statistics would better guide policies. The mission notes ongoing efforts by the Office of Statistics, Budget and Economic Management, Overseas Development Assistance, and Compact Management (SBOC) to improve data collection and management, including efforts to release quarterly CPI data and upgrade its website. The authorities are encouraged to further enrich statistics and use them for policy-making. In particular, it is crucial to collect and consolidate fiscal data across national and state governments in a timely manner.

The mission would like to thank the authorities for their hospitality and thank members of the government, political leaders, and private sector representatives for fruitful discussions.

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Table 1. Micronesia: Medium-term Scenario (Current Policies), FY2009–17 1/

	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
				Est.	Proj.	Proj.	Proj.	Proj.	Proj.
Real sector									
Real GDP (percent change)	1.0	2.5	2.1	1.4	0.8	0.7	0.6	0.6	0.6
Consumer prices (percent change)	7.8	6.3	4.6	5.6	4.2	3.5	2.7	2.0	2.0
General government finance (in percent of GDP)									
Revenue and grants	65.9	68.2	65.9	65.2	62.6	60.5	59.3	58.3	57.5
Total domestic revenue	21.4	21.8	21.8	23.3	22.0	21.1	20.8	20.5	20.2
Grants	44.5	46.3	44.1	42.0	40.6	39.4	38.5	37.8	37.2
Expenditure	64.2	67.7	65.3	64.0	61.8	59.9	58.6	57.7	56.9
Current	47.4	48.1	46.9	46.8	45.3	43.9	43.0	42.4	41.9
Capital	16.9	19.6	18.4	17.2	16.6	16.0	15.6	15.3	15.0
Overall balance	1.6	0.5	0.6	1.2	0.8	0.6	0.6	0.6	0.6
Compact Trust Fund									
(in millions of US$; end of period)	138.3	177.2	198.5	257.4	297.5	341.0	388.5	440.0	496.1
Balance of payments (in millions of U.S. dollars)									
Trade balance	-128.4	-130.7	-134.2	-133.1	-130.4	-128.8	-126.1	-124.2	-125.8
Net services	-51.9	-43.6	-47.4	-47.6	-47.6	-47.7	-47.9	-48.0	-48.1
Net income	20.6	13.6	14.9	23.0	22.0	21.2	22.1	22.9	23.7
Private and official transfers	108.4	112.1	108.0	108.7	107.3	106.3	104.1	102.4	100.9
Current account	-51.3	-48.7	-58.6	-49.0	-48.7	-49.0	-47.8	-46.9	-49.2
(In percent of GDP)	-18.5	-16.6	-18.9	-15.0	-14.3	-14.0	-13.3	-12.8	-13.2
Current account excluding official transfers	-155.9	-157.2	-162.2	-153.9	-152.0	-151.5	-148.0	-145.5	-146.4
(In percent of GDP)	-56.2	-53.4	-52.3	-47.0	-44.8	-43.3	-41.3	-39.8	-39.2
External debt (in millions of US$; end of period) 2/									
Stock	84.6	84.3	87.1	87.1	87.1	86.9	86.8	86.7	86.3
(in percent of GDP)	30.5	28.7	28.1	26.6	25.7	24.9	24.2	23.7	23.1
Debt service	3.9	4.3	5.0	5.1	5.0	5.1	5.0	5.0	5.1
(in percent of exports of goods and services)	6.6	6.6	6.9	6.6	6.1	6.0	5.6	5.2	5.2

Sources: the FSM authorities and Fund staff estimates.

1/ Estimates for FY2012 and projections from FY2013–17 are preliminary and based on data received from the authorities.

2/ Government and public enterprise debts only.

Box 1. Micronesia: Long-term Fiscal Sustainability

This box assesses the FSM's long-term fiscal sustainability, updating the estimates in the 2010 Article IV consultation. The analysis considers implications of the expected expiry of annual Compact grants on the fiscal sustainability of the FSM and possible policy options to address the challenge. Fiscal sustainability is measured by the usable government's asset position as of end-FY2023 that would generate an investment income large enough to supplement the expiring Compact grants without significantly disrupting public services and eroding the value of the Compact Trust Fund (CTF).[1]

The CTF has exhibited a volatile investment performance over FY2008–12. For FY2008–09, net return on assets was negative by a cumulative 17 percent, substantially eroding the market value of the CTF. Over the period of FY2010–12, the average annual rate of return improved to about 7½ percent with better financial market conditions, bringing the value of the CTF to about $257 million as of end-FY2012. As of end-FY2012, financial assets of the CTF are invested into U.S. equity (30 percent), non-U.S. equity (30 percent), fixed income investment (22 percent), real estate (7 percent), hedge fund (4 percent), and private equity (8 percent).

The long-term fiscal outlook is assessed through presenting alternative adjustment scenarios against the baseline. The baseline scenario features limited fiscal adjustment and structural reforms, while alternative scenarios consider comprehensive fiscal reforms, including implementation of tax and structural reforms. Throughout all scenarios, net investment returns on the CTF assets are assumed to be at 6 percent, in line with an earlier GAO study.

1. **Baseline scenario**

The baseline scenario assumes that small fiscal surplus (around ½ percent of GDP), similar to those in recent years, will continue over the medium term, as expenditure adjusts to the declining Compact grants. Medium-term real growth is expected to be low at about ½ percent, reflecting sluggish investment, continued outmigration, and low productivity growth.

Under the baseline, the CTF would not generate sufficient investment income to replace the annual Compact grants expiring in FY2023. By end-FY2023, the stock of financial assets would be about $840 million (in FY2011 dollars), of which $770 million would be in the CTF and about $70 million in other funds.[2 3.] During the drawdown phrase beginning FY2024, investment income would only be about $50 million per year. On the other hand, Compact sector grants in FY2024 are estimated to be about $66 million, leaving a shortfall of about 5 percent of FY2011 GDP.[4] With no firm commitment of grants beyond FY2023 and lack of vibrant private sector activity, the government would be forced to either sharply tighten budgets or rapidly deplete its accumulated savings.

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[1] The Compact Trust Fund for the FSM was created to contribute to the long-term budgetary self-reliance of the FSM and to provide the FSM government with an ongoing source of revenue after FY2023. The amended Compacts and their subsidiary agreements contain no commitments, either express or implied, regarding the level of the revenue that will be generated by the trust fund, not is there any commitment regarding the degree to which the revenue will contribute to the long-term budgetary self-reliance of the FSM.

[2] All the amounts in this box are based on FY2011 prices, unless otherwise stated.

[3] Government reserves in various funds are assumed to contribute to closing the revenue gap.

[4] The shortfall would be even larger at about 10 percent of GDP if the Supplemental Education Grants (SEG) is discontinued after FY2023.

Box 1. Micronesia: Long-term Fiscal Sustainability (Cont'd)

Higher investment returns could narrow the shortfall, but simply relying on high returns over a long horizon is not recommended. To generate sufficient investment income to offset the expiring Compact grants, the net investment returns would need to be 7.2 percent per year until FY2023. While the CTF has recorded high investment returns in some past years, given the high volatility in its performance, it is not advisable to expect as the baseline continuation of such high investment returns over a long period.

2. Policy adjustment scenarios

Fiscal sustainability can be achieved through significant fiscal adjustment and structural reforms to promote private-sector growth. In policy adjustment scenarios, the government would accumulate savings by fortifying the recent fiscal surplus through comprehensive tax reform and cuts in wasteful current expenditures. According to the PFTAC preliminary estimates, the planned tax reform could improve tax revenue by about 4 percent of GDP. In parallel, structural reforms (e.g., improved education, and other development needs) could boost potential growth to about 2½ percent in the medium term despite fiscal consolidation.

a. Swift adjustment scenario

The estimates indicate that long-term fiscal sustainability would be achieved through gradually increasing fiscal surplus by about 1¼ percent of GDP per annum for four years to reach 6.4 percent of GDP in FY2016, and maintaining that level until FY2023. The budget would need to run a surplus sufficient to keep the real value of the fund after FY2023.

Under this adjustment scenario, the stock of government assets (including cumulative earnings from these fiscal surpluses) would reach about $1.1 billion by the end of the Compact period in FY2023, thus generating sufficient income to offset the expiring Compact grants. The required fiscal adjustment is higher than that in the 2010 Article IV Staff Report by about ½ percent of GDP, which reflects a shorter accumulation period until FY2023.

b. Gradual adjustment scenario

Alternatively, the government could accumulate fiscal surpluses more gradually over a longer period than the swift adjustment scenario, though with the higher risk of reform fatigue and the higher overall level of fiscal surplus required for the fiscal sustainability. If the adjustment were to be made over eight years rather than four years, fiscal surplus would need to be increased by 0.8 percent of GDP per annum to reach around 7.8 percent of GDP in FY2020, and then maintained at that level until FY2023. The expected amount of the CTF assets is the same as under the swift adjustment scenario.