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Federated States of Micronesia: 2008 Article IV Consultation—Staff Report; and Public Information Notice on the Executive Board Discussion

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 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 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 21, 2008, 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 10, 2009. 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, 2009, discussion of the staff report that concluded the Article IV consultation.

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

Statistical Appendix

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

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INTERNATIONAL MONETARY FUND

FEDERATED STATES OF MICRONESIA

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representatives for the 2008 Consultation
with the Federated States of Micronesia

Approved by Philip Gerson and Jerald Schiff

February 10, 2009

- **This report is based on discussions held in Pohnpei and Yap** during November 12–21, 2008. The team comprised Messrs. Kang (Head) and Sommer (both APD). Mr. Moveni (OED) joined the mission in Pohnpei, while Mr. Gill (AsDB) participated as an observer.
- **Counterparts:** The team met the Secretary of Finance, the Vice-Speaker of Congress, and other senior members of national and state governments, as well as parliamentarians and private sector representatives.
- **Outreach:** The mission's outreach included meetings with legislatures of Pohnpei and Yap, business leaders, and interviews with the local press.
- **Context of past surveillance:** During the 2006 Article IV consultation, the authorities and the Fund agreed on the broad policy priorities—fiscal adjustment through expenditure cuts and tax reforms to achieve self-sufficiency when the Compact ends in 2023 and structural reforms to support private sector development (for details, see http://www.imf.org/external/np/sec/pn/2007/pn0730.htm). While some progress was made on fiscal consolidation, the pace of reforms has been slow, partly due to capacity limitations and the loose federation of government, which has made it difficult to forge a consensus for reform and coordinate policies.
- **Exchange rate:** The U.S. dollar is the official currency. The government of the Federated States of Micronesia (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 except for security reasons.
- **Statistical issues:** Limited domestic capacity to produce economic data hampers surveillance and policy analysis. FSM continues to receive assistance from the Pacific Financial Technical Assistance Centre (PFTAC) to improve the quality of national accounts and balance of payment data.

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EXECUTIVE SUMMARY

Background

- **Economic performance of the Federated States of Micronesia (FSM) has been weak in recent years.** As a result of problems with disbursing grants under the Compact agreement with the United States, rising commodity prices, and difficult business environment, the economy has contracted for five years in a row—one of the worst outturns among the Pacific nations.

- **Growth could recover modestly in the near term as falling commodity prices boost real incomes and progress is made on spending unused Compact infrastructure grants.** However, risks are on the downside given the ongoing global slowdown and persistent fiscal deficits.

- **Without stronger reform efforts, medium-term growth prospects are poor.** With Compact support on a declining path, the authorities face the need to downsize the public sector, a task made more difficult without sustained private growth. Meanwhile, the fiscal balance remains well below the medium-term surplus necessary to build savings that would help achieve self-sufficiency when the Compact expires in 2023.

Key Policy Issues

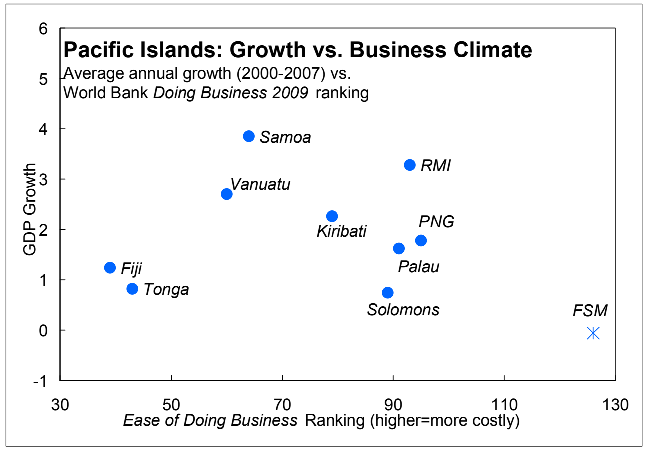
- **The authorities have limited tools to address risks from the global slowdown.** Monetary policy is not available as the U.S. dollar is the FSM's legal currency. Since fiscal policy is constrained by the need to adjust to the shrinking Compact grants, priority should be given to unlock undisbursed Compact funds, especially for infrastructure, and make progress on structural reforms.

- **Given the urgency of fiscal consolidation, expenditures should be streamlined and preparations for the comprehensive tax reform should be intensified.** Further efforts to reduce the large wage bill, reduce subsidies, and strengthen tax administration would help preserve spending on infrastructure and development needs, while putting long-term finances on sound footing.

- **Reforms to ease the cost of doing business are crucial to help catalyze growth and create jobs.** The priorities should be to reduce the large public-private sector wage gap, strengthen the enforcement of contracts, and lower the barriers to foreign investment. In addition, improvement to secured lending and refocusing of the FSM Development Bank on supporting new businesses would increase the availability of credit.

I. INTRODUCTION

1. **The FSM is a small Pacific island country highly dependent on external aid, mainly U.S. grants.**[1] A renewed Compact Agreement with the United States ("Compact") effective since FY2004[2] steadily lowers transfers to the FSM through FY2023. Thereafter, the FSM is expected to complement its domestic revenues with returns from its Compact Trust Fund and other savings. The new Compact has placed stricter rules on reporting, auditing, and the use of grants, which have proved difficult for the national and state governments to meet. As a result, about $100 million (34 percent of GDP) in grants have not been used, contributing to a contraction of the FSM economy in recent years.[3]



2. **This year's Article IV consultation focused on the authorities' fiscal reform agenda and the impact of the global slowdown on the FSM economy.** The ongoing global turmoil is likely to reduce remittances, tourist arrivals, and the value of governments' financial assets, which could constrain the domestic activity. In the absence of monetary policy and given the urgent need for fiscal consolidation, the authorities have limited scope to address risks from the global slowdown. In this difficult environment, the authorities' priority should be to meet the requirements under Compact to release held-up infrastructure grants and make progress on structural reforms. Over the medium term, there is a need to further reduce the oversized public payrolls and discretionary spending, strengthen tax administration, and accelerate preparations for the tax reform. Reforms to promote private sector development will be crucial to support fiscal consolidation and put the country on the path of sustainable development.

[1] The FSM (with a population of about 108,000) has four states—Chuuk, Kosrae, Pohnpei, and Yap, each with its own executive and legislative bodies. Authority is highly decentralized, with state governments significantly larger than the national authority.

[2] The fiscal year runs from October to September (for example, FY2008 covers October 2007 to September 2008).

[3] A recent PFTAC mission concluded that the existing national accounts statistics may have underestimated GDP growth in recent years. However, the preliminary revised estimates still point to a stagnating economy.

II. Economic Background and Outlook

A. Recent Developments

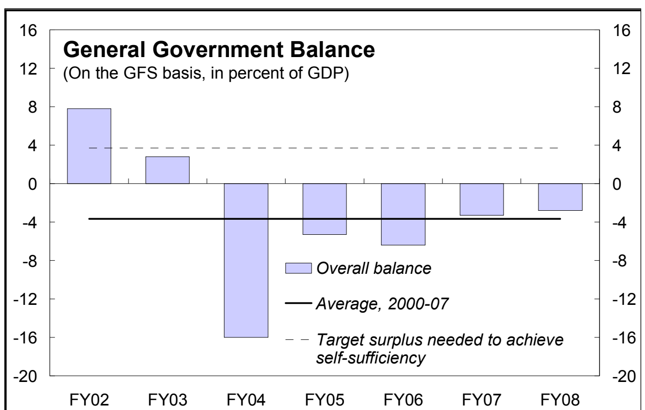
3. **Since the last Article IV consultation, the economic situation has deteriorated.** Compact-related spending cuts, particularly in Chuuk and Kosrae, have reduced public employment, while high commodity prices further reduced the real value of Compact grants and household incomes. In the absence of reforms to boost private sector growth, output declined by 3.6 percent in FY2007 and by an estimated 1 percent in FY2008. Poor job prospects have continued to stimulate migration to the United States where FSM citizens can work without a visa. The current account is estimated to have widened by 8 percentage points to 21 percent of GDP in FY2008 as the rapidly increasing costs of fuel and food imports outsized higher fishing revenues.[4]

Selected Economic Indicators

	Average FY2000-2007	FY2007	Proj. FY2008
	(year-on-year changes)		
Real GDP	-0.1	-3.6	-1.0
CPI	2.1	3.6	5.0
Employment	0.1	-0.7	0.2
	(in percent of GDP)		
Current account balance	-11.2	-12.7	-20.3

Sources: FSM authorities and Fund staff estimates.

4. **Inflation has remained relatively muted, despite higher oil and food prices.** The inflation rate has stayed between 4–5 percent in the past several years, compared with 3–4 percent in the United States. The use of the U.S. dollar as the official currency, high prevalence of subsistence farming, and economic slack have limited price increases, while the pass-through of higher commodity prices was partially mitigated by switching to lower-quality imports.[5]



Sources: FSM authorities and Fund staff estimates.

5. **The fiscal situation has improved.** On the basis of preliminary information, staff is forecasting a reduction in the consolidated fiscal deficit to about 3 percent of GDP in FY2008, down from over 6 percent in FY2006. This improvement was achieved largely through a reduction in the public wage bill

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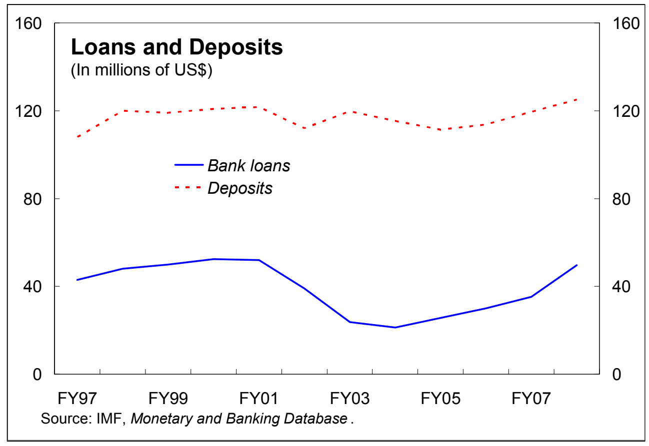
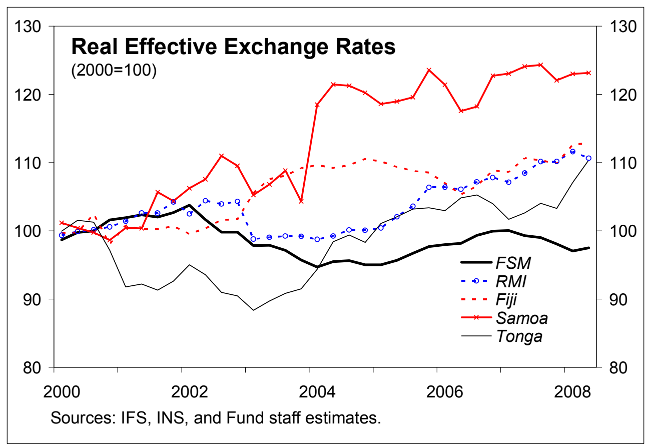
[4] The large current account deficit has been largely financed by capital transfers related to the Compact and unrecorded remittances.

[5] Some doubts remain over the reliability of official CPI statistics as the food and fuel-related items account for over half of the CPI basket.

in Chuuk and Kosrae and grants from China, which helped offset stagnant tax revenue and an increase in fuel subsidies (mostly in Yap).[6]

6. **The recent pickup in bank lending has been concentrated on state-owned enterprises and overseas firms** (especially in Saipan), with limited impact on the local private sector. Obtaining financing for local businesses and consumers remains difficult. During FY2008, the share of nonperforming loans jumped from 3 percent to 6 percent at the Bank of FSM (the main commercial bank), mainly as a result of one large delinquent loan, but the bank remains well capitalized with a capital adequacy ratio of 35 percent.





7. **Structural problems, rather than exchange rate competitiveness, have held back exports.** The weakening of the U.S. dollar since 2002 and low inflation have helped to keep the FSM real effective exchange rate depreciated relative to other Pacific island currencies. However, given the difficult business environment and geographical remoteness, new export projects have been limited in scale.

B. Outlook and Risks

8. **In the near term, the FSM economy is likely to remain weak.** Growth is projected to recover modestly to ½ percent in FY2009, as falling commodity prices boost real household incomes and states make progress on spending Compact infrastructure grants. However, the risks to the outlook are on the downside. The unfolding global slowdown could spill over through various channels and lead to greater-than-expected declines in tourist arrivals, remittances, exports, and foreign investment (Box 1). Falling global equity prices have reduced significantly the value of the Compact Trust Fund and state investments and could force governments to scale back their spending. In addition, slowing activity could lead commercial banks to tighten their lending standards.

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[6] The share of tax revenue in GDP in the FSM fell by about 1 percentage point between FY2006–08.

Box 1. Micronesia: Possible Implications of the Global Slowdown and Financial Turmoil

Although so far largely insulated from the immediate fallout of the global credit turmoil, the FSM faces risks from a protracted global slowdown and deepening financial crisis. In addition to the direct impact of declining equity prices on the FSM's sizable overseas investments, the FSM is exposed through other possible spillover channels:

Weaker exports and budget revenues. FSM's exports represent around 9½ percent of GDP, with the United States and Asia, mainly China and Japan, as the largest export destinations. A sharp slowdown in advanced economies with spillovers to Asia could reduce demand for FSM's exports, mainly in fish and foodstuffs, and lower fish prices would further erode export values, while decreasing fishing fees paid to the budget. The recent strengthening of the U.S. dollar could also lead to a loss of export competitiveness.

Declining tourism. The number of visitors has risen by 8 percent since 2004 to around 14,000 per year. The global slowdown is likely to dampen prospects for tourism, while the stronger U.S. dollar may deter visitors from Australia and Europe whose numbers have increased significantly in recent years.

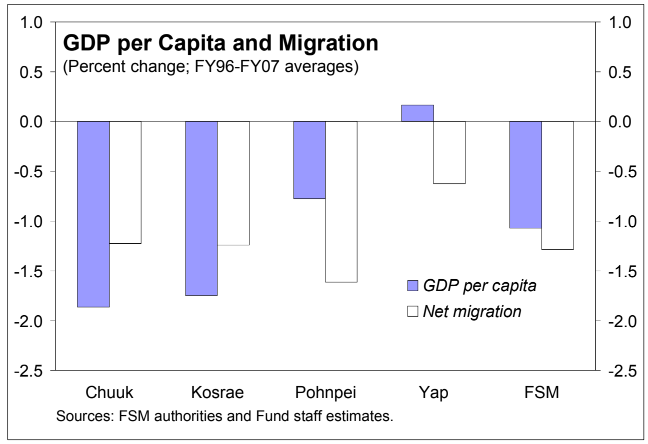
Lower remittances. Overseas worker remittances are estimated to have nearly tripled over the past five years, reaching around $9 million annually. Many workers are reported to be in lower-skilled jobs in the United States that may be at risk in a softening U.S. labor market. Besides reducing remittances, returning workers could put a downward pressure on local wages.

Potential impact of higher shipping costs. The global credit crisis has curtailed trade financing, raising the risk of a sharp fall in international trade. Although importers in the FSM do not rely on trade credits, their overseas suppliers could be affected by tighter credit conditions, forcing them to raise shipping charges and delivery prices.

Declining value of overseas investment. The FSM has sizable overseas investment through the Compact Trust Fund and other reserves held by the states and large public enterprises. In addition, the banking system has exposure through its foreign asset holdings, which make up nearly ⅔ of their assets. Much of this comprises of U.S. Treasuries and bonds issued by U.S. government sponsored entities, and to a lesser extent, loans in Guam and Saipan, but equity holdings are also significant at the FSM Development Bank (see the main text). Although the FSM banking system is well capitalized, liquid, and under FDIC coverage, concerns over potential losses could cause banks to become conservative in their lending. Lower U.S. interest rates would generate capital gains on their bond holdings, but over the longer term would depress net interest margins.

Official aid flows and foreign direct investment. Although Compact assistance is largely independent from global financial developments, other aid flows and concessional financing could come under pressure as advanced countries face tighter budget constraints with slowing growth. External debt is low, and FDI flows remain small, but financing for future projects may be constrained by the difficult market conditions.

9. **The authorities broadly shared the staff's assessment and expressed concern about the difficult situation in Chuuk**, where the government has had difficulties purchasing fuel to power electric generators and pay its vendors. The authorities in Chuuk have responded through significant downsizing and measures to improve financial management, while securing donor assistance to pay down part of the arrears. As for the spillovers from the global slowdown, the authorities have not yet observed a decline in remittances, which they attributed to the continued outmigration; however, they agreed that this is a risk going forward. They were also hopeful that the planned expansion of the military base in Guam and a donor-financed airport extension in Pohnpei would help partly offset the negative effects of the slowdown by boosting remittances and business opportunities for local firms.



10. **The authorities and the mission agreed that medium-term growth prospects will remain poor without meaningful progress on structural reforms, particularly given the size of pending cuts in Compact funds.** After a temporary boost from delayed Compact disbursements and lower commodity prices, growth will likely be flat over the medium term, reflecting the structural impediments to private sector development and the scheduled decline in Compact aid (amounting to about 1 percent annually in real terms). In contrast, growth in other Pacific islands with a more favorable business environment has been in the range of 2–4 percent annually.

C. External Stability and Exchange Rate

11. **There was consensus between staff and the authorities that medium-term external stability is not at significant risk** given the relatively low level of external debt (about 30 percent of GDP), its long-term nature, availability of Compact funding, and current level of net financial assets. However, the authorities recognized that, over the longer term, insufficient fiscal adjustment to declining Compact grants or adverse market conditions could deplete the Compact Trust Fund and other savings and lead to an unsustainable buildup in external debt.

12. **The staff and the authorities agreed that the use of the U.S. dollar as the official currency remains appropriate** given FSM's close macroeconomic and financial linkages with the United States (including under the Compact) and limited administrative capacity to conduct its own monetary policy.

III. Policies to Promote Sustainable Growth

A. Strategy for Fiscal Policy

13. **The FSM has limited means to deal with negative effects of the global slowdown since fiscal policy is constrained by the need for medium-term consolidation.** The authorities could, however, support growth in the short term by taking steps to release delayed Compact grants. At least $100 million allocated for infrastructure and other sectoral programs during FY2004–08 remains undisbursed as a result of administrative delays and implementation issues. At this juncture, the steps needed to release these funds include a timely assessment of bidding proposals, prompt execution of contracts, and budget allocation of co-financing funds. The authorities noted that all unspent Compact funds have been allocated and several construction projects are expected to start in mid–2009.

14. **Despite the recent improvement, the fiscal deficit still falls well short of the surpluses needed to achieve self-sufficiency after the Compact expires.** The mission projects that national and state governments combined would need to save around 3¾ percent of GDP annually to build sufficient savings, which would generate—together with the Compact Trust Fund—the income needed to offset the end of Compact grants in FY2023 (see Appendix I for details).[7] To achieve these surpluses, the national and state governments would need to undertake further adjustment of around $18 million (7 percent of GDP) compared to their estimated FY2008 outturn. While the adjustment clearly needs to be spread over time, decisive actions are needed to eliminate the deficit, not least because the financial turmoil has further reduced the value of state savings.[8] The authorities recognized the need to generate surpluses and noted that the recent downsizing in Chuuk and Kosrae and smaller subsidies in Yap would further help reduce expenditures in FY2009. In the short term, however, consolidation plans were bounded by political pressures and difficulties in coordinating states' fiscal policy.

Fiscal Balance and Government Free Assets
(FY2008 staff estimates, in millions of U.S. dollars)

	Balance	Free assets 1/
National government	-2.8	4.2
Chuuk	1.6	-21.3
Kosrae	1.2	-1.0
Pohnpei	-2.7	4.5
Yap	-4.1	26.4
Micronesia	-6.8	12.8
Memorandum item:		
Nominal GDP		247.5

Source: FSM authorities; and IMF staff estimates.
1/ Unreserved balance on the general budget account.
Negative free assets for Chuuk and Kosrae indicate arrears.

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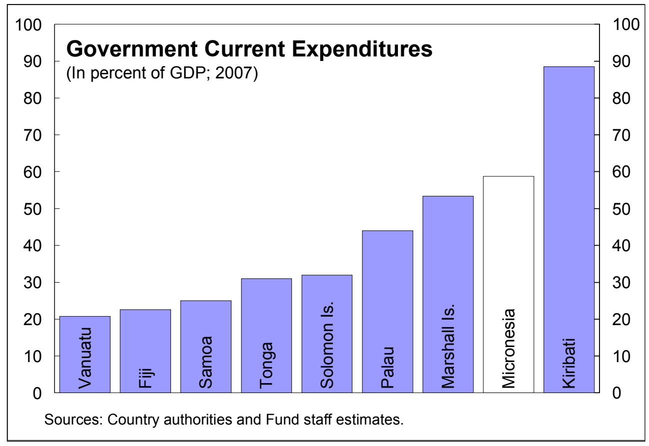
[7] The required budget surplus varies by state given the different starting level of savings, but even Yap—the state with relatively high savings—will need to improve its fiscal position.

[8] On current trends, the national government and Pohnpei would run out of cash in two years. Chuuk and Kosrae continue to be in arrears. The implications of the ongoing financial turmoil for government finances are discussed in more detail in Appendix I.

15. **Looking ahead, the scope for reducing current spending is significant.** Despite payroll reductions, current spending is—at 60 percent of GDP—still large by regional standards and public sector wages remain much higher than in private businesses. A further reduction in public employment together with wage restraint and cuts in non-essential expenditures could save an additional $7 million (3 percent of GDP) and balance the consolidated FSM budget. Costly fuel subsidies should be scaled back and replaced with more targeted assistance to vulnerable households, while critical spending on health care, infrastructure, and education should be preserved for fostering sustainable development. The authorities responded that, despite political pressures, the national government is seeking savings of about $3 million (1 percent of GDP) in non-essential expenditures over the next few years.



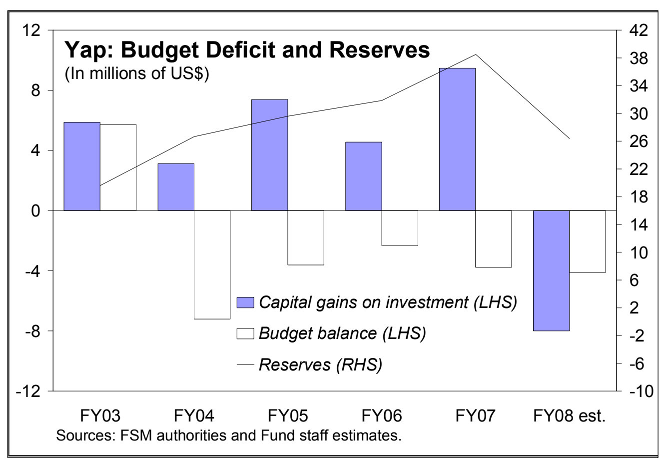
Sources: Country authorities and Fund staff estimates.

Wage Indicators by State (FY2007)

	Government-private sector wage ratio
National government 1/	3.5
Chuuk	2.1
Kosrae	2.6
Pohnpei	2.3
Yap	1.5

Source: FSM authorities.
1/ Includes national government employees in all states.

16. **The mission cautioned against using investment earnings to finance budget shortfalls as recently done by Yap and the national government.**[9] The authorities broadly agreed and noted that, while challenges remain in convincing lawmakers to set aside funds for the Compact step-down, the national government and Yap have both established a trust fund to protect their existing savings. Moreover, the national government has decided not to include any investment earnings in its FY2009 budget.



Sources: FSM authorities and Fund staff estimates.

17. **The mission stressed that medium-term sustainability will also require significant tax revenue measures.** Compared with other Pacific Island countries, the FSM collects

[9] Yap's fiscal deficit increased from $2.3 million to estimated $4.1million (10 percent of state GDP) during FY2006–08.

comparatively little from its income and sales taxes.[10] Priority should be given to passing quickly the government's tax reform package comprising the value-added tax (VAT), the net profits tax, and the Unified Revenue Authority (URA), which could over time generate an additional 3 percent of GDP of tax revenue. These tax reforms would also benefit the private sector by easing investment costs, streamlining tax payments, and improving efficiency.

18. **The authorities indicated that the launch of the tax reform is likely to be postponed by one year until FY2011.** The draft legislation has not been submitted to Congress as planned because of a dispute among states over the constitutionality of shifting taxing powers to the URA. To address these concerns, the mission suggested building in safeguards, such as through memoranda of understanding with the URA, without compromising the benefits of a centralized and uniform tax system. The economic costs of further delays are significant for both the governments (the lost revenue could amount to $8 million annually) and the private sector.[11] The authorities remain committed to the tax reform initiative and have scheduled a state-wide meeting in early 2009, along with an IMF legal counsel, to assist in ironing out the differences, and hope to finalize legislation by mid–2009. The mission supported the authorities' plan to intensify outreach including through the state tax reform units.

19. **Given the delay of the tax reform, the mission discussed ways of strengthening the current tax administration.** The limited capacity to conduct tax audits has undermined compliance and hiring additional tax auditors could more than pay for itself through higher revenue. Greater information sharing between the national and state governments on self-employed contractors would also help boost revenue. The authorities agreed on the need for greater information sharing and noted that sharing should be extended to include the municipal governments and other information, such as business licenses and registries.

20. **The mission also reiterated that reforms of the state-owned enterprises (SOEs) would reduce their burden on the budget while supporting private sector development.** In FY2008, the SOEs (based on partial information) received about $4 million in loans and subsidies from the authorities, while likely exceeding their combined $8 million in FY2007 operating losses. The mission saw the need to further

State-Owned Enterprises: Selected Financial Information
(In thousands of U.S. dollars; FY 2007)

	Operating Profit/ Loss	Subsidies
National government	-278	586
Chuuk	-2,414	448
Kosrae	-625	10
Pohnpei	-4,921	318
Yap	447	716
FSM (Consolidated)	-7,792	2,078

Source: FSM authorities.

[10] Tax revenue in the FSM account for only 12 percent of GDP, compared with more than 20 percent of GDP in many other Pacific Island countries, such as Kiribati, Palau, Samoa, and Tonga.

[11] For example, there is anecdotal evidence that companies are delaying investment over uncertainty regarding the introduction of the net profit tax, which will allow them to deduct investment expenses from the tax base.

reduce the scope of SOEs, especially in market sectors such as in fisheries where SOEs are competing with private firms. To level the competitive playing field, SOEs should also be brought into the tax system and be encouraged to seek out market financing, instead of subsidized government loans. Meanwhile, SOEs continue to pay wages that are significantly higher than in the private and government sectors, and despite their poor performance, have increased the average wage by 11 percent since FY2005. To strengthen SOEs' commercial orientation, governments should link compensation to performance and set a target for dividends paid to the budget.

21. **The authorities noted that they have taken some steps to shut down insolvent enterprises**, such as the National Fisheries Corporation. They have also attempted to put the telecommunication company under the gross revenue tax (GRT); however, the legislation has stalled in the Congress. The mission welcomed the move by the new FSM Petroleum Corporation to pay the GRT and noted that this could be a model for other SOEs to be included in the net profit tax when the reforms are passed.

22. **The Social Security System remains underfunded.** The authorities noted that the Social Security Fund has run operating deficits despite savings measures legislated in 2006. The Administration has prepared a new bill designed to trim down its unfunded liabilities by about $85 million through an increase in social security taxes, higher retirement age, caps on benefits, tightening of eligibility criteria, and other measures. The legislation is currently being considered by the FSM Congress. The mission welcomed these steps and urged the authorities to continue in their efforts to reduce the current stock of unpaid social security taxes, which is still high at about $3 million.

23. **The mission cautioned that the increased volatility in financial markets and creation of new trust funds highlighted the need for a sound framework for financial management.** While the recent steps by some states to establish their saving funds are welcome, establishing separate trust funds with their own staff could be costly and difficult to manage given the limited resources to monitor and assess investment strategies.[12] Instead, the mission suggested that the various trust accounts be consolidated under a single investment arrangement to minimize fees while preserving autonomy over the fund.[13] The authorities saw the benefits of a centralized saving fund; however, some states continue to prefer direct control over their savings. In addition, the mission and the authorities agreed that there was scope for enhancing transparency of the

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[12] Many FSM institutions recorded losses on their overseas investments over the past year, for example, the Compact Trust Fund lost about 20 percent of its value during FY2008. However, the national authorities noted the losses of the Social Security Fund were larger than the relevant benchmarks due to the inexperienced investment board.

[13] For example, a state investing $30 million with management fees that are higher by 0.5 percent annually could under plausible assumptions pay $4.3 million in additional fees and lost returns by FY2023.

existing investment funds—in particular, the last audit of the Compact Trust Fund was completed in FY2006, although it is meant to be published annually.

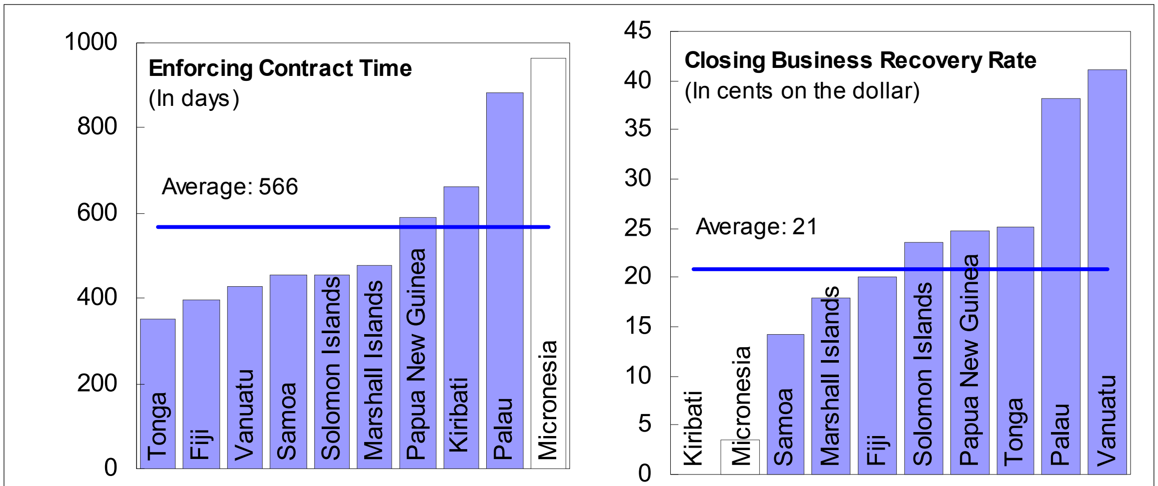
Investment Holdings of Selected FSM Entities
(As of end–September 2007, in millions of U.S. dollars)

	Compact Trust Fund	Social Security Administration	Yap	National Government	Bank of FSM	FSM Development Bank	FSM Telecom	Total
Equities	105.3	25.6	45.9	22.3	1.8	5.3	6.6	212.8
Bonds and money market	17.2	14.0	20.0	10.8	31.6	5.9	3.6	103.3
Of which AAA-rated	...	11.6	20.0	6.4	31.6	2.8	...	...
Total investments	122.5	39.6	65.9	33.2	33.4	11.3	10.2	316.1
Memorandum item:								
Nominal GDP (FY2007)	238.1							

Sources: The FSM National Auditor; FDIC; JP Morgan; and IMF staff estimates.

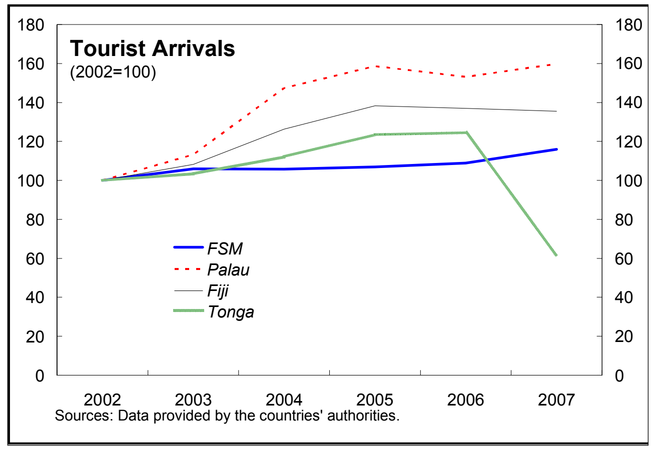
B. Real and Financial Sector Reforms

24. **The mission noted that the business environment remains difficult, holding back private sector development**. According to the most recent *Doing Business* report from the World Bank, the FSM slipped to 126th place in the world, the lowest among Pacific Island countries, in terms of the ease of doing business. In particular, the FSM fared poorly on the time needed to enforce contracts and the low recovery rates in bankruptcy. Problems with land titling have also deterred new investment.



Source: World Bank, *Doing Business*, 2009.

25. **The authorities saw promoting private-sector growth as important, not least to create new jobs during fiscal adjustment.** Fishing industry and tourism had potential to develop further (tourist arrivals are higher and growing at a faster pace in some PICs), although the authorities saw significant challenges from FSM's geographical remoteness, high transport costs,



and poor infrastructure. In mission's view, the priorities remain to expand the capacity of courts, develop a market for land, and relax investment restrictions, which could—in addition to attracting foreign investment—help promote domestic growth in retail, services, and other nontradable sectors. The authorities recognized the difficulties with the courts and noted that some states plan to hire additional judges. The states have taken steps to facilitate land use by offering leases for up to 55 years. However, resistance remains strong against allowing the sale of land, which in case of Pohnpei, is prohibited by constitution. The authorities also noted that Kosrae and Yap have liberalized their foreign investment laws, but progress in other states remains slow given ongoing concerns about the impact on local businesses.

26. **Commercial banks remain reluctant to lend to local businesses despite their highly liquid position.** The banks continue to primarily invest in safe U.S. government securities (almost 2/3 of their assets), rather than lend to new businesses. Part of the reason is the inherent risk of start-up lending, the high fixed costs associated with small loans, and the difficulties in collecting on collateral. At the same time, the FSM Development Bank continues to lend to well-established firms (in direct competition with commercial banks), rather than supporting start-ups. To improve access to credit, the mission recommended:

- *Redirecting the focus of the FSM Development Bank*. Graduating established firms from using the Development Bank after a fixed time, granting flexibility to the bank in adjusting rates to match the risk of the borrower, and reducing the holdings of overseas equities—a significant source of market risk—would increase availability of financing for start-ups.

- *Expanding micro-credit*. Credit unions and micro-credit agencies are helping to overcome the high fixed costs of small commercial loans, but their size remains very small. The FSM Development Bank and commercial banks could provide seed money or equity capital, as well as technical training, to support these specialized lenders.

- *Improve the functioning of the secured transaction framework*. Banks have actively used the new law to register their security interest over a range of collateral. In order to build confidence in its use, early claims under the law should be handled in a transparent and prompt manner. Secured lending could also be supported by having the filing office automatically notify lenders of any subsequent liens on property to avoid duplication and requiring more specific information on the collateral, particularly inventory.

27. **The authorities saw merit in the mission's proposals,** noting that the FSM Development Bank could also help facilitate mortgage lending for commercial banks and credit unions given its legal power to foreclose on property. The authorities also observed that the use of secured transaction law has become widespread, with the commercial banks collateralizing most lending, although the banks so far have had limited opportunities to collect on the collateral.

28. **Looking ahead, the key risks for the banking system stem from the weak domestic economy, spillovers from the global slowdown (including on overseas loans), and lower interest income, which could push banks to tighten lending standards.** Against this backdrop, the mission recommended that the supervisors monitor carefully banks' exposure to market risk and rising NPLs, including at the FSM Development Bank, and ensure adequate provisioning. In light of their recent growth, credit unions should be regulated by the Banking Commissioner and subject to appropriate licensing requirements. The authorities expected the commercial banks to weather the global financial turmoil well although the Development Bank—which should also be supervised by the Banking Commissioner—has made losses on its equity holdings of about $2 million. Risks from rising NPLs were seen as manageable given the current high levels of provisioning and capital adequacy.

IV. Other Issues

29. **Efforts to transform the FSM into an offshore financial center and a tax haven for foreign corporations run the risk of damaging financial relations with other countries and attracting intense scrutiny from an AML/CFT perspective**. The mission and the authorities agreed that the Banking Commissioner's limited resources in insurance supervision and the national tax administrator's difficulties in auditing foreign corporations with tax haven status hinder their ability to safeguard against such risks. The authorities acknowledged that the revenue generated so far has been minimal, but noted that the initiatives are strongly supported by the President and many in Congress.

30. **The FSM participates in various regional and preferential trade initiatives.** Micronesia is involved in second-round negotiations on services trade within the Pacific Island Countries Trade Agreement (PICTA) and also participates in the regional petroleum purchasing initiative. Discussions with the European Union on an Economic Partnership Agreement, which would significantly expand the FSM's tuna export market, are ongoing.

31. **The limited domestic capacity to produce economic data hampers surveillance and policy analysis.** On a positive side, the authorities are compiling new GDP series and plan to improve timeliness and coverage of the balance of payments data with PFTAC assistance.

V. STAFF APPRAISAL

32. **The FSM has limited means to deal with negative effects of the global slowdown.** Fiscal policy is constrained by persistent deficits and the need for medium-term consolidation. The authorities could, however, support growth in the short term by taking steps to release delayed Compact grants.

33. **The deteriorating external environment increases the urgency of deep fiscal and structural reforms.** The FSM has relied heavily on the Compact of Free Association grants to advance its economic development and sustain a large public sector. With support under the amended Compact projected to decline and expire by 2023, the authorities face the challenge of adjusting to the step-down, a task made more difficult by limited private sector growth. Without stronger reform efforts, the FSM faces poor medium-term growth prospects.

34. **The fiscal deficit has declined, but the government still faces the need for significant adjustment.** Securing fiscal sustainability will require a strategy that phases in spending cuts and launches a comprehensive tax reform. Consolidation should begin with cuts to the large wage bill and subsidies. On the revenue side, priority should be given to passing tax reforms, including the VAT, and strengthening tax administration. Concerns of states about the URA should be addressed without diminishing the gains from a centralized tax collection system.

35. **At the same time, reforms to improve the business environment would boost growth, create new employment, and generate higher budget revenue**. The priority should be to strengthen the judiciary, reduce the large public-private wage gap, and further liberalize the foreign investment regime. In addition, reform of the state-owned enterprises would create space for the private sector and reduce drain on the budget.

36. **The financial system also needs to do more to support private sector development.** Refocusing of the FSM Development Bank to avoid competition with commercial banks would help develop further the financial system. At the same time, supervision should be strengthened, particularly for credit unions and the FSM Development Bank.

37. **The U.S. dollar is the appropriate currency for the FSM**, given the close ties to the United States and the lack of administrative capacity for independent monetary and exchange rate policies.

38. **Improving domestic capacity to compile data is necessary to strengthen monitoring and policy analysis.** Fund staff, including through PFTAC, will continue to assist in this area.

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

Table 1. Micronesia: Basic Data, FY2004–09 1/

Nominal GDP (FY2007):	US$238 million
Population (FY2007):	108,031
GDP per capita (FY2007):	US$2,204
IMF Quota:	SDR5.1 million

	FY2004	FY2005	FY2006	FY2007 Est.	FY2008 Est.	FY2009 Proj.
Real sector (average annual percent change unless otherwise noted)						
Real GDP	-3.3	-0.5	-1.6	-3.6	-1.0	0.5
Consumer prices	1.8	4.1	4.4	3.6	5.0	3.0
Employment	-0.9	-1.1	1.5	-0.7	0.2	0.5
Public (incl. public enterprises)	-2.8	0.0	2.9	-5.9	-2.0	-2.0
Private	1.5	-2.1	0.1	5.5	2.5	3.0
Nominal wages	-0.7	1.6	1.5	-1.1	…	…
Public-private wage ratio	2.1	2.2	2.1	2.2	…	…
Consolidated government finance (in percent of GDP)						
Revenue and grants	59.6	58.6	58.6	61.0	59.5	59.3
Revenue	26.7	22.4	23.0	22.2	21.6	20.7
Grants	33.0	36.1	35.6	38.8	37.9	38.7
Expenditure	75.6	63.9	65.0	64.3	62.3	61.5
Current	56.6	58.9	62.3	58.7	56.7	53.8
Capital	19.0	4.9	2.8	5.5	5.6	7.7
Overall balance	-16.0	-5.3	-6.4	-3.3	-2.8	-2.2
Compact Trust Fund (millions of U.S. dollars)	62.5	80.4	99.0	122.5	118.2	129.8
Commercial banks (in millions of U.S. dollars; end of period, through August 2008)						
Foreign assets	105.2	99.2	101.1	106.2	101.4	96.3
Loans	21.3	25.7	30.0	35.3	49.7	55.0
Total deposits	115.4	111.4	113.7	119.5	125.0	130.0
Interest rates (in percent, average for FY)						
Consumer loans	15.1	16.4	15.8	14.3	14.4	…
Commercial loans	6.9	7.8	8.6	9.0	8.8	…
Balance of payments (in millions of U.S. dollars)						
Trade balance	-120.3	-122.2	-128.9	-127.5	-142.8	-130.7
Net services and income	-23.5	-22.1	-22.1	-19.5	-23.6	-19.2
Private and official transfers	99.1	115.2	112.7	116.6	116.2	114.1
Current account including official transfers	-44.7	-29.1	-38.4	-30.3	-50.2	-35.7
(in percent of GDP)	-20.0	-12.5	-16.1	-12.7	-20.3	-13.9
Current account excluding official transfers	-141.3	-140.9	-145.7	-141.1	-160.0	-143.1
(in percent of GDP)	-63.1	-60.7	-61.1	-59.2	-64.6	-55.8
Overall balance	-58.6	-8.9	-19.5	-7.1	-19.6	-1.6
(in percent of GDP)	-26.2	-3.8	-8.2	-3.0	-7.9	-0.6
Gross reserves (in months of imports)	3.5	3.1	2.8	2.9	2.3	2.2
External debt (in millions of U.S. dollars; end of period) 2/						
Stock	62.9	64.0	65.8	67.2	68.1	68.4
(in percent of GDP)	28.1	27.6	27.6	28.2	27.5	26.7
Debt service	2.6	2.5	3.4	2.8	3.3	3.3
(in percent of exports of goods and services)	7.4	6.7	9.1	6.4	6.4	6.3
Exchange rate regime	U.S. dollar is the official currency					
Real effective exchange rate 3/	95.4	95.6	98.3	99.6	…	…

Sources: Data provided by the FSM authorities and Fund staff estimates.
1/ Fiscal year ending September 30.
2/ Government and public enterprise debt only.
3/ Year 2000=100.

Table 2. Micronesia: General Government Operations, FY2004–09 1/

	FY2004	FY2005	FY2006	FY2007 Est.	FY2008 Est.	FY2009 Proj.
	(In millions of U.S. dollars)					
Overall balance	-35.9	-12.3	-15.3	-7.8	-6.8	-5.6
Total revenue and grants	133.6	135.9	139.7	145.2	147.3	152.0
Revenue	59.8	52.1	54.9	52.8	53.5	53.0
Tax revenue	27.3	29.2	29.7	27.8	28.5	30.0
Non-tax revenue	32.5	22.9	25.2	24.9	25.0	23.0
Fishing access revenue	12.1	13.3	13.2	15.0	15.5	14.0
Dividend and interest income	3.3	2.0	1.4	2.7	2.0	1.5
Other nontax revenues	17.1	7.6	10.6	7.2	7.5	7.5
Grants (from abroad)	73.9	83.9	84.8	92.5	93.8	99.1
Current	73.9	83.9	81.8	85.6	83.8	82.1
Capital	0.0	0.0	3.0	6.9	10.0	17.0
Total expenditure	169.5	148.2	155.0	153.0	154.1	157.6
Current	126.8	136.8	148.4	139.9	140.4	137.9
Goods and services	120.5	131.4	142.8	136.8	135.3	134.0
Wages and salaries	27.8	29.3	31.1	30.1	29.1	28.6
Travel	2.3	2.3	2.8	2.6	2.3	2.0
Other	90.4	99.8	108.9	104.1	103.9	103.4
Subsidies	2.4	1.3	1.2	2.4	4.4	3.2
Net transfers	4.0	4.1	4.4	0.7	0.7	0.7
Capital	42.7	11.4	6.6	13.1	13.7	19.7
Acquisition of fixed capital	2.8	5.9	2.7	2.7	2.7	2.7
Multi-purpose development projects	11.6	5.6	3.8	10.4	11.0	17.0
Capital Transfers	28.3	0.0	0.0	0.0	0.0	0.0
Memorandum items:	(In percent of GDP)					
Overall balance	-16.0	-5.3	-6.4	-3.3	-2.8	-2.2
Revenue	26.7	22.4	23.0	22.2	21.6	20.7
Tax revenue	12.2	12.6	12.5	11.7	11.5	11.7
Non-tax revenue	14.5	9.9	10.6	10.5	10.1	9.0
Grants	33.0	36.1	35.6	38.8	37.9	38.7
Total expenditure	75.6	63.9	65.0	64.3	62.3	61.5
Current	56.6	58.9	62.3	58.7	56.7	53.8
Capital	19.0	4.9	2.8	5.5	5.6	7.7

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

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

Table 3. Micronesia: Indicators of Financial and External Vulnerability, FY2004–08

	FY2004	FY2005	FY2006	FY2007	FY2008
Commercial banks 1/					
	(Year-on-year percent change)				
Deposits	-3.7	-3.4	2.1	5.1	4.6
Loans (incl. overseas activities)	-5.6	16.7	8.4	3.0	44.7
(in percent of GDP)	8.7	9.8	10.3	10.6	14.9
	(In percent of total assets)				
Foreign assets	80.2	77.2	76.3	76.2	69.1
Return on assets 2/	0.8	1.2	1.6	1.6	1.2
Equity capital	9.6	10.1	10.8	11.1	10.6
Return on equity 2/	5.0	7.7	9.5	8.8	6.2
	(In percent of total loans)				
Loss allowance	6.1	5.7	4.9	4.0	5.7
Non-performing loans 2/	1.0	1.0	0.9	3.3	6.0
FSM Development Bank 1/					
	(Year-on-year percent change)				
Loans	-4.2	8.0	8.5	6.2	5.5
(in percent of GDP)	9.0	9.4	9.9	10.5	10.7
	(In percent of total assets)				
Foreign assets	22.7	7.3	7.1	7.9	7.7
Equity capital	71.5	84.3	75.7	99.0	89.2
	(In percent of total loans)				
Loss allowance	22.7	17.5	21.0	18.7	21.9
External indicators					
Exports (goods & services, y/y percent change)	-17.4	5.1	0.5	15.8	18.1
Imports (goods & services, y/y percent change)	10.2	2.4	3.0	1.3	12.7
Current account balance (percent of GDP)					
Including official transfers	-20.0	-12.5	-16.1	-12.7	-20.3
Excluding official transfers	-63.1	-60.7	-61.1	-59.2	-64.6
Overall balance (percent of GDP)	-26.2	-3.8	-8.2	-3.0	-7.9
Gross official reserves					
In millions of U.S. dollars	56.3	51.1	47.2	49.5	45.3
In months of imports of goods and services	3.5	3.1	2.8	2.9	2.3
In percent of GDP	25.1	22.0	19.8	20.8	18.3
Total external debt 3/					
In millions of U.S. dollars	62.9	64.0	65.8	67.2	…
In percent of exports of goods and services	178.7	173.0	177.1	156.2	…
In percent of GDP	28.1	27.6	27.6	28.2	…
Debt service					
In millions of U.S. dollars	2.6	2.5	3.4	2.8	…
In percent of exports of goods and services	7.4	6.7	9.1	6.4	…
In percent of GDP	1.2	1.1	1.4	1.2	…

1/ Data for 2008 as of August.
2/ For the Bank of FSM on calendar year basis. 2008 data are for January-August.
3/ About 2/3 of the total is concessional debt to the Asian Development Bank.

Table 4. Micronesia: Balance of Payments, FY2004–09

	FY2004	FY2005	FY2006	FY2007 Est.	FY2008 Proj.	FY2009 Proj.
	(In millions of U.S. dollars)					
Overall balance	**-58.6**	**-8.9**	**-19.5**	**-7.1**	**-19.6**	**-1.6**
Current Account Balance	**-44.7**	**-29.1**	**-38.4**	**-30.3**	**-50.2**	**-35.7**
Trade balance	-120.3	-122.2	-128.9	-127.5	-142.8	-130.7
Exports, f.o.b.	17.0	18.5	17.0	19.7	23.3	24.2
Imports, f.o.b.	-137.3	-140.7	-145.9	-147.2	-166.0	-154.9
Petroleum products	-17.2	-21.7	-27.0	-28.3	-42.5	-27.1
Services account	-37.3	-38.2	-37.3	-35.6	-38.7	-32.9
Receipts	18.2	18.5	20.1	23.4	27.6	28.7
Travel	16.5	17.1	18.3	21.1	25.0	26.0
Communications (net)	1.5	1.3	1.8	2.1	2.5	2.6
Other	0.3	0.1	0.0	0.1	0.1	0.1
Payments	-55.5	-56.7	-57.5	-58.9	-66.3	-61.6
Freight and insurance	-24.2	-24.8	-25.8	-26.4	-29.7	-27.6
Transportation	-11.4	-12.1	-12.3	-12.6	-14.2	-13.2
Travel	-5.3	-5.5	-5.7	-6.6	-6.1	-6.5
Other	-14.5	-14.3	-13.7	-14.1	-15.9	-14.7
Income, net	13.7	16.2	15.2	16.1	15.1	13.7
Receipts	20.1	21.5	20.5	21.5	20.5	19.0
Fishing rights fees	12.1	13.3	13.3	15.0	15.5	14.0
Interest dividend income	8.1	8.2	7.2	6.5	5.0	5.0
Payments	-6.4	-5.3	-5.3	-5.4	-5.4	-5.3
Foreign workers earnings	-3.3	-2.3	-2.3	-2.3	-2.3	-2.3
Interest payments	-1.8	-1.6	-1.6	-1.7	-1.7	-1.6
Dividends	-1.3	-1.4	-1.4	-1.4	-1.4	-1.4
Unrequited transfers	99.1	115.2	112.7	116.6	116.2	114.1
Private	2.5	3.4	5.3	5.9	6.4	6.8
Inflows	5.0	6.0	8.0	8.6	9.1	9.5
Outflows	-2.5	-2.6	-2.7	-2.7	-2.7	-2.7
Official	96.6	111.8	107.3	110.8	109.8	107.4
Compact funds	52.1	56.0	60.1	60.6	58.8	57.1
Other	44.5	55.9	47.3	50.1	51.0	50.3
Capital and financial account	**-13.9**	**20.1**	**18.9**	**23.2**	**30.6**	**34.1**
Capital Transfers	-21.6	7.1	16.2	21.1	29.0	33.0
Official	-27.7	0.0	7.2	11.1	18.0	21.0
In-kind	6.1	7.1	9.1	10.0	11.0	12.0
Financial account (borrowing)	7.7	13.1	2.7	2.1	1.6	1.1
Short term, net	7.5	12.0	0.8	0.8	0.8	0.8
Medium term, net	0.3	1.1	1.9	1.3	0.8	0.3
Memorandum items	(In percent of GDP)					
Current account balance	-20.0	-12.5	-16.1	-12.7	-20.3	-13.9
Trade balance	-53.7	-52.7	-54.1	-53.5	-57.7	-51.0
Exports	7.6	8.0	7.1	8.3	9.4	9.5
Imports	-61.3	-60.6	-61.2	-61.8	-67.1	-60.5
Service	-16.6	-16.5	-15.7	-14.9	-15.6	-12.8
Income	6.1	7.0	6.4	6.8	6.1	5.3
Transfers	44.2	49.6	47.3	49.0	46.9	44.6
Private	1.1	1.5	2.2	2.5	2.6	2.7
Official	43.1	48.2	45.0	46.5	44.4	41.9
Current account, ex. transfers	-64.2	-62.2	-63.4	-61.7	-67.2	-58.5
Overall balance	-26.2	-3.8	-8.2	-3.0	-7.9	-0.6

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

Table 5. Micronesia: Medium-term Scenario (Current Policies), FY2007–13 1/

	FY2007 Est.	FY2008 Est.	FY2009 Proj.	FY2010 Proj.	FY2011 Proj.	FY2012 Proj.	FY2013 Proj.
Real sector							
Real GDP (percent change)	-3.6	-1.0	0.5	2.0	1.0	0.5	0.5
Consumer prices (percent change)	3.6	5.0	3.0	2.5	5.0	2.5	2.5
General government finance (in percent of GDP)							
Revenue and grants	61.0	59.5	59.3	60.0	60.9	61.8	61.9
Total domestic revenue	22.2	21.6	20.7	20.5	22.3	23.0	22.8
Grants	38.8	37.9	38.7	39.5	38.6	38.8	39.1
Expenditure	64.3	62.3	61.5	62.2	61.2	61.9	61.9
Current	58.7	56.7	53.8	50.4	48.0	46.8	45.1
Capital	5.5	5.6	7.7	11.8	13.2	15.2	16.8
Overall balance	-3.3	-2.8	-2.2	-2.1	-0.3	-0.1	0.0
Balance of payments (in millions of U.S. dollars)							
Trade balance	-127.5	-142.8	-130.7	-137.8	-146.1	-149.2	-151.4
Net services	-35.6	-38.7	-32.9	-34.5	-36.0	-35.3	-34.1
Net income	16.1	15.1	13.7	13.7	14.7	15.8	15.8
Private and official transfers	116.6	116.2	114.1	109.8	108.6	106.2	105.0
Current account	-30.3	-50.2	-35.7	-48.8	-58.8	-62.6	-64.7
(In percent of GDP)	-12.7	-20.3	-13.9	-18.2	-20.7	-21.4	-21.5
Current account excluding official transfers	-141.1	-160.0	-143.1	-151.3	-159.3	-160.0	-160.2
(In percent of GDP)	-59.2	-64.6	-55.8	-56.5	-56.1	-54.7	-53.1
Overall balance	-7.1	-19.6	-1.6	-6.2	-9.7	-5.6	-0.6
(In percent of GDP)	-3.0	-7.9	-0.6	-2.3	-3.4	-1.9	-0.2
External debt (in millions of US$; end of period) 2/							
Stock	67.2	68.1	68.4	68.3	67.8	67.4	66.9
(in percent of GDP)	28.2	27.5	26.7	25.5	23.9	23.0	22.2
Debt service	2.8	3.3	3.3	3.6	3.9	3.9	3.8
(in percent of exports of goods and services)	6.4	6.4	6.3	6.3	6.3	5.7	5.3

Sources: Data provided by the FSM authorities; and Fund staff estimates.
1/ Projections assume a launch of the tax reform in FY2011 but limited effort to reduce expenditures and improve business environment.
2/ Government and public enterprise debt only.

Table 6. Micronesia: Social Indicators

	Micronesia	Same Region/Income Group	
		East Asia and Pacific	Lower-middle Income
Population			
Total population (millions)	0.11	1,914	3,437
Growth rate (percent annual)	0.3	0.8	1.0
Urban population (percent of population)	22.5	43.3	41.7
Total fertility rate (births per woman)	3.8	2.0	2.3
GNI per capita (in U.S. dollars)	2,470	2,180	1,887
Current public expenditure			
Health (in percent of GDP)	12.4	1.8	2.0
Education (in percent of GDP)	7.3	2.7	4.7
Gross primary enrollment			
(in percent of school age population)	110	114	111
Male	109	115	113
Female	110	114	110
Immunization rate (percent 12-23 months)			
Measles	83	89	77
Diphtheria/Pertussis/Tetanus (DPT)	67	89	75
Life expectancy at birth (years)			
Total	68	71	69
Male	68	69	67
Female	69	73	70
Mortality			
Infant (per thousand live births)	33	24	41
Under 5 (per thousand live births)	41	29	54

Sources: World Development Indicators 2008 and Millenium Development Goals, World Bank.

APPENDIX I. MICRONESIA— MEDIUM-TERM FISCAL OUTLOOK

This appendix updates previous staff work on the size of the needed fiscal adjustment to achieve self-sufficiency after the end of the Compact in FY2023. The appendix describes the results of medium-term simulations under three scenarios: (i) a baseline with limited fiscal adjustment and structural reforms, (ii) a scenario with comprehensive fiscal and structural reforms, and (iii) a reform, but under more adverse financial market conditions. The results indicate that structural reforms and fiscal adjustment are crucial for raising growth prospects and ensuring that the government has sufficient savings to offset the end of Compact grants in FY2023.

A. Baseline Scenario with Limited Fiscal Adjustment and Structural Reforms

Policy assumptions. In the baseline, the planned tax reform helps eliminate the budget deficit in FY2011. The budget is then kept roughly in balance as expenditures are adjusted to the Compact step-down. In the absence of deep structural reforms, medium-term real GDP growth is low at ½ percent reflecting continued outmigration, limited investment, and low labor productivity growth. Net nominal investment returns on government savings are projected at 6 percent in line with historical returns and other studies.[1]

Outcomes. With these assumptions, GDP and budget revenues are flat. At end–FY2023, the government's stock of financial assets would be around $670 million in 2007 dollars of which around $645 million would be in the Compact Trust Fund and about $25 million in other funds. During the draw-down phase, investment income would only be around $40 million (in 2007 dollars). By contrast, FY2023 Compact grants are estimated to be $51 million (in 2007 dollars), leaving a shortfall of 5 percent of GDP. The government would be forced to either implement a sharp expenditure cut or deplete its non-Compact savings.

B. Comprehensive Reform Scenario

Policy assumptions. In this scenario, fiscal reforms (in particular, through a better utilization of Compact infrastructure grants, streamlined spending, and tax reform) are implemented in full and, combined with structural reforms to promote private sector growth, help increase potential GDP growth to 2¾ percent. The fiscal balance reaches 3¾ percent of GDP after the launch of tax reform in FY2011.[2]

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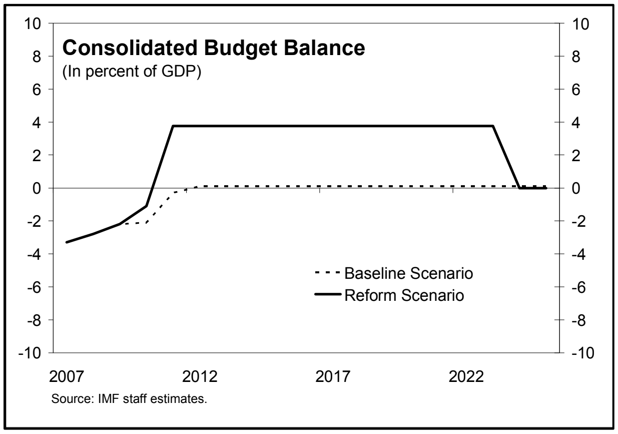
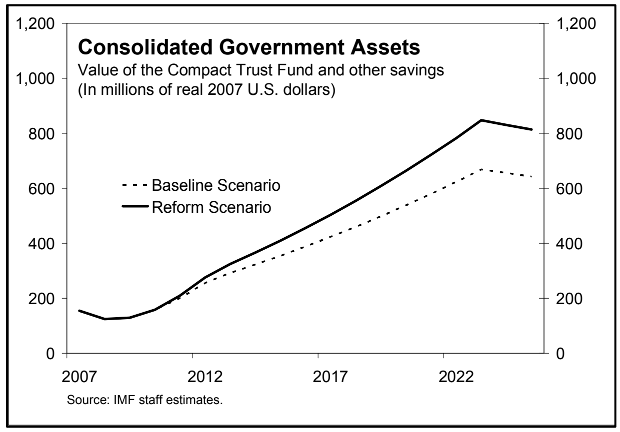
[1] Government Accountability Office, 2007, "Compact of Free Association: Trust Funds for Micronesia and the Marshall Islands May Not Provide Sustainable Income," Report to Congressional Committees.

[2] The assumed 2¾ percent GDP growth rate is not unprecedented in the FSM as Yap reached similar growth during the first Compact period. Compared with the 2006 Article IV Consultation (Country Report No. 07/106), the estimated target medium-term surplus has slightly increased (by about ¼ percentage point of GDP) as a result of the greater-than-expected FY2006 fiscal deficit, recent increase in subsidies, and one-year delay of the tax reform. These factors, however, have to some degree been offset by strong investment returns during FY2006–07, fiscal consolidation in Chuuk and Kosrae, donor assistance, and the partial write-off of arrears in Chuuk.

Outcomes. In this scenario, per capita income is more than 35 percent higher in FY2023 than under the baseline. Stronger growth raises the budget revenue, allowing higher spending on education and other development needs. By the end of the Compact, the stock of government assets would reach about $850 million in 2007 dollars—thanks to strong growth and consistent saving—and would generate sufficient income to replace expiring grants.





Breakdown of the simulation results across states. Because of the federal nature of the FSM, each state would need to supplement the Compact Trust Fund returns with its own savings, without relying on other states. According to staff estimates, all states need to improve their fiscal performance; however, the size of the required adjustment differs across states according to their initial deficits and stock of financial assets:

Recommendations for Medium-term Budget Surpluses
(In millions of U.S. dollars, unless otherwise noted)

	Fiscal balance (GFS) 1/		Savings 2/		Recommended fiscal surpluses (GFS) 3/		
	FY2007	FY2008 (projection)	FY2007	FY2008 (projection)	FY2011 (in USD mn)	FY2023 (in USD mn)	FY2011-2023 (in percent of GDP)
National government	-2.3	-2.8	8.1	4.2	0.8	1.5	…
Chuuk	-0.9	1.6	-22.9	-21.3	6.4	12.0	8.0
Kosrae	0.1	1.2	-1.2	-1.0	1.3	2.4	5.7
Pohnpei	-1.0	-2.7	9.0	4.5	2.6	4.9	1.9
Yap	-3.8	-4.1	38.5	26.4	-0.2	-0.5	-0.5
FSM (Consolidated)	-7.8	-6.8	154.0	131.0	10.9	20.3	3.75
Memorandum:							
FSM Compact Trust Fund	…	…	122.5	118.2	…	…	…

Source: FSM authorities.
1/ Fiscal deficit on the IMF's *Government Financial Statistics* basis.
2/ State savings include unreserved balance on general account and, in the case of the national government, also its trust fund.
For FSM, savings equal the value of FSM Compact Trust Fund plus the sum of state savings. Negative savings indicate arrears.
3/ The first sub-column indicates the desired fiscal balance in FY2011. Thereafter, the fiscal surplus should grow together with the economy, as specified in the second and third sub-columns.

- As a result of past fiscal prudence, Yap already has the financial resources to replace Compact grants after FY2023. However, in order to maintain such a favorable position, Yap needs to quickly eliminate its growing deficit (estimated at $4 million in FY2008).

- Other states need to generate annual surpluses in the range of 2–8 percent of GDP, with Chuuk and Kosrae being on the upper end of the range given their lack of savings.

C. Impact of Adverse Market Conditions

Policy assumptions. In the baseline and reform scenarios, the current financial turmoil has no long-term impact on FSM savings because stock prices are assumed to eventually return to their long-term trajectory. However, if higher risk aversion and lower credit availability reduce overseas stock market returns, the FSM could face budgetary shortfalls after FY2023 even in the reform scenario. This is because both total savings and annual payouts would turn out to be lower than expected.

Outcomes. With net investment returns at 5½ percent (instead of 6 percent) annually, the estimated fiscal surplus required to achieve self-sufficiency would increase to as much as 5½ percent of GDP from 3¾ percent of GDP under the baseline. Since maintaining such as a large surplus would likely be difficult, the authorities could reduce the need for higher surpluses by adopting further structural reforms to boost potential growth beyond 2¾ percent, topping up their savings with privatization receipts, and seeking additional donor financing. Securitization of the Trust Fund contributions could in principle increase expected returns by borrowing against the future U.S. Trust Fund contributions and investing proceeds in the stock market, but such strategy may not be desirable given higher investment risks.[3]

While it is too early to assess the impact of the current financial turmoil on the long-term government finances, staff analysis suggests that given the large uncertainties, premium will be placed on more pro-active fiscal policies and structural reforms.

[3] See the IMF Selected Issues Papers on the Republic of Marshall Islands (Country Report No. 07/105).

INTERNATIONAL MONETARY FUND

FEDERATED STATES OF MICRONESIA

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by the Asia and Pacific Department
(In consultation with other departments)

February 10, 2009

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ANNEX I. FEDERATED STATES OF MICRONESIA: FUND RELATIONS

(As of December 31, 2008)

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	1.39	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 except for security reasons.

VIII. **Article IV Consultation:**
The FSM is on the 24–month consultation cycle. The 2006 Article IV consultation discussions took place during October 10–20, 2006. The Executive Board discussed the staff report (Country Report No. 07/106) and concluded the consultation on February 28, 2007.

IX. **Technical Assistance, 1999–2006:**
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.

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

Since 2000, the Center's assistance to the FSM has included 30 advisory missions, mostly in the areas of tax policy and administration, financial sector supervision, and statistics. The FSM has also sent a number of officials to various regional seminars and workshops organized by PFTAC.

Tax Administration and Policy

PFTAC designed a comprehensive tax reform program to help FSM improve the effectiveness of its tax regime and raise additional revenue. In 2005, the President approved recommendations of the *Tax Reform Task Force* and established an Executive Steering Committee to manage the reform process. The FSM authorities are currently discussing the legislation drafts prepared by IMF Legal Department and PFTAC. PFTAC continues to provide further technical assistance in revenue estimation and project management.

PFTAC has also participated in a major customs modernization program including development and implementation of the PC Trade computer software system and provided related TA to facilitate trade, speed up clearances, and improve data accuracy.

Financial Sector Regulation and Supervision

In May 2006, a PFTAC advisor visited FSM to review draft insurance legislation. An aide memoire was provided to authorities on the supervision of insurance in FSM. The mission discussed and reviewed the proposed insurance legislation and followed up on aspects of issues identified in an IMF technical assistance (TA) mission in March 2006. The Commissioner was cognizant of the need to establish a legislative and supervisory framework for insurers, domestic and foreign, which are active in FSM. Subsequently, a peripatetic expert was assigned by the Monetary and Capital Markets Department (MCM) to the FSM to provide assistance to the Commissioner in insurance regulation and supervision. In addition to the peripatetic advisor on insurance regulation and supervision, the PFTAC advisor also visited the FSM in April 2008. The PFTAC advisor provided assistance to the Commissioner in a number of areas, including drafting proposed regulations for the supervision of captive insurance companies, reviewing and making recommendations

[1] The Pacific Financial Technical Assistance Center (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 sustained economic development. 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.

regarding applications submitted by a foreign bank to expand the number of branch offices in the FSM, and providing training in off-site bank supervision to Commissioner's staff. The PFTAC advisor continues to liaise closely with the authorities on issues relating to the regulation and supervision of captive insurance companies as well as banking supervision.

Economic and Financial Statistics

A workshop on National Accounts was conducted in October 2006 by the PFTAC Coordinator and Statistics Advisor. Wider macroeconomic statistics issues were also covered briefly, and an outreach program involving education of officials in the four state governments of the importance and uses of macroeconomic statistics was conducted.

A PFTAC Statistics Advisor undertook a TA mission to Pohnpei during October 2008 to improve the national accounts statistics. During the mission, the advisor completed a review of the latest current and constant price GDP estimates. A number of improvements were proposed, including in the coverage of the informal sector and subsistence activities and use of more appropriate price deflators and volume indicators. In addition, a number of recommendations were made to further strengthen the national accounts methodology and source data. The mission concluded that at this stage, producing estimates of GDP using production and expenditure approaches as well as gross value added (GVA) by industry is not feasible due to source data limitations. To boost local capacity, a two-week training seminar was delivered on the main concepts of *System of National Accounts 1993*. On-the-job training in compilation of GDP using the income method was also provided as part of the review process of data sources and compilation spreadsheets.

ANNEX III. FEDERATED STATES OF MICRONESIA—RELATIONS WITH THE ASIAN DEVELOPMENT BANK (ASDB)[2]

Since becoming a member in 1990, the FSM has received substantial assistance from the AsDB. As of December 2008, cumulative AsDB assistance to the FSM consisted of eight loans and 40 TA grants.[3]

The AsDB continues to assist the FSM by (i) supporting good governance, with a particular focus on economic management and accountability; (ii) ensuring inclusive social development; and (iii) promoting sustained private sector-led economic growth. Under AsDB's country operations business plan for 2007–09 special attention will be given to results-oriented implementation of ongoing projects, performance-based allocation of AsDB funds among the states, and continued support for capacity building. The government of FSM and the AsDB are currently developing a new country partnership strategy for 2009–13.

Currently, four loans are active: one focused on basic social services, two on infrastructure and one 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 Program assists the government in improving an environment for private sector development through the establishment of secured transaction systems, land administration and management, improvement of the regulatory environment, and support for job creation. The Basic Social Services Project is intended to improve the human resources of FSM in a sustainable manner to enable long-term social and economic development. Health and Education sectors are the specific focus with emphasis on improving service quality, raising community participation, and developing sustainable funding options. Implementation of this $8 million loan began in 2003. The Omnibus Infrastructure Development project loans (totaling $19m), approved in 2004, are designed to enhance public health, environmental quality, and surface water quality through improved wastewater infrastructure and management for Pohnpei and improved delivery of water services and expanded water supply systems for Yap and Kosrae; and improved management and provision of power in Chuuk.

AsDB's non-lending program focuses on improving public sector efficiency, effectiveness, and accountability. Technical assistance is provided in financial management and planning. AsDB is also working toward improving access to potable water in Chuuk, FSM's most populated state.

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

[3] The eight loans are for: (i) fisheries development; (ii) law, economic management and public policy; (iii) finance; (iv) water supply and sanitation; (v) basic social services; and (vi) private sector development.

Table 1. Loans to the Federated States of Micronesia by Sector
(In millions of U.S. dollars; as of December 2007)

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	1	18.0
Law, Economic Management and Public Policy	2	13.0
Water Supply, Sanitation & Waste Management	1	10.6
Multisector	3	27.0
Other	0	0
Total	8	75.1
Memorandum Item:		
Technical Assistance Provided	40	24.3

Table 2. Loan Approvals and Disbursements to the FSM, 2000–07
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005	2006	2007	Total 1990–2007
Loan Approvals 1/	8.0	13.0	0.0	0.0	19.0	0.0	0.0	0.0	75.1
Loan Disbursements	4.4	2.5	1.4	2.7	1.1	1.7	2.5	3.6	42.7
Undisbursed balance at the end of the year	14.2	23.3	22.0	19.2	18.1	16.4	13.9	10.6	…
Memorandum Item:									
TA approvals 1/	0.8	1.2	1.0	1.2	0.85	0.0	0.6	0.4	24.3

ANNEX IV. FEDERATED STATES OF MICRONESIA: RELATIONS WITH THE WORLD BANK GROUP[4]

(As of December 2008)

Total Commitments:	None.
IFC Investments:	None.
Recent Reports:	*Doing Business In Small Islands Developing States 2009.* *Opportunities to Improve Social Services: Human Development in the Pacific Islands*, 2007. *At Home and Away: Expanding Job Opportunities for Pacific Islanders through Labour Mobility*, 2006. *Not If, But When: Adapting to Natural Hazards in the Pacific Islands Region*, 2006. *Pacific Regional Strategy FY2006-2009*, May 2005.

The FSM joined the World Bank Group in June 1993. In 1995, the FSM received a grant of about $140,000 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, including through privatization. In 2002, the economic importance of fisheries to Pacific Islands was estimated and presented in a study jointly with the AsDB, the Forum Fisheries Agency, and the Secretariat of the Pacific Community.

Several regionally focused reports which cover the FSM have recently been published. In particular, the policy note, "*Not If, But When: Adapting to Natural Hazards in the Pacific Islands Region*" reviewed the disaster trends and lessons learned from pilot risk management of natural hazards initiatives, and recommends a strategic way forward on risk mitigation measures.

More recently, the report, "*At Home and Away: Expanding Job Opportunities for Pacific Islanders through Labour Mobility*," studies in detail the development potential of labour movement schemes for the Pacific Islands and advocates greater mobility for Pacific unskilled workers to help overcome the challenges the region faces because of small economies, remoteness, growing youth populations and low jobs growth.

The recently-released *Doing Business 2009* (and its localized version *Doing Business in Small Island Economies*) is an annual report investigating the regulations that either enhance or constrain business activity. The report presents the ranking of FSM on key measures that can be compared across 181 countries and over time.

FSM is an IBRD-eligible country.

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[4] Prepared with input from World Bank staff.

ANNEX V. MICRONESIA—STATISTICAL ISSUES

As of December 19, 2008

I. ASSESSMENT OF DATA ADEQUACY FOR SURVEILLANCE

General: Limited domestic capacity to produce economic data hampers surveillance and policy analysis, although there have been a number of improvements in data compilation, reflecting substantial assistance provided by the AsDB-financed Economic Management Policy Advisory Team (EMPAT; now closed) and PFTAC. The authorities are attempting to enhance local capacity to produce statistics and the SBOC (Department of Statistics, Budget, Overseas Development Assistance, and Compact Management) is responsible for the compilation of national statistics. However, major weaknesses remain, particularly in the area of national accounts and balance of payments.

National Accounts: GDP estimates are mostly calculated from tax and social security data; however, the FY2007 national accounts were estimated primarily from the social security data given recent changes in the gross revenue tax base. No unemployment or aggregate production indicators are available. An October 2008 PFTAC statistics mission suggested improvements to the nominal and volume estimates.

Price statistics: The authorities have published the quarterly consumer price index for the FSM as a whole and each state; however, the FY2008 consumer price index has not yet been compiled.

Government finance statistics: The national and the state governments and public sector enterprises publish annual audit reports detailing their fiscal operations; consultants put these data in the GFS format with a lag of about one year. Further improvements in the quality and timeliness of the fiscal data dependent on greater cooperation between the national and state governments.

Monetary statistics: The Banking Commissioner reports monthly monetary data to STA with a two- to three-month lag. The data comprise interest rates, the accounts of the monetary authorities, commercial banks, and the FSM Development Bank. The Commissioner has taken the view that a new banking law prevents the sharing of this information with the rest of the government, hampering domestic surveillance.

Balance of payments: The SBOC publishes annual estimates of the balance of payments and external debt statistics. Questions remain regarding the accuracy of the trade data as the authorities do not track the export of goods from ports. The data on workers' remittances are highly incomplete. Given capacity constraints, balance of payments estimates are currently only available for FY2006, with some partial estimates of imports also available for FY2007.

II. DATA STANDARDS AND QUALITY

Does not participate in the IMF's General Data Dissemination System.
No data ROSC is available.

III. REPORTING TO STA (OPTIONAL)

Only international liquidity and monetary statistics are currently reported to STA for publication in the *International Financial Statistics*.

MICRONESIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

AS OF DECEMBER 19, 2008

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of publication[7]
Exchange Rates	Dec. 2008	Dec. 2008	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Aug. 2008	Nov. 2008	M	M	M
Reserve/Base Money	Aug. 2008	Nov. 2008	M	M	NA
Broad Money	Aug. 2008	Nov. 2008	M	M	NA
Central Bank Balance Sheet	Aug. 2008	Nov. 2008	M	M	NA
Consolidated Balance Sheet of the Banking System	Aug. 2008	Nov. 2008	M	M	NA
Interest Rates[2]	Aug. 2008	Nov. 2006	M	M	M
Consumer Price Index	Dec. 2007	Aug. 2008	Q	A	I
Revenue, Expenditure, Balance/Composition of Financing[3] General Government[4] and Central Government	FY2007	Aug. 2008	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	N/A	N/A	N/A	N/A	N/A
External Current Account Balance	Sep. 2006	Aug. 2007	A	A	I
Exports and Imports of Goods and Services	Sep. 2006	Aug. 2007	A	A	I
GDP/GNP	Sep. 2007	Aug. 2008	A	A	I
Gross External Debt	Sep. 2007	Aug. 2008	A	A	I
International Investment Position [6]	N/A	N/A	I	I	I

1 Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
2 Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
3 Foreign, domestic bank, and domestic nonbank financing.
4 The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
5 Including currency and maturity composition.
6 Includes external gross financial asset and liability positions vis-à-vis nonresidents.
7 Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA)

INTERNATIONAL MONETARY FUND
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March 5, 2009

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IMF Executive Board Concludes 2008 Article IV Consultation with the Federated States of Micronesia

On February 25, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Federated States of Micronesia (FSM).[1]

Background

Economic performance in the FSM has been weak in recent years. As a result of problems with disbursing grants under the Compact agreement with the United States, rising commodity prices, and difficult business environment, the economy has contracted for five years in a row—one of the worst outturns among the Pacific nations. Output declined by 3.6 percent in FY2007 (October-September) and by an estimated 1 percent in FY2008. The economy continues to be dominated by the public sector and poor job prospects have stimulated migration to the United States where FSM citizens can work without a visa.

Inflation has remained relatively muted recently at about 5 percent, despite higher oil and food prices. The use of the U.S. dollar as the official currency, high prevalence of subsistence farming, and switching to lower-quality imports have limited price increases. The current account is estimated to have widened by 8 percentage points to 21 percent of GDP in FY2008 as the rapidly increasing costs of fuel and food imports outsized higher fishing revenues.

The fiscal situation has improved. On the basis of preliminary information, staff is forecasting a reduction in the consolidated fiscal deficit to about 3 percent of GDP in FY2008, down from over 6 percent in FY2006. This improvement was achieved largely through a reduction in the public wage bill in Chuuk and Kosrae and grants from China,

[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.

which helped offset stagnant tax revenue and an increase in fuel subsidies. However, despite the recent improvement, the fiscal deficit still falls well short of the surpluses needed to achieve self-sufficiency after the Compact expires. Staff projects that national and state governments combined would need to save around 3¾ percent of GDP annually to build sufficient savings which would generate—together with the Compact Trust Fund—the income needed to offset the end of Compact grants in FY2023.

The recent pick up in bank lending has been concentrated on state-owned enterprises and overseas firms (especially in Saipan), with limited impact on the local private sector. Obtaining financing for local businesses and consumers remains difficult. During FY2008, the share of nonperforming loans jumped from 3 percent to 6 percent at the Bank of FSM (the main commercial bank), mainly as a result of one large delinquent loan, but the bank remains well capitalized with a capital adequacy ratio of 35 percent.

In the near term, the FSM economy is likely to remain weak. Growth is projected to recover modestly to ½ percent in FY2009, as falling commodity prices boost real household incomes and states make progress on spending Compact infrastructure grants—about $100 million in grants have not been used. However, the risks to the outlook are on the downside. The unfolding global slowdown could reduce tourist arrivals, remittances, exports, and foreign investment. Falling global equity prices have reduced significantly the value of the Compact Trust Fund and state investments and could force governments to scale back their spending. In addition, slowing activity could lead commercial banks to tighten their lending standards.

Without stronger reform efforts, medium-term growth prospects are poor. According to the World Banks' Doing Business survey, FSM recently slipped to 126th place in terms of the ease of doing business. At the same time, with Compact support on a declining path, the authorities face the need to downsize the public sector, a task made more difficult without sustained private growth.

Executive Board Assessment

Executive Directors noted that economic growth in the Federated States of Micronesia (FSM) has remained weak, reflecting high food and fuel prices, delays in disbursements of Compact grants from the United States, and a difficult business environment. While the recent decline in commodity prices and a faster pace of infrastructure investment could boost real incomes and growth, downside risks arise from the global economic slowdown, in particular from smaller remittance inflows and reduced tourism revenues. Directors stressed that fiscal consolidation, an acceleration of structural reforms, and further efforts to develop the private sector will be essential to improve medium-term growth prospects.

Directors commended the authorities for reducing the budget deficit in FY2008. They noted that further sustained efforts are needed to build savings that will allow the FSM to achieve fiscal self-sufficiency when the Compact expires in FY2023, as well as to provide a cushion against external shocks. Fiscal balances will need to improve at both the national and state levels.

To secure fiscal sustainability, Directors recommended additional cuts in non-essential spending and implementing comprehensive tax reforms, including the VAT, on a timely basis. The income tax base should be broadened and revenue administration strengthened, including by hiring more auditors and promoting greater information sharing between the national and state governments on the self-employed. The Unified Revenue Authority should be established and made operational as soon as possible. Directors called for a further reduction in the public sector wage bill, which is still large by regional standards, to provide scope for preserving essential spending on health care, infrastructure, and education. The authorities should also take advantage of lower fuel prices to reduce fuel subsidies.

Directors considered that the FSM's financial sector has weathered well so far the global downturn. They welcomed the authorities' commitment to strengthen the supervisory framework. To support private sector development, Directors encouraged the authorities to improve access to credit by small firms and to refocus the FSM Development Bank on supporting new businesses and micro-credit institutions.

Directors encouraged the authorities to move ahead with structural reforms to improve the business environment and facilitate the development of a more dynamic private sector, which will be key to catalyzing growth and supporting fiscal consolidation. Priority should be given to expanding the capacity of the courts to enforce contracts; liberalizing land use and titling requirements; and easing restrictive foreign investment rules. Directors welcomed the decision to shut down a large loss-making public enterprise and the steps taken to incorporate the other state-owned enterprises in the tax net.

Directors encouraged the authorities to intensify their efforts to strengthen the statistical base, especially the fiscal and balance of payments data, in order to improve surveillance and policy analysis.

Micronesia: Selected Economic Indicators, 2004–08 1/

	FY2004	FY2005	FY2006	FY2007 Est.	FY2008 Est.
Real sector (average annual percent change unless otherwise noted)					
Real GDP	-3.3	-0.5	-1.6	-3.6	-1.0
Consumer prices	1.8	4.1	4.4	3.6	5.0
Employment	-0.9	-1.1	1.5	-0.7	0.2
Public (incl. public enterprises)	-2.8	0.0	2.9	-5.9	-2.0
Private	1.5	-2.1	0.1	5.5	2.5
Nominal wages	-0.7	1.6	1.5	-1.1	…
Public-private wage ratio	2.1	2.2	2.1	2.2	…
Consolidated government finance (in percent of GDP)					
Revenue and grants	59.6	58.6	58.6	61.0	59.5
Revenue	26.7	22.4	23.0	22.2	21.6
Grants	33.0	36.1	35.6	38.8	37.9
Expenditure	75.6	63.9	65.0	64.3	62.3
Current	56.6	58.9	62.3	58.7	56.7
Capital	19.0	4.9	2.8	5.5	5.6
Overall balance	-16.0	-5.3	-6.4	-3.3	-2.8
Compact Trust Fund (millions of U.S. dollars)	62.5	80.4	99.0	122.5	118.2
Commercial banks (in millions of U.S. dollars; end of period, through August 2008)					
Foreign assets	105.2	99.2	101.1	106.2	101.4
Loan	21.3	25.7	30.0	35.3	49.7
Total deposits	115.4	111.4	113.7	119.5	125.0
Interest rates (in percent, average for FY)					
Consumer loans	15.1	16.4	15.8	14.3	14.4
Commercial loans	6.9	7.8	8.6	9.0	8.8
Balance of payments (in millions of U.S. dollars)					
Trade balance	-120.3	-122.2	-128.9	-127.5	-142.8
Net services and income	-23.5	-22.1	-22.1	-19.5	-23.6
Private and official transfers	99.1	115.2	112.7	116.6	116.2
Current account including official transfers	-44.7	-29.1	-38.4	-30.3	-50.2
(in percent of GDP)	-20.0	-12.5	-16.1	-12.7	-20.3
Current account excluding official transfers	-141.3	-140.9	-145.7	-141.1	-160.0
(in percent of GDP)	-63.1	-60.7	-61.1	-59.2	-64.6
Overall balance	-58.6	-8.9	-19.5	-7.1	-19.6
(in percent of GDP)	-26.2	-3.8	-8.2	-3.0	-7.9
Gross reserves (in months of imports)	3.5	3.1	2.8	2.9	2.3
External debt (in millions of U.S. dollars; end of period) 2/					
Stock	62.9	64.0	65.8	67.2	68.1
(in percent of GDP)	28.1	27.6	27.6	28.2	27.5
Debt service	2.6	2.5	3.4	2.8	3.3
(in percent of exports of goods and services)	7.4	6.7	9.1	6.4	6.4
Exchange rate regime	U.S. dollar is the official currency				
Real effective exchange rate 3/	95.4	95.6	98.3	99.6	…

Sources: Data provided by the FSM authorities and Fund staff estimates.
1/ Fiscal year ending September 30.
2/ Government and public enterprise debt only.
3/ Year 2000=100.