INTERNATIONAL MONETARY FUND

IMF Country Report No. 21/237

FEDERATED STATES OF MICRONESIA

November 2021

2021 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE FEDERATED STATES OF MICRONESIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2021 Article IV consultation with the Federated States of Micronesia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its October 27, 2021 consideration of the staff report that concluded the Article IV consultation with the Federated States of Micronesia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on October 27, 2021, following discussions that ended on July 30, 2021, 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 October 5, 2021.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Statement by the Executive Director** for the Federated States of Micronesia.

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

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International Monetary Fund
Washington, D.C.

PRESS RELEASE

PR21/318

IMF Executive Board Concludes 2021 Article IV Consultation with the Federated States of Micronesia

FOR IMMEDIATE RELEASE

Washington, DC – **November 1, 2021:** The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Federated States of Micronesia (FSM) on October 27, 2021.

The FSM economy had performed relatively well before the pandemic but the global COVID-19 outbreak and related containment policies are putting strains on the economy. Growth reached 1.2 percent in FY2019 (October 1-September 30) owing to a strong rebound of construction activity, particularly public infrastructure investment. A public health emergency was declared and international travel restrictions were adopted at the onset of the pandemic, and subsequently extended through end-January 2022. Thanks to these measures, there has been no confirmed COVID-19 case in the FSM so far (as of October 5, 2021). However, domestic services activity has contracted sharply, planned investment projects have been delayed, and real GDP is estimated to have declined by 1.8 percent in FY2020.

The economic contraction is likely to deepen in FY2021 and a slow recovery is projected for FY2022. Once the pandemic fades, real GDP is expected to recover to the pre-COVID level in FY2024. Inflation is expected to rise in FY2021 due to higher imported prices including for commodities, before converging to U.S. levels of around 2 percent over the medium term. Fiscal and external balances are projected to remain in surplus in FY2021-22.

Uncertainty surrounding the outlook remains high, and risks are tilted to the downside. A prolonged border closure due to the pandemic or a possible domestic outbreak could extend subpar economic growth. Uncertainty related to the expiration of financial support and public services under the *Compact of Free Association Agreement* with the United States by end-FY 2023 could undermine investor confidence and weigh significantly on the medium-term economic prospects. Given the country’s geographic dispersion and isolation, climate change-induced natural disasters remain a key downside risk to the economy. On the upside, a renewal of support under the Compact Agreement would boost confidence and shore up potential growth.

Executive Board Assessment[2]

Executive Directors commended the authorities for their strong and swift policy response to the pandemic, which successfully prevented a local outbreak and helped cushion the economic downturn. Directors were encouraged by the prospects for a recovery in the coming

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

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

year, subject to high uncertainty. They noted macroeconomic risks stemming from the possible expiration of the Compact Agreement with the United States as well as the economy's vulnerability to climate change. Against this backdrop, Directors emphasized the need for policy actions to mitigate risks and facilitate stronger, greener, and more sustainable growth.

Directors emphasized that a coordinated and well-targeted policy response to support the economy and the most vulnerable remains a priority until the recovery is firmly underway. They welcomed the authorities' commitment to ensure transparency and accountability of pandemic-related outlays.

Directors agreed that a gradual fiscal consolidation is needed to rebuild long-term fiscal resilience to cope with the possible fiscal cliff in FY2024. They recommended adjustment through both expenditure rationalization and domestic revenue mobilization, including a timely introduction of the value-added tax. They also stressed the importance of strengthening public financial management and public investment management to help improve access to finance and expedite the implementation of key infrastructure projects. A medium-term fiscal framework could also usefully guide budget planning.

Directors agreed on the need to continue upgrading the legal and regulatory framework for banking supervision and enhancing the authorities' supervisory capacity. In this regard, they noted that placing the FSM development bank and credit unions under the supervision of the Banking Board would help ensure effective supervision and prudent lending. Directors also underscored the importance of strengthening AML/CFT risk-based supervision to preserve U.S. dollar correspondent banking relationships.

Directors encouraged steadfast implementation of priority reforms to support private sector development. They recommended prioritizing efforts to enhance the investment climate, improve governance, strengthen coordination across states, and expand digital connectivity.

Directors agreed that strengthening the country's resilience to climate change requires speeding up adaptation and enhancing disaster preparedness. They called for prompt actions to develop an overarching National Adaptation Plan and a disaster resilience strategy.

Directors welcomed the authorities' interest in continued technical assistance in areas such as revenue administration, public financial management, banking supervision, and statistics.

Federated States of Micronesia: Selected Economic Indicators, FY2018–26 1/

Nominal GDP (FY2018): US$402 million
Population (FY2018): 104,286
GDP per capita (FY2018): US$3,854
IMF Quota: SDR 7.2 million

	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026
		Est.	Est.	Projections					
Real sector (annual percent change)									
Real GDP	0.2	1.2	-1.8	-3.2	0.6	3.2	1.9	0.8	0.6
Consumer prices	1.4	1.5	0.5	2.6	2.6	2.6	2.6	2.5	2.4
Employment	1.2	0.6	-1.2	-3.8	0.0	2.6	1.3	0.2	0.2
Public (incl. public enterprises)	0.5	...	...	...	...	...	...	...	...
Private	2.8	...	...	...	...	...	...	...	...
Nominal wages	1.1	...	...	...	...	...	...	...	...
Public average wage/private average wage	2.2	...	...	...	...	...	...	...	...
Consolidated government finance (in percent of GDP)									
Revenue and grants	79.7	77.7	69.3	72.8	67.7	64.6	57.2	54.7	54.8
Revenue	53.5	46.4	33.5	31.0	31.6	31.0	42.2	41.6	41.1
Tax revenue	32.2	25.5	12.3	11.3	11.4	11.2	11.2	11.1	11.1
of which: corporate income tax	21.0	14.9	2.4	3.0	2.9	2.7	2.5	2.4	2.4
Non-tax revenue	21.3	20.9	21.1	19.7	20.2	19.8	31.0	30.5	30.0
of which: Fishing license fees	18.0	17.5	17.8	16.3	16.9	16.5	15.4	15.3	15.1
Grants 2/	26.2	31.3	35.9	41.9	36.1	33.5	15.0	13.1	13.7
Expenditure	55.5	60.3	68.8	71.6	64.8	62.2	61.3	59.6	59.8
Expense	45.9	44.6	54.3	56.8	47.6	44.6	44.3	44.1	43.9
Net acquisition of nonfinancial assets	9.6	15.7	14.5	14.8	17.2	17.6	16.9	15.4	15.8
Net lending/borrowing	24.2	17.4	0.6	1.3	2.8	2.4	-4.1	-4.9	-5.0
Net lending/borrowing (excl. grants)	-1.9	-13.9	-35.3	-40.6	-33.3	-31.2	-19.0	-18.0	-18.7
Balance of trust funds 3/	211.1	230.5	263.7	317.3	335.1	344.3	329.2	318.6	309.4
Commercial banks (in percentage of GDP; end of period)									
Loans	12.3	11.1	11.2	10.8	11.5	11.7	11.9	12.1	12.3
Deposits	83.5	84.9	94.3	99.8	88.9	84.9	84.9	85.0	85.0
Interest rates (in percent, average for FY)									
Consumer loans	15.7	14.7	14.7	...	...	...	...	...	...
Commercial loans	7.6	7.8	5.9	...	...	...	...	...	...
Balance of payments (in millions of U.S. dollars)									
Trade balance	-128.5	-125.0	-117.8	-132.7	-128.5	-136.6	-130.0	-131.5	-135.2
Net services and income	18.6	-1.7	-8.5	-17.5	-7.5	-7.9	44.3	44.0	43.7
Private and official transfers	194.5	196.9	138.4	154.9	140.7	143.0	61.9	63.9	66.1
Current account	84.6	70.2	12.1	4.7	4.7	-1.5	-23.8	-23.6	-25.4
(in percent of GDP)	21.0	17.0	3.0	1.2	1.1	-0.4	-5.1	-4.9	-5.2
External debt (in millions of U.S. dollars; end of period)									
Outstanding stock	75.4	77.3	65.4	61.0	60.8	60.2	76.5	98.2	122.0
(in percent of GDP)	18.8	18.7	16.1	15.1	14.6	13.6	16.5	20.6	24.8
Memorandum items:									
Exchange rate regime 4/									
Real effective exchange rate 5/	105.8	107.7	106.3	...	...	...	...	...	...
Nominal GDP (in millions of U.S. dollars)	401.9	412.9	407.3	404.2	417.2	442.1	462.3	477.7	491.9

Sources: FSM authorities and IMF staff estimates and calculations.
1/ Fiscal year ends on September 30.
2/ Excludes contributions to the Compact Trust Fund.
3/ Compact Trust Fund and FSM Trust Fund.
4/ The U.S. dollar is legal tender and the official currency.
5/ Calendar year. 2010=100.

INTERNATIONAL MONETARY FUND

FEDERATED STATES OF MICRONESIA

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

October 5, 2021

KEY ISSUES

Context. The COVID-19 pandemic and related containment measures have put severe strains on the economy. The economic policy response has been strong and generally appropriate, helping counter the negative effects of the pandemic. Nevertheless, as the international borders remain shut, the economic contraction is likely to deepen in FY2021. A slow recovery is expected for FY2022 driven by a gradual border reopening. The FSM is facing significant medium-term uncertainty, owing to the possible expiration of grants and other assistance provided under the Compact Agreement with the United States. The FSM is also highly vulnerable to climate change-induced natural disasters.

Policies. Economic policies should focus on supporting the recovery and rebuilding fiscal resilience to cope with the possible fiscal cliff in FY2024. Main policy recommendations include:

- Maintain policy support until the recovery is firmly underway, while ensuring that emergency assistance is well-targeted.
- Subsequently, phase in gradual fiscal consolidation to reduce risks related to the expiration of the U.S. Compact grants.
- Strengthen public financial management and public investment management to accelerate donor-supported public investment, which in turn will help underpin the recovery and speed up adaptation to climate change.
- Accelerate structural and financial sector reforms to support private sector development and financial deepening, and help lift medium-term growth.

Approved By
Andreas Bauer (APD) and Martin Sommer (SPR)

Discussions took place by video conference during July 19-30, 2021. The staff team comprised Piyaporn Sodsriwiboon (head), Antoine Arnoud, Fan Qi (all APD), and Shinya Kotera (OAP). Lae Tui Siliva (OED), Rommel Rabanal (Asian Development Bank), Reshika Singh (World Bank), and staffs of the Pacific Financial Technical Assistance Center (PFTAC) participated in meetings. Mr. Chang Huh (OED) attended the Concluding Meeting. The team met with Finance Secretary Amor, Environment, Climate Change, and Emergency Management Secretary Yatilman, Transportation, Communication, and Infrastructure Secretary Apis, senior officials of the national government and state-owned enterprises, the financial sector community, development partners and private sector representatives. Seble Abebe and Yadian Chen (both APD) assisted with the preparation of this report.

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APPENDICES

CONTEXT

1. **The Federated States of Micronesia (FSM) economy entered the COVID-19 pandemic on a relatively strong footing.** Growth in recent years (1.9 percent during FY2015-FY2019) exceeded the long-term average (-0.6 percent during FY2004-FY2014). Employment and income growth were buoyant. Inflation remained subdued, owing to low energy and food prices. Fiscal and external balances recorded large surpluses, amid significant revenue windfalls from foreign investment companies domiciled in the FSM.

2. **However, the medium-term outlook was already clouded by a number of long-standing structural challenges and vulnerabilities.** The FSM is a small, fragile state, heavily dependent on foreign grants. The country is facing significant uncertainty owing to the expiration by end-FY2023 of the provisions related to financial support and other macro-critical services under the Compact of Free Association (COFA) with the United States (Appendix I). The FSM is also highly vulnerable to climate change-induced natural disasters. Higher ocean surface temperatures may dislocate abundant tuna fisheries—the country's primary economic resource, weighing on fiscal revenues, the current account, and growth outlook. The FSM's remoteness and disperse geography hinders infrastructure development and foreign direct investment.

3. **There has been limited progress on the implementation of past Fund advice** (Appendix II). Some progress had been made toward the adoption of a public financial management reform roadmap for FY2017-20 and the revision of the banking law and regulations in line with the international standards. However, these reform efforts have been stalled since early 2020 due to international travel disruptions caused by the COVID-19 pandemic. More broadly, capacity constraints continue to hinder the implementation of past Fund advice by the FSM.

THE COVID SHOCK: IMPACT, OUTLOOK, AND RISKS

4. **A local outbreak of COVID-19 has been avoided thus far, thanks to strong and timely prevention.** At the onset of the pandemic, the authorities preemptively declared a public health emergency, which has been extended through the end of January 2022. The national and state governments have enacted containment measures to limit the risk of a local outbreak, including travel bans on international flights and strict mandatory quarantine for incoming passengers. These measures have been effective, with the FSM being among the few countries without any confirmed COVID-19 cases so far. The FSM has successfully repatriated its stranded citizens abroad to the state of Pohnpei since May 2021.

5. **However, the pandemic and related containment policies are putting strains on the economy.** While tourism plays a limited role, economic activity was affected by the travel restrictions.[1] Real GDP is estimated to have declined by 1.8 percent in FY2020 (ending September 2020). Domestic services activity has contracted sharply. Major investment projects have been

[1] Tourism and hospitality accounted for about 1.7 percent of GDP during FY2016-18.

delayed, due to restrictions on the movement of personnel and materials. Tax revenue collection dropped and government spending rose due to the pandemic response, although stable fishing license fees and large foreign grant inflows kept the fiscal balance in a small surplus of 0.6 percent of GDP in FY2020 (Table 1).

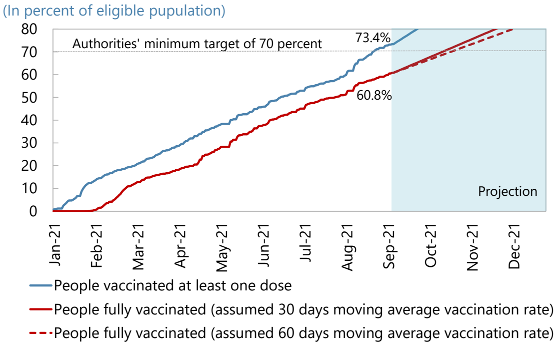
6. The impact of the COVID-19 crisis on the balance of payments is expected to be relatively muted. The current account is estimated to have remained in a surplus of 3 percent of GDP in FY2020. While corporate tax payments from foreign companies domiciled in the FSM, tourism receipts, and remittances are expected to have declined, these shortfalls have been mitigated by falling oil prices, declining imports due to domestic demand contraction, and large grant inflows from bilateral and multilateral partners. The FSM's external position in 2020 is assessed to remain broadly consistent with the level implied by fundamentals and desirable policies (Appendix III). The SDR allocation[2] of SDR 6.9 million (about US$ 9.8 million or 2.4 percent of GDP) which came into effect on August 23, 2021 will support foreign exchange reserves but does not alter the staff's policy advice.

7. External borders are likely to remain shut until herd immunity can be achieved and the pandemic subsides. FSM aims to transit from a COVID-free to a COVID-protected country by achieving the authorities' target of at least 70 percent vaccination coverage. However, the vaccine rollout faces some challenges from hesitancy and the remoteness of some localities, especially on the outer islands. On July 29, 2021, the government stepped up the efforts to accelerate vaccination by mandating the vaccination for all 18 years and older citizens. As of September 13, 2021, about 61 percent of the eligible population have been vaccinated (Text Chart 1).

Text Chart 1. FSM: Vaccination Rate and Growth Outlook

FSM Vaccination Rate

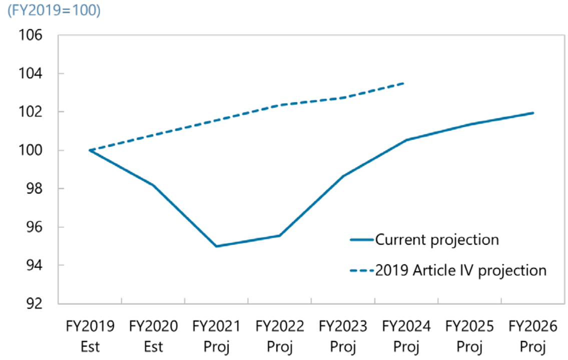
(In percent of eligible population)



Sources: United States Centers for Disease Control and Prevention; and IMF staff estimates.

FSM: Real Gross Domestic Product

(FY2019=100)



Source: IMF staff estimates and projections.

[2] The Department of Finance and Administration as part of the FSM national government accrues the SDR allocation. The baseline projections and the Debt Sustainability Analysis include the impact of the SDR allocation. The authorities have indicated that they do not intend to use the allocated SDRs in the near term and will include them as reserves.

8. The near-term growth outlook has significantly deteriorated. As the international borders remain shut, the economic contraction is likely to deepen with growth estimated at -3.2 percent in FY2021. A slow recovery is projected for FY2022 driven by a gradual border reopening. Once the pandemic fades, real GDP is expected to return to the pre-COVID level in FY2024, albeit output will remain on a lower trajectory through the medium term reflecting some permanent scarring. Inflation is expected to rise in FY2021 due to higher imported prices including for commodities. Fiscal and external balances are projected to remain in surplus in FY2021-22.

9. Uncertainty surrounding the outlook remains high, and risks are still tilted to the downside (Appendix IV). A longer border closure due to the pandemic or a possible domestic outbreak could prolong subpar economic growth. The uncertainty related to the expiration of financial and public services support under the Compact Agreement could undermine investor confidence and weigh significantly on the medium-term economic prospects, particularly the FSM's capacity to cope with a potential fiscal cliff post-FY2023. Given the country's geographic dispersion and isolation, climate change-induced natural disasters remain a key downside risk to the economy. On the upside, a renewal of financial and public services support provisions under the Compact Agreement would boost confidence. Prompt implementation of fiscal and structural reforms could lift potential growth and ensure budget self-sufficiency and fiscal sustainability (Box 1).

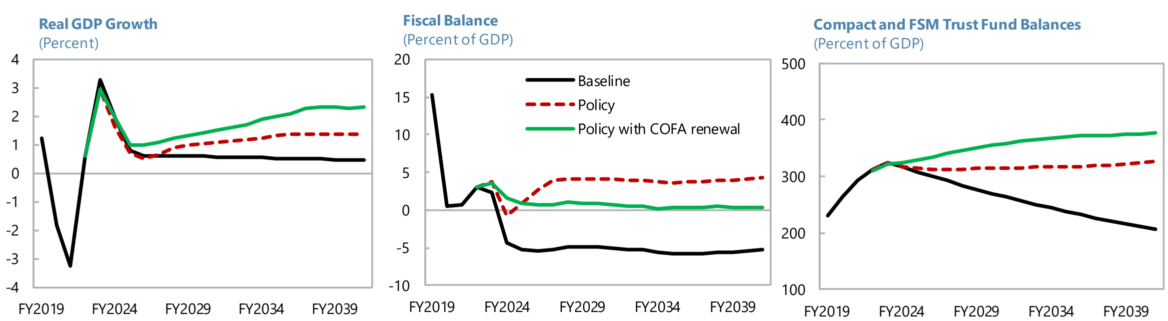
Authorities' Views

10. The authorities broadly agreed with staff's assessment on the economic outlook and risks. They noted that the pandemic and domestic containment measures have had severe impacts on the economy through a sharp contraction of business activity, rising unemployment, and delayed critical infrastructure projects. They expected further economic contraction in FY2021, followed by a slow recovery in FY2022 on the premise of an expedited vaccination rate. While recognizing significant economic trade-offs, they remained cautious on the reopening of the international borders as the FSM's health system does not have the capacity to handle a major local outbreak. They acknowledged that the high uncertainty about the renewal of the Compact grants could weigh significantly on the medium-term outlook and the FSM's capacity to handle economic shocks going forward. In this regard, they have begun to lay some groundwork for policy adjustments to mitigate downside risks, should the current arrangement end in FY2023.

Box 1. Federated States of Micronesia: Baseline and Policy Scenarios

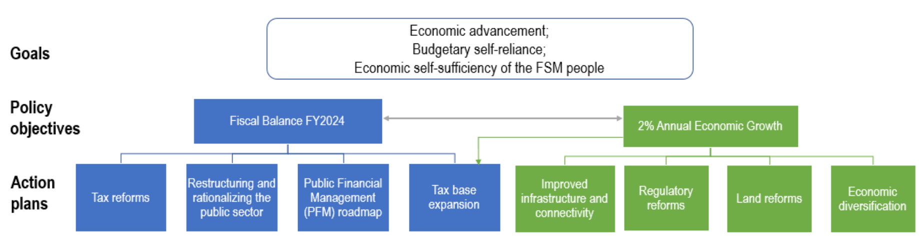
Given the uncertainty related to the Compact Agreement, this box lays out three illustrative scenarios, and their relevant assumptions and potential economic outcomes.

- ***Baseline scenario.*** This scenario reflects the authorities' current policies and the assumption that U.S. Compact grants (22 percent of GDP) will not be renewed after FY2023. Despite the use of investment returns accruing to the Compact Trust Fund (CTF) to partially compensate for the loss of grants, the fiscal and external balances would turn from a small surplus to a deficit of around 4-5 percent of GDP from FY2024 onward. Public debt would sharply rise to 82 percent of GDP over the next 20 years from the current low level, while the value of the CTF and its revenue generating capacity in percent of GDP would gradually erode. With the post-FY2023 uncertainty weighing on the medium-term outlook, the FSM would remain trapped in a low-investment low-growth equilibrium.
- ***Policy scenario.*** In this scenario, the authorities are assumed to lay the foundations for sustained stronger medium-term growth and budgetary self-reliance in line with past IMF advice and the FSM's Strategic Development and FY2023 Action Plan. The FSM government pursues a gradual fiscal adjustment of 1-2 percent of GDP per year over a period of 5 years from FY2023 onward through domestic revenue mobilization and expenditure rationalization, as well as structural fiscal reforms. While this adjustment would have some dampening effect on growth in the near term, the medium-term outlook would be bolstered by structural reforms aimed at improving the business climate and a fast-tracking of key infrastructure investment projects financed by external grants to address growth bottlenecks. The fiscal adjustment combined with higher investment and more buoyant economic activity would help the FSM avoid a fiscal cliff, stabilize trust fund balances, and keep the public debt in check.
- ***Policy scenario with renewal of U.S. Compact grants.*** In this scenario, the current arrangements under the Compact agreement are assumed to be renewed and the government pursues structural reforms as in the policy scenario. While the renewed Compact grants will help relieve fiscal pressures and enable higher public investment, some fiscal adjustment and reforms will still be beneficial to strengthen the tax system, reduce leakages, and improve government efficiency and effectiveness. The greater certainty about medium-term economic prospects and reform implementation would help attract foreign direct investment, putting the economy on a stronger growth path.



Source: IMF staff estimates and calculations.

FSM: Strategic Development and 2023 Action Plan



Source: FSM authorities.

BUILDING RESILIENCE IN A POST-PANDEMIC WORLD

Near-term policies should prioritize measures to protect vulnerable segments of the population, assist negatively affected businesses, and underpin a robust economic recovery. To ensure fiscal resilience, a comprehensive medium-term fiscal framework is needed that copes with the possible fiscal cliff and safeguards debt sustainability. Accelerating structural reforms would be key to develop a dynamic private sector, diversify the sources of growth, and adapt to climate change.

A. Navigating the Pandemic: Immediate Policy Responses

11. The economic policy response to the COVID-19 shock has been strong and broadly appropriate (Text Table 1). The response has included additional resources to strengthen the capacity of the health system, financial assistance to affected firms, and income support to the unemployed and vulnerable groups, which have helped mitigate the negative effects of the pandemic. Due to capacity constraints, the implementation of unemployment assistance and economic stimulus package was slow initially but picked up eventually.

12. Supportive fiscal measures should remain in place until the recovery is firmly underway. The budget implies a moderately contractionary fiscal stance in FY2021-22. With output projected to further decline in FY2021, some additional fiscal support in the near term would be desirable to help contain the economic damage from the pandemic. This could be achieved by the extension of income support provided to the unemployed, low-income households, and informal workers. In line with staff's advice and amid further extension of border closure through January 2022, the authorities recently extended the Economic Stimulus Package for businesses until June 2022 and appropriated about US$ 2.5 million or 0.6 percent of GDP to augment the social protection program for low-income household assistance. They intend to prioritize the support for individuals most affected by the pandemic until funds run out.

13. Strong policy efforts will be needed to strengthen the recovery. The vaccination process should be accelerated to achieve collective immunity as early as possible to safeguard the public health and enable a gradual reopening of the economy. In particular, efforts to vaccinate remote communities and the young population should be intensified. To ensure an inclusive growth recovery, measures should continue to be targeted to sectors and households most affected by the pandemic slowdown, while rationalizing and limiting some of the most generous assistance schemes, including by reducing the compensation threshold and introducing a ceiling on wage subsidies. Efforts to execute existing commitments for public infrastructure investment should also be increased to help reactivate economic activity and strengthen the recovery, as soon as the borders are reopened.

Text Table 1. FSM: Policy Responses to COVID-19 Pandemic in FY2020-22
(In millions of US dollars)

	FY2020		FY2021		FY2022	Financing sources
	Commitment	Disbursement	Commitment	Disbursement 1/	Commitment	
Health Action Plan	20	20	...	...	...	
COVID 19 Response Framework						
Develop quarantine and isolation facilities, provide mandatory infection control training, and increase testing capacity and ventilators						Foreign grants
Economic Stimulus Package	7.5	4.0	7.5	1.8	Carryover	Domestic revenue mobilization and foreign grants
Salary subsidy: a subsidy of 100% of salaries & wages paid per fortnight						
Gross Revenue Tax (GRT) rebate: 100% refund of GRT paid per quarter						
Social security rebate: 100% refund of social security payments						
Debt relief: interest payments to banks on behalf of affected businesses						
Pandemic Unemployment Assistance (PUA) 2/	Up to 36	0.3	Up to 36	14.5	...	Foreign grants
Weekly unemployment benefits to qualified unemployed persons, in line with the United States' PUA						
Assistance to low-income households	...	...	14	14	2.5	Foreign grants (FY2021) and domestic revenue mobilization (FY2022)
Cash transfers to households in the informal labor market						
Assistance to vulnerable groups e.g. waivers of medical expenses and other benefits						
Spending to increase COVID-19 awareness						

Source: FSM authorities.
1/ Data through June 2021. Fiscal year ends on September 30th.
2/ Total commitment during FY2020-21 is up to US$ 36 million.

14. To limit risks of inefficiency and leakage caused by the rapid scaling up of government spending, additional pandemic-related spending safeguards should be introduced. The Department of Finance and Administration has prepared quarterly situation reports containing information about the COVID-19 response and beneficiaries of the countercyclical measures. Building on this, additional pandemic-related spending safeguards should be put in place, including publication of the COVID-related spending reports, the pandemic-related procurement contracts and collection and publication of beneficial ownership information for companies awarded contracts, as well as an ex-post audit reporting of such spending.

Authorities' Views

15. The authorities agreed with staff's recommendations on near-term policy support. They underscored downside risks from the termination of various ongoing support, such as the Pandemic Unemployment Assistance (PUA) from the U.S., the social protection program funded by the Asian Development Bank, and the FSM's Economic Stimulus Package, all scheduled to end in September 2021. Together with the extension of the border closure, the authorities also announced the extension of policy support for businesses and low-income households. They expected such support to help counter downside risks to the economy. The authorities will audit COVID-19 related spending and publish relevant reports.

B. Rebuilding Longer-Term Fiscal Resilience

16. Under current policies, the FSM will face increasing fiscal risks with the possible fiscal cliff, rising debt, and declining trust fund assets. Over the medium term, the possible expiration of U.S. Compact grants in FY2023 will only be partially compensated by the disbursement of investment returns from the Compact Trust Fund (CTF). The CTF yield volatility and the declining value of the CTF both in percent of GDP and per capita could reduce the CTF's revenue generating capacity and lead to significant revenue volatility, thus putting additional pressures on the annual budget financing. The fiscal balance would weaken sharply and record deficits of 4-5 percent of GDP from FY2024 onward, putting debt on an upward trajectory with the public debt-to-GDP ratio rising from 13.6 percent in FY2023 to around 83 percent in FY2041. The Debt Sustainability Analysis suggests that the FSM remains at high risk of overall debt distress though the debt is assessed to be sustainable.

17. Once the recovery is firm, a gradual fiscal consolidation is needed to reduce fiscal risks related to the possible expiration of Compact grants. To help achieving the authorities' objective of a self-reliant budget and preserving the real value of the trust funds in the medium term, a gradual fiscal adjustment of about 1-2 percent of GDP per year could be implemented over 5 years when growth is expected to bounce back and stay above trend. Such adjustment would lower GDP growth by about 0.2-0.4 percent annually but this negative effect could be countered by growth-enhancing structural reforms (Box 1 and Text Table 2).

18. Fiscal consolidation could be achieved through domestic revenue mobilization and expenditure rationalization (Text Table 3). Specifically,

- *Revenue*: The establishment of the National Tax Reform Commission to strengthen the tax system, expand the revenue base, and ensure equitable revenue sharing is welcome. In this regard, tax reforms could focus on the introduction of a value-added tax (VAT), replacing an outdated and inefficient gross revenue tax. Selected excises on tobaccos and alcohol and tightening the eligibility on concessional fishing license fees for the domestic fishing industry could also be considered. The introduction of excise taxes on gasoline and diesel that mimics a carbon tax would contribute to climate mitigation efforts and help mobilize extra revenue. These efforts could be supported by technical assistance (TA) from the Pacific Financial Technical Assistance Center (PFTAC), including a diagnostic review of the tax system and tax administration. The planned roll-out of a new tax administration IT system should be expedited. Any future revenue windfalls should be saved to further build up fiscal buffers.

- *Expenditure*: State support programs and purchases of goods and services, particularly non-essential expenditures, could be streamlined and rationalized, while protecting social spending and public infrastructure investment. Public financial management (PFM) reforms would help identify further expenditure savings, enhance foreign aid effectiveness (Appendix V), and reduce leakages.

Even if the Compact grants are renewed, some of the recommended adjustments would be beneficial to make the tax system and government spending more efficient. The resulting fiscal savings could be used to further build up the Compact and FSM trust funds, which are currently well below the target. This will ensure progressing toward economic self-sufficiency and benefit future generations.

Text Table 2. FSM: Fiscal Adjustments, FY2021-FY2027

(Percent of GDP, unless otherwise indicated)

	Baseline			Policy scenario 1/			Difference		
	2021	2023	2027	2021	2023	2027	2021	2023	2027
Real GDP Growth (percent)	-3.2	3.2	0.6	-3.2	2.9	0.6	0.0	-0.3	0.0
Fiscal Balance	1.3	2.4	-5.0	0.8	3.8	4.0	-0.5	1.4	8.9
CTF + FSM net assets per capita (USD thousands)	12.2	14.5	15.2	12.2	14.5	15.9	0.0	0.0	0.7
CTF + FSM net assets per capita (real, USD thousands)	7.3	8.2	7.8	7.3	8.2	8.2	0.0	0.0	0.4
Tax Revenue	11.3	11.2	11.1	11.3	12.0	15.4	0.0	0.8	4.3
Current Expenditure	56.8	44.6	43.2	56.8	44.2	38.6	0.0	-0.4	-4.6

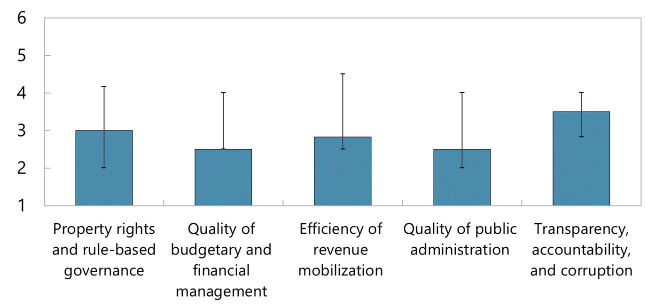
Source: IMF Staff Estimates.

1/ Includes the implementation of fiscal adjustments and structural reforms. The growth impacts of reforms are assumed to gradually phase in from FY2025 onward.

19. Efforts to strengthen PFM and public investment management (PIM) should be enhanced. The FSM has not been able to fully utilize the capital grants under the Compact agreement and from other development partners. The lack of government consensus and administrative capacity appears to have prevented progress on infrastructure projects, despite the availability of funds. Speedier investment implementation would help support the recovery and lift potential growth. The updated Financial Management Regulations passed in FY2019 are welcome. The long-pending IT system upgrade should proceed expeditiously. In addition to laying the foundation for more efficient PIM, improving coordination between national and state governments, and enhancing the public administrative capacity through training, standardization, and the use of digital technology (Appendix V) would be necessary to increase the effectiveness of government operations. A medium-term fiscal framework could be usefully developed to guide annual budget planning while ensuring fiscal sustainability.

FSM: Public Sector Management and Institutions 1/

(2017-2019 average, 1=lowest to 6=highest)



Source: World Bank's Country Policy and Institutional Assessment (CPIA).

1/ The World Bank's CPIA. The black line shows the range of scores in each category for 9 Pacific Islands countries. Non-IMF indicators provide qualitative information about country policy and institutional framework. They do not represent the IMF's assessment of the quality of policies and institutions.

Text Table 3. FSM: Summary of Recommended Fiscal Response

	During COVID-19	Post COVID-19: Short term	Medium to Long Term
Fiscal Policy Objectives	-Effectively implement the COVID-19 response packages	-Gradual fiscal adjustments to reduce risks of a possible fiscal cliff due to the expiration of the Compact grants; -Enhance the utilization of the capital grants for public investment to support the recovery	-Preserve the real value of the Compact Trust Fund to protect long-term income; -Implement structural fiscal reforms to enhance the government efficiency and support revenue mobilization
Expenditure Policy	-Reprioritize, rationalize, and better targeted covid-related spending; -Provide some additional fiscal support to the most vulnerable, as needed.	-Strengthen PFM and PIM to fully utilize the capital grants for public investment including for digital connectivity and climate adaptation; -Streamline non-essential expenditures while protecting scoial spending	-Develop a medium-term fiscal framework and improve annual budget planning; -Improve coordination between national and state governments and strengthen fiscal responsibility
Tax Policy		-Introduce a value-added tax (VAT) to replace the gross revenue tax (GRT); -Tighten eligibility on concessional fishing license fees for the domestic fishing industry; -Increase excise taxes on tobacco, alcohol, fuel	-Accelerate tax administration reforms; -Roll out a new tax administration IT system

Source: IMF Staff.

Authorities' Views

20. The authorities concurred with staff's fiscal policy advice for the post-pandemic period. They noted that tax reforms have recently gained political momentum and several initiatives are underway. The National Tax Reform Commission is mandated to conduct a study on the existing taxation system in the FSM at both the national and state levels to identify its strengths and weaknesses and determine areas for improvements and adjustments. The Commission is expected to report its findings and recommendations to the President by January 1st, 2022, including the legislative proposals for consideration by the FSM Congress and State Legislatures. The authorities would prioritize the introduction of VAT in a revenue neutral manner, though it is expected to boost revenue through improved tax efficiency. The revised tax legislation to increase the excise taxes on cigarettes and tobacco has been submitted to the FSM Congress for consideration. They estimated that these tax reforms would raise tax revenue to about 16 percent of GDP, from the current level of about 12 percent. They would also consider the changes to non-tax revenues, including to reassess the concessional domestic fishing license fees. In this regard, they requested PFTAC TA to assist with these tax reform efforts and relevant changes to the tax legislatives.

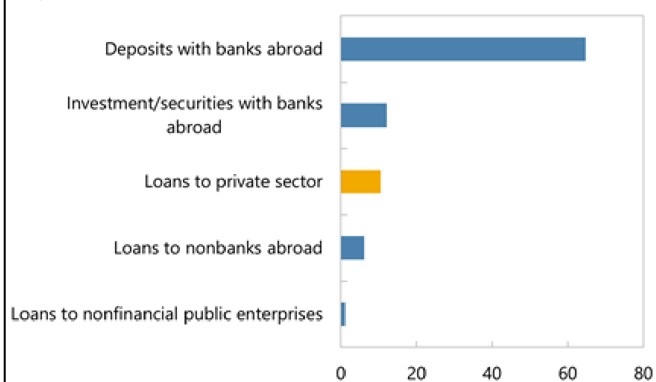
21. The authorities agreed that government expenditure could be streamlined and spending efficiency could be enhanced. They acknowledged that after the COVID shock expenditure rationalization would be necessary. They explained that the large amount of unused funds was mainly due to the lack of implementation capacity. The authorities have established a Project Management Unit at the national level and Project Management Offices at the state level to strengthen project coordination and provide technical support for implementation. They expected these measures to help accelerate project implementation and grant disbursement. The authorities recognized that a medium-term fiscal framework would be beneficial and they are receiving capacity development from the European Union in this area.

C. Fostering Financial Intermediation to Support Economic Development

22. The banking system has remained sound and financial stability risks appear generally contained. The banking sector is dominated by two commercial banks accounting for 85 percent of total banking assets and supervised by both the U.S. Federal Deposit Insurance Corporation (FDIC) and the FSM Banking Board (FSMBB). Interest payment relief, a 90-day voluntary loan moratorium, and a concessional loan program for small businesses, have helped mitigate the adverse financial sector impact from the pandemic. As of December 2020, the regulatory capital to risk-weighted assets ratio of the two banks stood at 37.6 percent, while the non-performing loan (NPL) ratio was 0.1 percent. Preliminary sensitivity analysis suggests that bank capital would remain well above prudential limits even under significant stress.[3] This reflects in part that loans to firms and households represent only a small portion of total bank assets (see text chart).

FSM: Major Components of Commercial Bank Assets 1/

(In percent of total assets, 2020 data)



1/ Comprises two commercial banks in FSM.

23. Near-term financial sector support should be maintained, subject to close monitoring. Against the backdrop of continued border closures, interest payment relief and the debt moratorium could be extended for viable firms to limit permanent economic damage.[4] Close monitoring of non-performing loans and broader credit quality indicators such as restructured and doubtful loans is warranted given that policy support may mask possible vulnerabilities. The FSM Development Bank (FSMDB), which accounts for 14 percent of total banking assets and is neither regulated nor supervised by the Banking Board due to its non-deposit taking status, has steadily

[3] This estimation assumes that one third of the private sector loan portfolio experiences a credit rating downgrade with the NPL ratio rising from below one percent to around five percent.

[4] Eligibility criteria could be based on firms' financial strength, including income or operating profits. Support should not be provided to nonviable firms, including those with structurally negative profitability or those that have been in serious financial difficulties pre-crisis. See IMF Special Series on COVID-19 "*Considerations for designing temporary liquidity support to businesses*".

grown its credit portfolio in recent years. Its NPL ratio reached 14 percent[5] as of June 2021, which could deteriorate further if policy support phases out. Maintaining adequate loan-loss provisions and strengthening oversight by the FSMDB Board of Directors is necessary to contain potential risks. Credit unions are very small and under-supervised, although they play an important role in consumer finance. To ensure prudent lending and reduce possible liquidity stress, closer monitoring and contingency plans for the sector should be considered.

24. The FSM's financial system plays a limited role in supporting economic development. This reflects a broad range of development challenges, including the lack of collateral due to the prohibition for non-FSM citizens to own land[6], complex ownership structure of land related to family ties, and the absence of a functioning credit and land registry. The results have been low credit growth, high intermediation spreads, and limited access to credit (Figure 4).

25. More needs to be done to facilitate financial development over the medium-term. Financial sector reforms, complemented by broader structural reforms, are needed to address bottlenecks to credit supply and demand (Text table 4). These include:

- Unless the service agreements under the Compact Agreement are renewed, the FSM could lose the financial sector oversight provided by the U.S. FDIC post FY2023. Building on the Banking Regulatory Reform project initiated in 2017, the FSMBB should continue to upgrade the legal and regulatory framework for banking supervision and its supervisory capacity. The draft governance and risk management prudential standards for banks in the FSM should be finalized and implemented. The amendment of the Banking Act should be aligned to international standards and clearly define the FSMBB's role and supervisory powers. The FSMDB and credit unions[7] should be placed under the FSMBB's regulation and supervision.

- The FDIC insurance and supervision are essential for the Bank of FSM to maintain its correspondent banking relationships (CBRs). The Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) framework, in particular, risk-based supervision of banks should be strengthened to ensure compliance with international standards, which is necessary to secure U.S. dollar CBRs and maintain remittance inflows in case of a lapse of the FDIC services on CBRs.

[5] Based on the authority's definition which includes loans with principal and interest payment past due 90 days and over. Based on the classification of European Investment Bank (EIB)—a creditor of the FSMDB—which includes the principal payment past due 90 days, principal loans in nonaccrual status, all restructured loans within the last 12 months regardless of status and all deferred loans due to COVID-19 regardless of status, the NPL ratio rose to 47 percent at end-December 2020.

[6] The two main commercial banks in FSM are prohibited from owning land, as Bank of Guam is a foreign bank and Bank of FSM has minor foreign holding.

[7] Credit unions are excluded from Micronesia Bank Act and are not subject to any oversight by the FSMBB nor any form of prudential supervision by their state authorities. In certain cases, there is state level law governing the operation of credit unions; however, there is no unified or common law on this subject.

- Structural reforms could help ease the bottlenecks to credit supply and demand. The management of land tenure could be upgraded including through digitalizing the land registry. Growth-enhancing structural reforms could boost credit demand for bankable projects in the private sector, while digitalization could help enhance financial inclusion and literacy.

Authorities' Views

26. The authorities are planning to extend near-term support for borrowers and enhance monitoring. They concurred that interest payment relief and loan deferrals may need to be extended for viable firms as long as the border closure continues. They agreed that close monitoring is warranted, given risks that loan quality could deteriorate once extraordinary support measures are phased out.

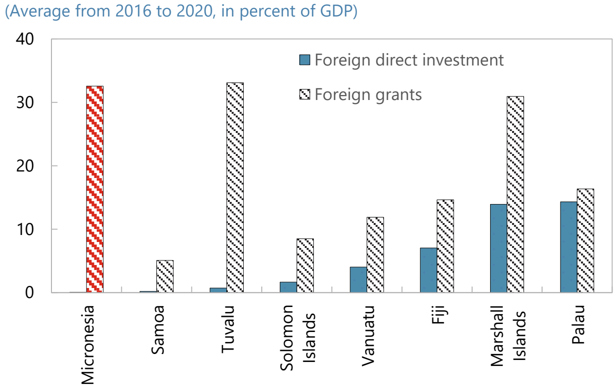
27. The authorities agreed that banking regulation and supervision should be strengthened to cope with the possible expiration of FDIC oversight. The authorities acknowledged the need to upgrade banking laws, adopt prudential banking regulations, and strengthen the supervisory capacity. They noted that the current banking laws only provides the FSMBB with a mandate to regulate deposit-taking banks. While highlighting differences in the business models of the non-deposit taking FSMDB and credit unions relative to traditional banks, they agreed that it would be beneficial to enhance monitoring of the FSMDB and credit unions through the FSMBB.

D. Charting A Stronger, Greener and More Sustainable Growth

28. Accelerating structural reforms to support private sector development remains a top priority. Besides its remoteness, small size, and geographical dispersion, the FSM's large public sector and cumbersome business operating environment remain obstacles to private sector development, including foreign direct investment (Figure 5). Reforms should be carefully sequenced to maximize impact and avoid overstretching limited implementation capacity (Text Table 4).

- The authorities should revisit the FY2023 Action Plan to implement targeted structural reforms. The FSM adopted the FY2023 Action plan in 2012, which lays out ambitious fiscal and structural reform agenda to help achieve the budgetary self-reliance and economic self-sufficiency after FY2023 as the economic and financial support under the Compact Agreement is set to expire. The plan, which is supported by the World Bank and the Asian Development Bank, prioritizes prospective sectoral reforms in information and communications technology (ICT), fishery, maritime, energy and sustainable niche tourism. Facilitating private sector development and

FDI and Foreign Grants in Pacific Islands Countries
(Average from 2016 to 2020, in percent of GDP)



Sources: World Economic Outlook; and IMF staff estimates.

economic diversification is critical to set the stage for a robust recovery from the pandemic and pursue sustainable and inclusive growth.

- The amendment of the Foreign Investment Act should be expedited. This should be complemented by reform efforts that help reduce business startup costs and time for settling disputes, lower the regulatory burden on FDI, improve the efficiency of the judicial process, enhance coordination across states, and establish a national single window system for trade and FDI.

- Efforts to improve governance should continue. Priorities should include the adoption and implementation of the national anti-corruption strategy, prevention measures to enhance the detection of corruption and conflicts of interest, and relevant legislative measures to enhance transparency.

29. Improved digital connectivity is essential to help overcome the FSM's geographical bottlenecks and expand economic opportunities (Appendix VI). The COVID-19 pandemic and international border closures have highlighted the need for improved ICT infrastructure. Improved digital connectivity will help enlarge economic opportunities by expanding business markets, boosting productivity, improving the efficiency of public service delivery, and enhancing financial inclusion. Supported by development partners, ICT infrastructure investment should be expediated with the objective of providing universal and affordable digital services throughout the nation. A clear digitalization strategy should be established and complemented by a roadmap to expand e-government and online transactions, develop a regulatory framework for data protection and cybersecurity, and increase digital literacy.

30. Giving FSM's vulnerability to climate change, accelerating efforts to build a climate resilient economy is urgent (Appendix VII). Capacity constraints and large financing needs for investment have constrained the FSM's climate adaptation and disaster preparedness. Looking ahead, improving climate resilience would help support the recovery from the pandemic crisis, boost the long-term growth potential, and mitigate climate disaster risks. In this context,

- An overarching National Adaptation Plan (NAP) and disaster resilience strategy should be swiftly developed and implemented.

- Improving access to climate finance will require efficient PFM and PIM to expedite project selection, approval, and execution. FSM needs to develop a strategy to enhance disaster risk management and prepare financing options, given the possible expiration of the post-disaster reconstruction assistance under the Compact Agreement in FY2023.

- There is scope to enhance climate mitigation efforts, including through the introduction of an excise tax on road fuels, a motor vehicle excise tax, and feebates. Renewable sources for power generation and the use of energy efficient vehicles and products could be further expanded, and the tax system could be reconfigured to create incentives for greenhouse gas emission reduction.

- The recent amendment of the FSM trust fund law, which mandates the fund to invest in clean and green portfolio only, sends a strong signal of the FSM's call for green and low-carbon development.

Text Table 4. FSM: Sequencing Structural and Financial Sector Reforms

	During COVID-19	Post COVID-19: Short term	Medium to Long Term
Financial Sector Policy	-Maintain near-term financial sector support, subject to close monitoring	-Continue to upgrade the legal and regulatory framework for banking supervision and its supervisory capacity. -Strengthen AML/CFT framework to secure U.S. dollar CBRs.	-Place FSMDB and credit unions under the FSMBB's regulation and supervision; -Address bottlenecks to credit supply and demand, while enhancing financial inclusion and literacy.
Private Sector Development		-Accelerate the amendment of the Foreign Investment Act	-Advance regulatory reforms to ease doing business; -Adopt and implement the national anti-corrruption strategy and relevant measures to improve governance and enhance transparency.
Digital Connectivity		-Strengthen PFM and PIM to expedite ICT infrastructure investment	-Develop a digitalization strategy, a roadmap to expand e-government, and a regulatory framework for data protection and cybersecurity; -Increase digital literacy.
Climate Change Policy		-Strengthen PFM and PIM to improve access to climate finance and accelerate climate adaptation investment	-Develop and implement an overarching National Adaptation Plan and disaster resilience strategy; -Prepare a strategy to enhance disaster risk management and financing options.

Source: IMF Staff.

Authorities' Views

31. **The authorities believed that promoting the private sector is key to economic growth**. The authorities have drafted amendments to the foreign investment bill. In consultation with four state governments, the national government is finalizing the details of the bill to simplify the FDI application process. The authorities aim to establish a one-stop shop and fast-tracking processing for priority sectors to help facilitate FDI inflows.

32. **The authorities agreed with the need to improve digital connectivity**. Given the constraint of available transportation among the islands in the nation, the authorities acknowledged the importance of enhancing digital connectivity for economic development. They noted that the ongoing digitalization project in partnership with the World Bank would expand internet access and

ensure affordability. The authorities expected the project to help boost online business transactions and enhance financial inclusion through mobile banking.

33. The authorities remained committed to strengthen climate resilience. They acknowledged challenges in developing the overarching climate and disaster risk strategy and accessing climate finance due to the capacity constraints. With the support from development partners, work on the national climate adaptation plan is in progress, and the joint state action plans are being updated. They also stressed the need to build climate-resilient infrastructure by setting minimum requirements for buildings through a revision of the National Building Code. The authorities acknowledged the importance of strengthening the natural disaster management, including the availability of contingency financing.

E. Other Issues

34. Data provision has serious shortcomings that significantly hamper surveillance. There is a need to improve the adequacy and timeliness of economic data to support effective policymaking. The FSM's Statistical Office and the Department of Finance and Administration are in ongoing discussions to address the delayed release of key statistics. Resuming tax data sharing between the two data agencies and ensuring the consistent flow of key inputs for statistic compilation to the relevant authorities will be critical for improving the compilation of key statistics. In this regard, the memorandum of understanding to ensure access of the statistical agency to administrative data should be revisited as needed and consistently implemented. Due to the lack of capacity, the FSM relies on an external consultant to produce and compile key economic statistics. Continued support from development partners to build FSM's own capacity to compile key statistics remains very important.

35. Technical assistance (TA) was halted in 2020 due to international travel restrictions and connectivity issues. The authorities expressed interest in TA on revenue administration, public financial management, banking supervision, and statistics, all areas that are critical for addressing the FSM's challenges. While the modalities of such TA should reflect the FSM's capacity constraints, strong ownership by the authorities would be key for advancing reforms.

Authorities' Views

36. The authorities appreciated IMF and PFTAC TA and requested continued support. They expressed a strong preference for in-person TA. The authorities intended to resolve the delays of national account statistics and would appreciate TA to strengthen their capacity to compile these statistics going forward.

STAFF APPRAISAL

37. The FSM has been successful in preventing the spread of the COVID-19, although the pandemic and related containment policies are putting strains on the economy. The government's health and economic policy responses have been effective and helped mitigate the economic impact of the pandemic. Economic activity declined sharply in FY2020 and the contraction in real GDP is expected to deepen in FY2021, followed by a slow recovery in FY2022. The fiscal and external balances are expected to remain in surplus. The overall external position is assessed to be broadly in line with fundamentals and desirable policy settings. The economic outlook remains subject to heightened uncertainty and risks are tilted to the downside. The FSM will likely face increasing fiscal risks with a possible fiscal cliff, rising debt, and declining trust fund assets, should the financial and public services support under the Compact Agreement set to expire. This has put the FSM at high risk of overall debt distress, though debt is assessed to be sustainable.

38. A continued coordinated policy response to address the effects of COVID-19 pandemic and support the economy remains the policy priority for the near term. The authorities' efforts to accelerate the vaccination pace is welcome and will help support the recovery. Until the recovery is firmly underway, supportive fiscal measures should remain in place and be targeted to sectors and households most affected by the pandemic slowdown to ensure inclusivity. Meanwhile, some of the most generous assistance schemes should be rationalized and tightened. To limit risks of inefficiency and leakage caused by the rapid scaling up of government spending, additional pandemic-related spending safeguards should be introduced, particularly the publication of the spending, procurement, and audit reports to ensure transparency and accountability. Existing commitments on public infrastructure investment should be executed expeditiously to help revive the economic activity and strengthen the recovery.

39. Gradual fiscal consolidation in the post-pandemic period is needed to reduce fiscal risks related to the possible expiration of Compact grants. A gradual fiscal adjustment could be implemented through both domestic revenue mobilization and expenditure rationalization. The establishment of the National Tax Reform Commission to strengthen the tax system is a welcome step, but timely and effective implementation of key tax reforms including the introduction of VAT will be crucial for success. Public financial management and public investment management reforms should be accelerated, to help identify further expenditure savings, enhance foreign aid effectiveness, and reduce leakages. Even if the Compact grants are renewed, some adjustments would still be beneficial to make the tax system and government spending more efficient and ensure progressing toward economic self-sufficiency and benefit future generations.

40. Near-term support for borrowers should remain in place. The FSM's financial sector has so far remained resilient. To limit permanent economic damage and support the recovery, policy measures such as interest payment relief and debt moratorium could be extended for viable firms. Nevertheless, close monitoring is warranted as the policy support may mask vulnerabilities.

41. Financial sector reforms should be accelerated. The authorities should continue to upgrade the legal and regulatory framework for banking supervision and its supervisory capacity. The FSMDB and credit unions should be placed under the supervision of the Banking Board to ensure effective supervision and prudent lending. The AML/CFT risk-based supervision should be strengthened to ensure banks' ability to comply with relevant international standards and secure U.S. dollar CBRs. To help ease credit supply bottleneck, the authorities should upgrade the management of land tenure including through digitalizing the land registry. Growth-enhancing structural reforms could further boost credit demand, while digitalization could help enhance financial inclusion and literacy.

42. Steadfast implementation of priority reforms is crucial to promote a stronger, greener, and more sustainable growth. Accelerating structural reforms to support private sector development remains a top priority. To improve the business climate and attract foreign investment, the amendment of Foreign Investment Act should be expedited. Reform efforts should focus on ease of doing business, improving governance, and enhancing coordination across states. Improved digital connectivity should help expand economic opportunities and improve the efficiency of public service delivery.

43. Strengthening the FSM's resilience to climate change requires speeding up adaptation, enhancing disaster preparedness, and developing a disaster resilience strategy. An overarching National Adaptation Plan and disaster resilience strategy should be swiftly developed and the joint state action plans reconciled. Stronger public financial management and public investment management should help improve access to climate finance and expedite project implementation. Given the possible expiration of the post-disaster reconstruction assistance under the Compact Agreement in FY2023, FSM needs to develop a strategy to enhance disaster risk management and prepare financing options.

44. Further capacity building is critical to address the FSM's challenges and enhance the macroeconomic management. The authorities' interest in continued technical assistance by the Fund in areas such as revenue administration, public financial management, banking supervision, and statistics is welcome. Strong ownership by the authorities is also essential for effective capacity development and advancing reforms.

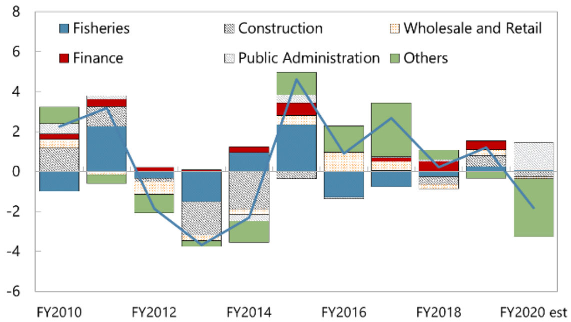
45. It is recommended that the next Article IV consultation take place on the current 24-month cycle.

Figure 1. Federated States of Micronesia: Real Sector Developments

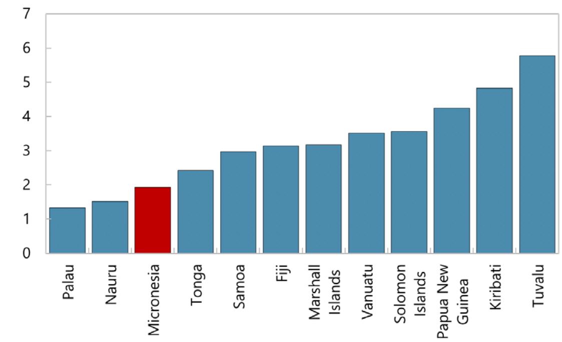
The FSM economy grew above its long-term average in the years prior to the COVID-19 pandemic.

While real GDP growth has lagged its peers,...

FSM: Contribution to Growth
(In percent)



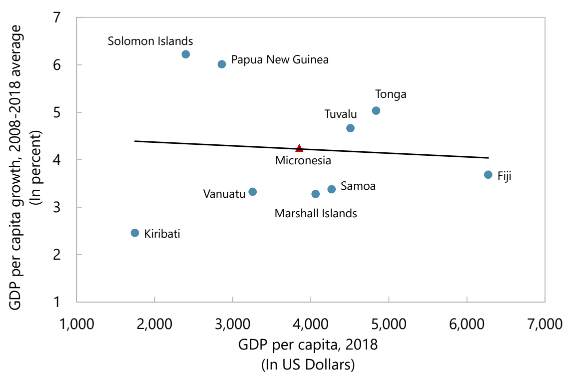
Real GDP Growth Rate
(Average annual growth rate of 2015-2019, in percent)



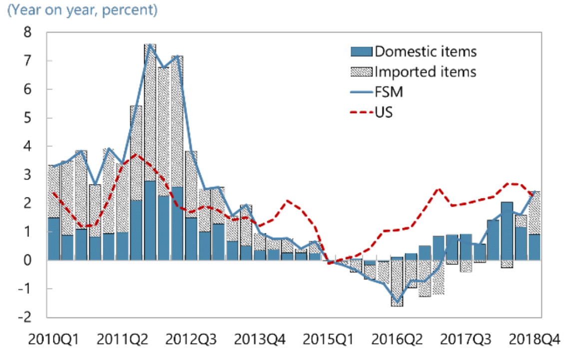
...per capita income has been comparable.

Inflation was contained due to low commodity prices.

Pacific Islands: Growth and GDP per capita



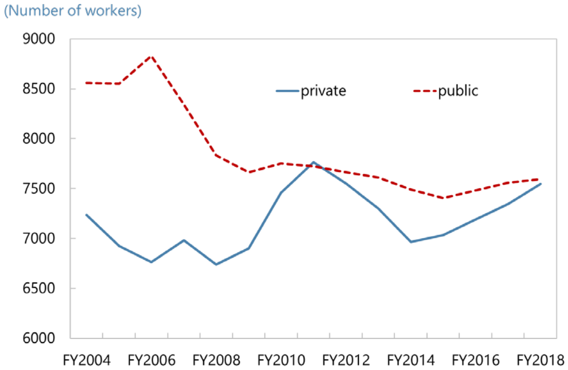
FSM: Inflation rate
(Year on year, percent)



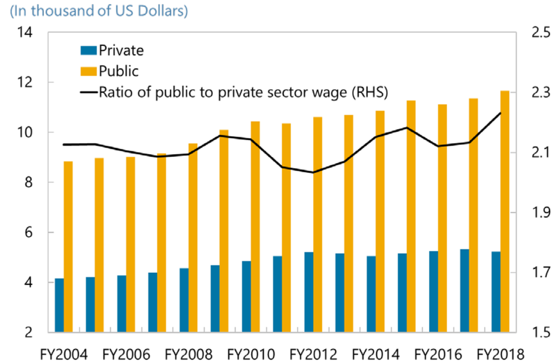
Public sector employment declined but remained relatively large...

... and large public-private wage gaps persisted.

FSM: Employment
(Number of workers)



FSM: Nominal Annual Wage
(In thousand of US Dollars)

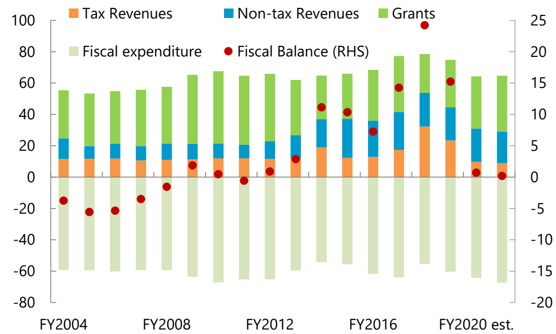


Sources: FSM authorities; IMF World Economic Outlook database; and IMF staff estimates and calculations.

Figure 2. Federated States of Micronesia: Fiscal Developments

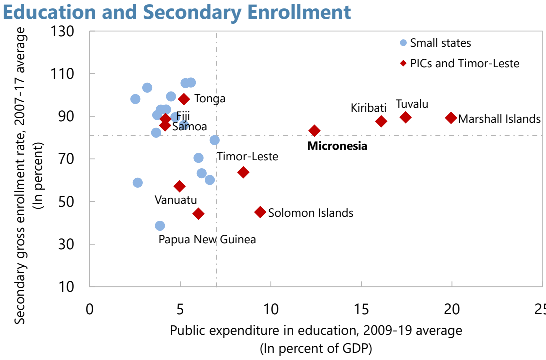
Fiscal balances have been in surplus thanks to revenue windfalls and foreign grants.

FSM: Fiscal Balance
(In percent of GDP)



Supported by the Compact grants, government spending on education was relatively high.

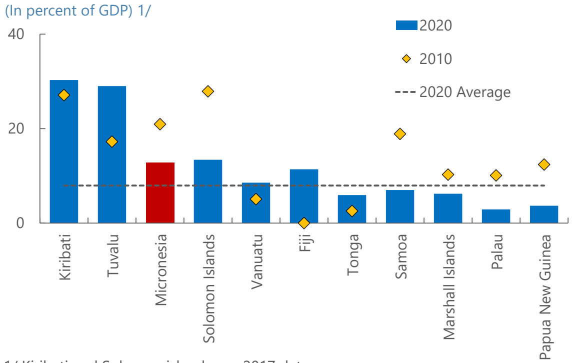
Pacific Islands & Small States: Public Expenditure in Education and Secondary Enrollment



Micronesia secondary enrollment data as of 2005.

Nevertheless, capital spending declined.

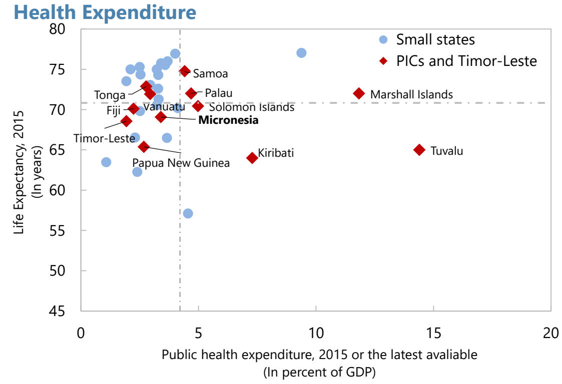
Government Capital Expenditure
(In percent of GDP) 1/



1/ Kiribati and Solomon islands use 2017 data.

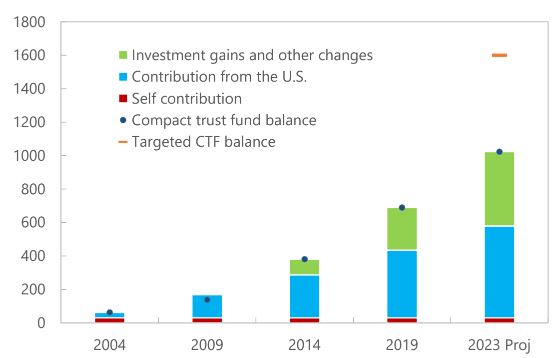
Health expenditure and outcomes remained weak.

Pacific Islands & Small States: Life Expectancy and Public Health Expenditure



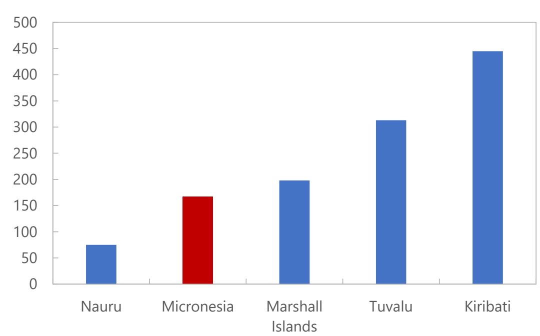
Compact trust fund (CTF) balances are likely to fall short of the 2023 target balance.

FSM: Compact Trust Fund Outstanding
(in millions of US dollars)



The CTF balance is low relative to peer economies.

Pacific Trust and Sovereign Funds
(In percent of GDP, Gratcheva and Emery (2021))

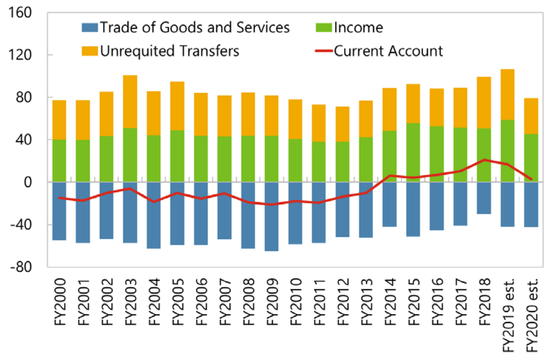


Sources: Country authorities, World Bank's World Development Indicator database, Gratcheva and Emery (2021), and IMF staff estimates.

Figure 3. Federated States of Micronesia: External Sector Developments

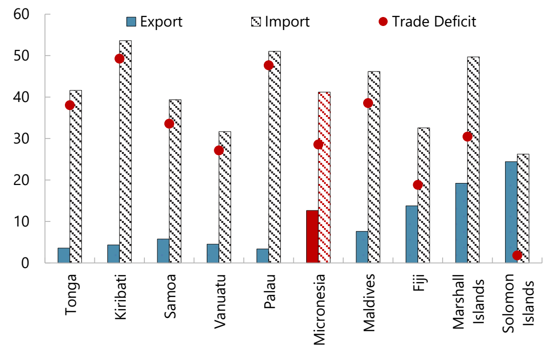
The current account balance registered a surplus in recent years, supported by rising fishing license fees, large foreign grants and corporate tax windfalls.

FSM: Balance of Payments
(In percent of GDP)



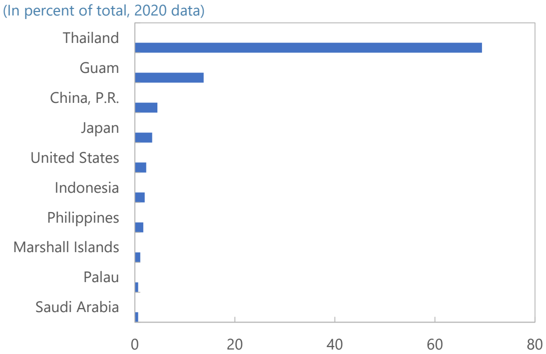
Limited exports and local production led to large trade deficits.

Trade Balances
(In percent of GDP, 2020 data)



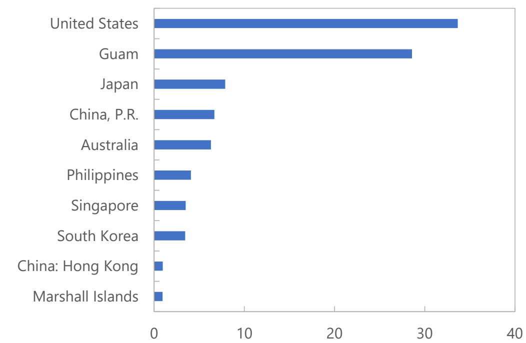
The FSM's main export partners are related to the fishing industry's supply chains.

FSM: Exports by Trading Partners
(In percent of total, 2020 data)



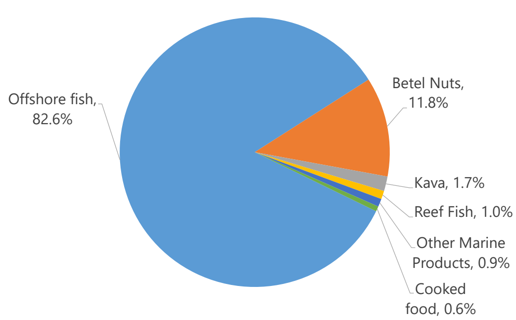
Imports come mostly from the United States and Guam, reflecting proximity and strong economic ties.

FSM: Imports by Trading Partners
(In percent of total, 2020 data)



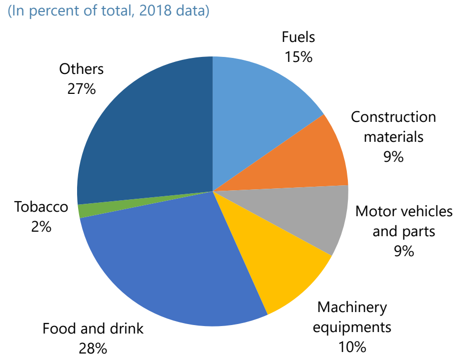
Offshore fish remains the FSM's primary export good.

FSM: Main Export Products
(In percent of total, 2018 data)



The FSM's import basket is diversified.

FSM: Main Import Products
(In percent of total, 2018 data)

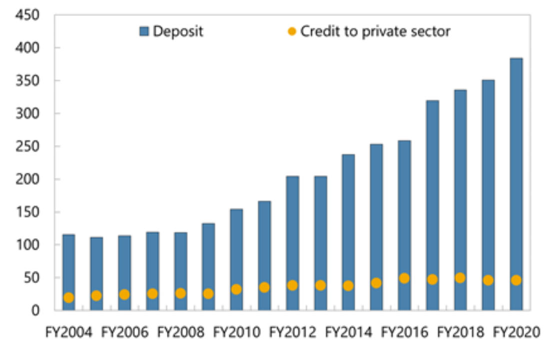


Sources: FSM Statistics, IMF Direction of Trade Statistics, IMF World Economic Outlook database, and IMF staff calculations.

Figure 4. Federated States of Micronesia: Monetary and Financial Sector Developments

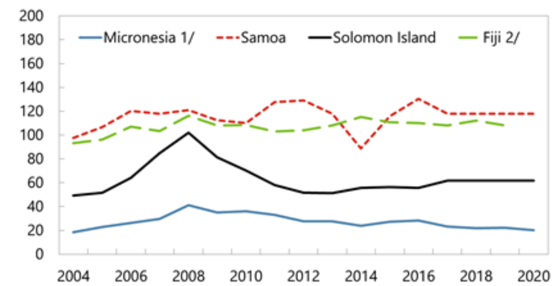
The FSM's bank deposits continued to grow, but loans were relatively flat.

FSM: Deposits and Credit to Private Sector
(In millions of U.S. Dollars)



As a result, the loan-to-deposit ratio declined further.

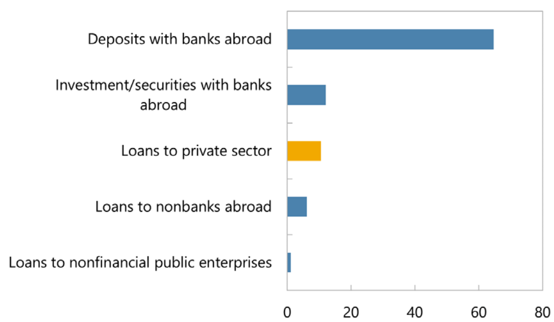
Loan-to-Deposit Ratio
(In percent)



1/ Loans include credit to private sector, non-financial public enterprises, and non-banks abroad.
2/ The latest available data for Fiji is in 2019.

Excess deposits were invested in deposits and investment securities with banks abroad.

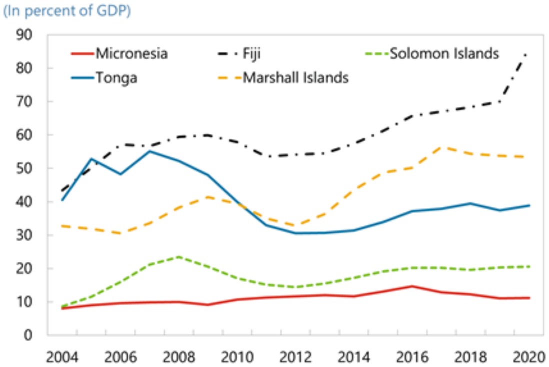
FSM: Major Components of Commercial Bank Assets 1/
(In percent of total assets, 2020 data)



1/ Comprises two commercial banks in FSM.

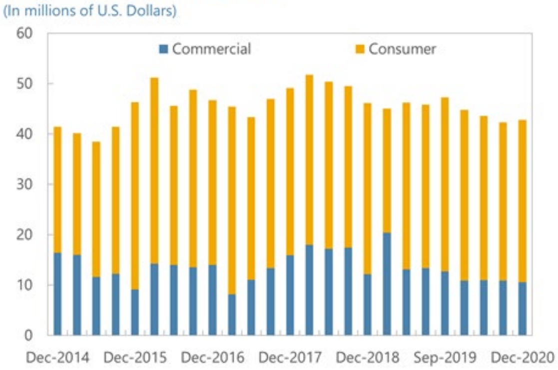
Financial deepening lags peers.

Credit to Private Sector
(In percent of GDP)



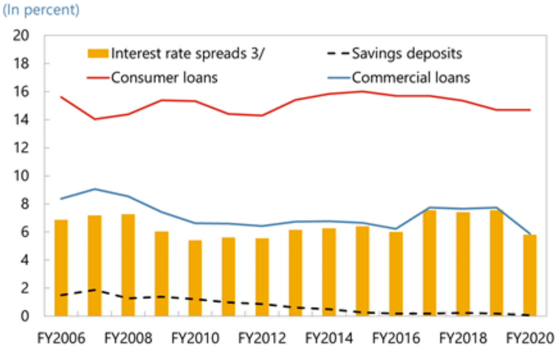
Domestic lending is dominated by consumer credit.

FSM: Private Loan Distribution
(In millions of U.S. Dollars)



High credit spreads continued to hinder access to credit.

FSM: Interest Rates
(In percent)



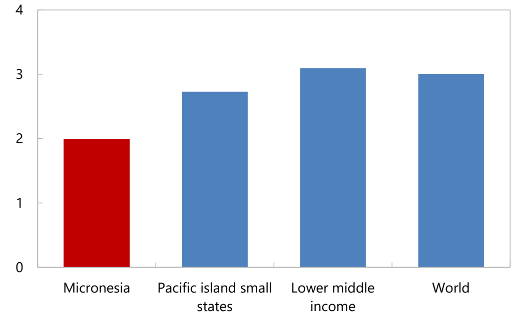
3/ Difference between interest rates for commercial loans and savings deposits.

Sources: FSM Banking Board, IMF World Economic Outlook database, and IMF staff calculations.

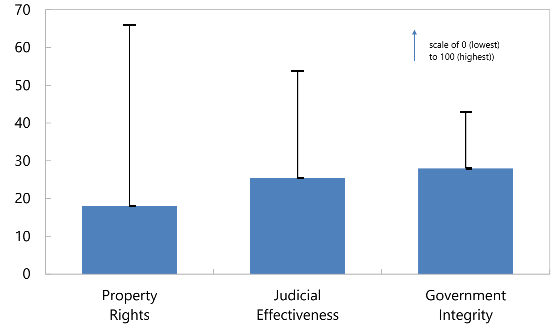
Figure 5. Federated States of Micronesia: Bottlenecks to Growth 1/

The FSM's structural bottlenecks remain large, including heavy regulatory burdens for businesses and weak institutions.

Business Regulatory Environment
(2017-2019 average, 1=lowest to 6=highest)

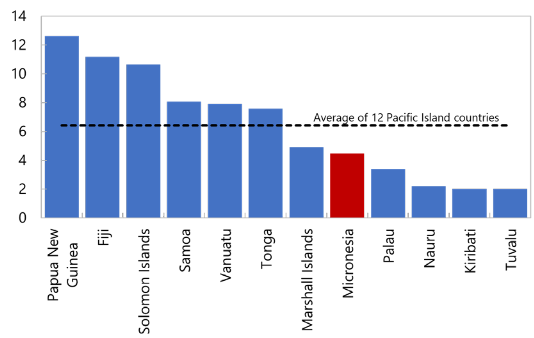


FSM: Rule of Law
(2019-2021 average, black line shows the score range for 8 Pacific Island countries)



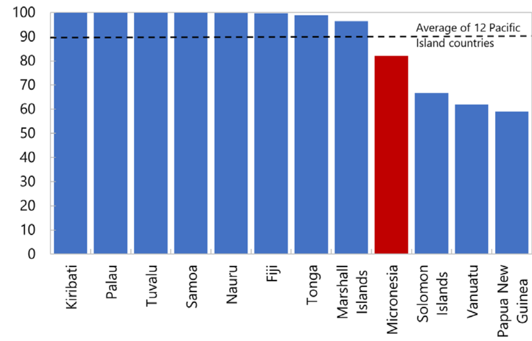
The FSM's geographical dispersion and remoteness hinders physical connectivity.

Liner Shipping Connectivity Index
(Maximum value = 100, 2019 data)



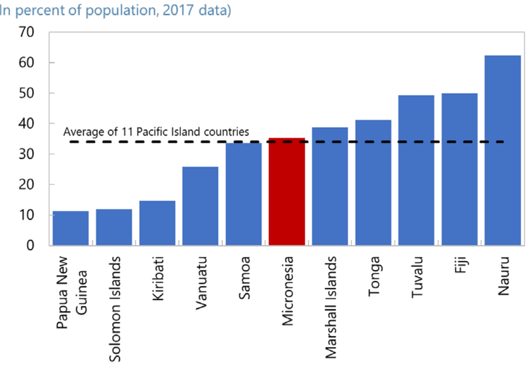
The availability of essential infrastructure lags peers.

Access to Electricity
(In percent of population, 2018 data)

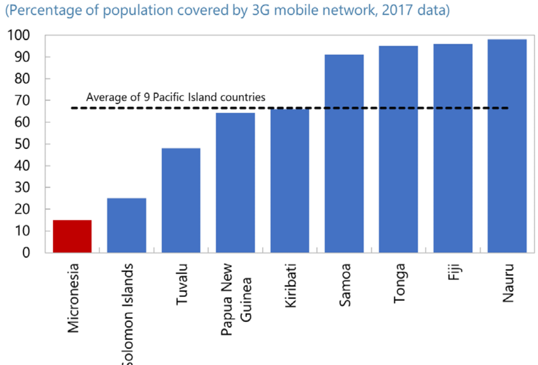


Digital and mobile technology could enhance the FSM's connectivity but the country is lagging in terms of access.

Individuals using the Internet
(In percent of population, 2017 data)



3G Mobile Network
(Percentage of population covered by 3G mobile network, 2017 data)



Sources: World Bank's Country Policy and Institutional Assessment (CPIA), World Development Indicator database, World Telecommunication/ICT Indicators database, and Terry Miller, Anthony B. Kim and James M. Roberts, *2021 Index of Economic Freedom* (Washington: The Heritage Foundation, 2021).

1/ The World Bank's CPIA assess the conduciveness of a country's policy and institutional framework to poverty reduction, sustainable growth, and the effective use of development assistance. The rule of law indicators are components of the Heritage Foundation's Economic Freedom Index, reflecting the country's business climate. Non-IMF indicators provide qualitative information about country policy and institutional framework. They do not represent the IMF's assessment of the quality of policies and institutions.

Table 1. Federated States of Micronesia: Selected Economic Indicators, FY2018-26 1/

Nominal GDP (FY2018): US$402 million
Population (FY2018): 104,286
GDP per capita (FY2018): US$3,854
IMF Quota: SDR 7.2 million

	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026
		Est.	Est.	Projections					
Real sector (annual percent change)									
Real GDP	0.2	1.2	-1.8	-3.2	0.6	3.2	1.9	0.8	0.6
Consumer prices	1.4	1.5	0.5	2.6	2.6	2.6	2.6	2.5	2.4
Employment	1.2	0.6	-1.2	-3.8	0.0	2.6	1.3	0.2	0.2
Public (incl. public enterprises)	0.5	…	…	…	…	…	…	…	…
Private	2.8	…	…	…	…	…	…	…	…
Nominal wages	1.1	…	…	…	…	…	…	…	…
Public average wage/private average wage	2.2	…	…	…	…	…	…	…	…
Consolidated government finance (in percent of GDP)									
Revenue and grants	79.7	77.7	69.3	72.8	67.7	64.6	57.2	54.7	54.8
Revenue	53.5	46.4	33.5	31.0	31.6	31.0	42.2	41.6	41.1
Tax revenue	32.2	25.5	12.3	11.3	11.4	11.2	11.2	11.1	11.1
of which: corporate income tax	21.0	14.9	2.4	3.0	2.9	2.7	2.5	2.4	2.4
Non-tax revenue	21.3	20.9	21.1	19.7	20.2	19.8	31.0	30.5	30.0
of which: Fishing license fees	18.0	17.5	17.8	16.3	16.9	16.5	15.4	15.3	15.1
Grants 2/	26.2	31.3	35.9	41.9	36.1	33.5	15.0	13.1	13.7
Expenditure	55.5	60.3	68.8	71.6	64.8	62.2	61.3	59.6	59.8
Expense	45.9	44.6	54.3	56.8	47.6	44.6	44.3	44.1	43.9
Net acquisition of nonfinancial assets	9.6	15.7	14.5	14.8	17.2	17.6	16.9	15.4	15.8
Net lending/borrowing	24.2	17.4	0.6	1.3	2.8	2.4	-4.1	-4.9	-5.0
Net lending/borrowing (excl. grants)	-1.9	-13.9	-35.3	-40.6	-33.3	-31.2	-19.0	-18.0	-18.7
Balance of trust funds 3/	211.1	230.5	263.7	317.3	335.1	344.3	329.2	318.6	309.4
Commercial banks (in percentage of GDP; end of period)									
Loans	12.3	11.1	11.2	10.8	11.5	11.7	11.9	12.1	12.3
Deposits	83.5	84.9	94.3	99.8	88.9	84.9	84.9	85.0	85.0
Interest rates (in percent, average for FY)									
Consumer loans	15.7	14.7	14.7	…	…	…	…	…	…
Commercial loans	7.6	7.8	5.9	…	…	…	…	…	…
Balance of payments (in millions of U.S. dollars)									
Trade balance	-128.5	-125.0	-117.8	-132.7	-128.5	-136.6	-130.0	-131.5	-135.2
Net services and income	18.6	-1.7	-8.5	-17.5	-7.5	-7.9	44.3	44.0	43.7
Private and official transfers	194.5	196.9	138.4	154.9	140.7	143.0	61.9	63.9	66.1
Current account	84.6	70.2	12.1	4.7	4.7	-1.5	-23.8	-23.6	-25.4
(in percent of GDP)	21.0	17.0	3.0	1.2	1.1	-0.4	-5.1	-4.9	-5.2
External debt (in millions of U.S. dollars; end of period)									
Outstanding stock	75.4	77.3	65.4	61.0	60.8	60.2	76.5	98.2	122.0
(in percent of GDP)	18.8	18.7	16.1	15.1	14.6	13.6	16.5	20.6	24.8
Memorandum items:									
Exchange rate regime 4/									
Real effective exchange rate 5/	105.8	107.7	106.3	…	…	…	…	…	…
Nominal GDP (in millions of U.S. dollars)	401.9	412.9	407.3	404.2	417.2	442.1	462.3	477.7	491.9

Sources: FSM authorities and IMF staff estimates and calculations.
1/ Fiscal year ends on September 30.
2/ Excludes contributions to the Compact Trust Fund.
3/ Compact Trust Fund and FSM Trust Fund.
4/ The U.S. dollar is legal tender and the official currency.
5/ Calendar year. 2010=100.

Table 2a. Federated States of Micronesia: General Government Operations, FY2018-26 1/
(In millions of U.S. dollars)

	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026
		Est.	Est.			Projections			
Revenue	320.4	320.7	282.5	294.4	282.3	285.6	264.5	261.3	269.5
Tax revenue	129.5	105.2	50.3	45.7	47.4	49.5	51.7	52.9	54.5
Wage and salary tax	9.1	10.0	10.7	7.5	7.7	8.2	9.6	9.9	10.2
Gross revenue tax	22.5	23.2	18.7	15.6	18.2	19.3	20.2	20.8	21.5
Corporate Tax	84.5	61.7	9.9	12.0	12.1	12.1	11.6	11.4	11.8
Import taxes	12.9	9.8	10.4	10.0	8.8	9.3	9.8	10.1	10.4
Other taxes	0.5	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.7
Grants 2/	105.2	129.3	146.2	169.2	150.6	148.3	69.3	62.7	67.5
Current	90.7	115.9	132.9	141.8	105.7	103.8	18.7	19.3	19.8
U.S. Compact sector grants	63.6	63.6	63.6	63.6	63.6	63.6	0.0	0.0	0.0
Other U.S. grants	17.2	17.3	29.6	40.2	17.6	17.7	5.6	5.8	5.9
Other	9.9	35.0	39.7	38.0	24.5	22.5	13.1	13.5	13.9
Capital	8.7	10.5	9.4	23.3	40.1	40.2	45.0	37.7	41.7
U.S. Compact sector grants	2.4	2.9	2.9	4.4	4.9	5.4	5.4	0.0	0.0
Other U.S. grants	6.3	6.4	6.4	6.6	11.1	6.9	6.8	7.0	7.2
Other	0.0	1.2	0.1	12.3	24.1	27.9	32.8	30.7	34.6
Other	5.8	2.9	3.9	4.1	4.9	4.3	5.6	5.8	5.9
Non-tax revenue	85.8	86.1	86.0	79.5	84.3	87.7	143.5	145.6	147.5
Fishing license fees	72.3	72.3	72.3	66.0	70.3	72.9	71.4	73.0	74.4
Dividend and interest income	0.4	0.4	0.4	0.4	0.4	0.5	0.5	0.5	0.5
Other nontax revenues	13.0	13.4	13.2	13.1	13.5	14.3	71.6	72.1	72.6
Distributions from trust funds	0.0	0.0	0.0	0.0	0.0	0.0	56.7	56.7	56.7
Other	13.0	13.4	13.2	13.1	13.5	14.3	15.0	15.5	15.9
Expenditure	223.0	248.9	280.1	289.2	270.5	275.1	283.3	284.5	294.0
Expense	184.5	184.2	221.0	229.5	198.7	197.1	204.9	210.8	216.1
Wages and salaries	74.5	76.6	75.5	74.9	77.4	82.0	85.7	88.6	91.2
Purchases of goods and services	94.9	91.3	98.9	87.7	90.5	95.9	100.3	103.6	106.7
Interest payments	0.9	1.8	1.9	1.9	2.0	1.9	1.8	1.9	2.1
Subsidies	0.2	0.3	15.2	10.2	5.3	0.4	0.4	0.4	0.4
Grants	4.4	4.5	4.5	4.4	4.6	4.9	5.1	5.2	5.4
Other expenses	9.5	9.7	24.9	50.3	18.8	12.1	11.6	11.0	10.3
Net acquisition of nonfinancial assets	38.6	64.7	59.0	59.7	71.8	78.0	78.3	73.7	77.9
Gross operating balance	135.9	136.5	61.4	64.9	83.7	88.4	59.6	50.5	53.4
Net lending/borrowing	97.4	71.7	2.4	5.2	11.8	10.4	-18.7	-23.2	-24.5
Memorandum items:									
U.S. Compact sector grants	66.0	66.5	66.5	68.0	68.5	69.0	5.4	0.0	0.0
Other U.S. grants	23.4	23.6	36.0	46.8	28.7	24.6	12.5	12.8	13.1
Net lending/borrowing excluding:									
Total grants	-7.8	-57.5	-143.8	-164.0	-138.8	-137.9	-88.1	-85.9	-92.0
U.S. grants	7.9	-18.4	-100.1	-109.6	-85.4	-83.2	-36.6	-36.0	-37.6
Balance of trust funds	848.6	951.6	1,074.1	1,282.3	1,398.4	1,522.0	1,541.5	1,541.5	1,541.5
Compact Trust Fund	636.1	689.5	783.9	957.3	1,042.2	1,133.0	1,133.0	1,133.0	1,133.0
FSM Trust Fund	212.5	262.1	290.2	325.0	356.2	389.0	408.5	408.5	408.5
Nominal GDP	401.9	412.9	407.3	404.2	417.2	442.1	462.3	477.7	491.9

Sources: FSM authorities and IMF staff estimates and calculations.

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

2/ Excludes contributions to the Compact Trust Fund.

Table 2b. Federated States of Micronesia: General Government Operations, FY2018-26 1/

(In percent of GDP)

	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026
		Est.	Est.			Projections			
Revenue	79.7	77.7	69.3	72.8	67.7	64.6	57.2	54.7	54.8
Tax revenue	32.2	25.5	12.3	11.3	11.4	11.2	11.2	11.1	11.1
Wage and salary tax	2.3	2.4	2.6	1.9	1.9	1.9	2.1	2.1	2.1
Gross revenue tax	5.6	5.6	4.6	3.9	4.4	4.4	4.4	4.4	4.4
Corporate Tax	21.0	14.9	2.4	3.0	2.9	2.7	2.5	2.4	2.4
Import taxes	3.2	2.4	2.6	2.5	2.1	2.1	2.1	2.1	2.1
Other taxes	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Grants 2/	26.2	31.3	35.9	41.9	36.1	33.5	15.0	13.1	13.7
Current	22.6	28.1	32.6	35.1	25.3	23.5	4.0	4.0	4.0
U.S. Compact sector grants	15.8	15.4	15.6	15.7	15.2	14.4	0.0	0.0	0.0
Other U.S. grants	4.3	4.2	7.3	10.0	4.2	4.0	1.2	1.2	1.2
Other	2.5	8.5	9.7	9.4	5.9	5.1	2.8	2.8	2.8
Capital	2.2	2.5	2.3	5.8	9.6	9.1	9.7	7.9	8.5
U.S. Compact sector grants	0.6	0.7	0.7	1.1	1.2	1.2	1.2	0.0	0.0
Other U.S. grants	1.6	1.5	1.6	1.6	2.7	1.6	1.5	1.5	1.5
Other	0.0	0.3	0.0	3.0	5.8	6.3	7.1	6.4	7.0
Other	1.4	0.7	1.0	1.0	1.2	1.0	1.2	1.2	1.2
Non-tax revenue	21.3	20.9	21.1	19.7	20.2	19.8	31.0	30.5	30.0
Fishing license fees	18.0	17.5	17.8	16.3	16.9	16.5	15.4	15.3	15.1
Dividend and interest income	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other nontax revenues	3.2	3.2	3.2	3.2	3.2	3.2	15.5	15.1	14.8
Distributions from trust funds	0.0	0.0	0.0	0.0	0.0	0.0	12.3	11.9	11.5
Other	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2
Expenditure	55.5	60.3	68.8	71.6	64.8	62.2	61.3	59.6	59.8
Expense	45.9	44.6	54.3	56.8	47.6	44.6	44.3	44.1	43.9
Wages and salaries	18.5	18.5	18.5	18.5	18.5	18.5	18.5	18.5	18.5
Purchases of goods and services	23.6	22.1	24.3	21.7	21.7	21.7	21.7	21.7	21.7
Interest payments	0.2	0.4	0.5	0.5	0.5	0.4	0.4	0.4	0.4
Subsidies	0.1	0.1	3.7	2.5	1.3	0.1	0.1	0.1	0.1
Grants	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Other expenses	2.4	2.4	6.1	12.5	4.5	2.7	2.5	2.3	2.1
Net acquisition of nonfinancial assets	9.6	15.7	14.5	14.8	17.2	17.6	16.9	15.4	15.8
Gross operating balance	33.8	33.1	15.1	16.1	20.1	20.0	12.9	10.6	10.8
Net lending/borrowing	24.2	17.4	0.6	1.3	2.8	2.4	-4.1	-4.9	-5.0
Memorandum items:									
Primary balance	24.1	17.0	0.2	0.9	2.5	2.0	-4.3	-5.1	-5.3
U.S. Compact sector grants	16.4	16.1	16.3	16.8	16.4	15.6	1.2	0.0	0.0
Other U.S. grants	5.8	5.7	8.8	11.6	6.9	5.6	2.7	2.7	2.7
Net lending/borrowing excluding:									
Total grants	-1.9	-13.9	-35.3	-40.6	-33.3	-31.2	-19.0	-18.0	-18.7
U.S. grants	2.0	-4.5	-24.6	-27.1	-20.5	-18.8	-7.9	-7.5	-7.6
Balance of trust funds	211.1	230.5	263.7	317.3	335.1	344.3	333.4	322.7	313.4
Compact Trust Fund	158.3	167.0	192.4	236.9	249.8	256.3	245.1	237.2	230.3
FSM Trust Fund	52.9	63.5	71.3	80.4	85.4	88.0	88.4	85.5	83.0
Public external debt	18.8	18.7	16.1	15.1	14.6	13.6	16.5	20.6	24.8

Sources: FSM authorities and IMF staff estimates and calculations.

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

2/ Excludes contributions to the Compact Trust Fund.

Table 3. Federated States of Micronesia: Balance of Payments, FY2018-26

	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026
		Est.	Est.			Projections			
				(In millions of U.S. dollars)					
Current account balance	84.6	70.2	12.1	4.7	4.7	-1.5	-23.8	-23.6	-25.4
Trade balance	-128.5	-125.0	-117.8	-132.7	-128.5	-136.6	-130.0	-131.5	-135.2
Exports, f.o.b.	47.2	59.6	53.1	53.3	65.0	71.0	73.6	76.0	78.3
Imports, f.o.b.	175.7	184.6	170.9	186.1	193.5	207.6	203.6	207.5	213.4
of which: petroleum products	31.1	32.0	21.1	35.6	45.9	58.4	52.7	54.4	56.0
Services account	8.3	-48.0	-54.9	-58.4	-51.9	-53.5	-55.3	-56.5	-57.5
Receipts	95.4	70.1	44.8	44.5	67.4	71.4	74.7	77.2	79.5
of which: travel	32.3	33.2	8.3	8.3	30.1	31.9	33.3	34.4	35.5
Payments	87.1	118.1	99.6	102.9	119.3	125.0	130.0	133.7	137.0
of which: freight and insurance	28.8	29.6	29.2	29.0	29.9	31.7	33.2	34.3	35.3
of which: transportation 1/	19.0	19.5	9.3	12.2	17.6	18.6	19.5	20.2	20.7
Income, net	10.3	46.3	46.4	40.9	44.4	45.6	99.6	100.5	101.2
Receipts	78.6	78.6	78.4	72.6	77.2	80.1	135.5	137.5	139.2
of which: fishing license fees	70.0	72.3	72.3	66.0	70.3	72.9	71.4	73.0	74.4
Payments	68.4	32.3	32.0	31.7	32.8	34.5	35.9	36.9	38.0
of which: foreign workers earnings	4.3	4.4	4.4	4.3	4.5	4.8	5.0	5.1	5.3
Transfers	194.5	196.9	138.4	154.9	140.7	143.0	61.9	63.9	66.1
Private	95.8	75.1	5.8	16.6	25.3	27.4	27.9	28.7	30.0
Inflows 2/	113.3	92.1	21.4	33.3	42.5	44.8	45.4	46.4	47.8
Outflows	17.4	17.1	15.6	16.7	17.2	17.4	17.5	17.7	17.8
Official	127.0	121.8	132.6	138.3	115.4	115.6	34.0	35.1	36.2
US Compact	63.6	63.6	63.6	63.6	63.6	63.6	0.0	0.0	0.0
Other	63.4	58.2	69.0	74.7	51.8	52.0	34.0	35.1	36.2
Capital account balance	19.6	21.3	20.2	33.9	46.1	50.4	55.4	47.9	51.8
Capital inflow	19.6	21.3	20.2	33.9	46.1	50.4	55.4	47.9	51.8
Compact Capital grants	2.4	2.9	2.9	4.4	4.9	5.4	5.4	0.0	0.0
Other	17.2	18.4	17.3	29.5	41.2	45.0	50.0	47.9	51.8
Financial account balance	136.4	91.5	32.3	38.6	50.8	48.9	31.6	24.3	26.4
Direct Investment (net)	-0.2	-0.2	-0.2	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3
Portfolio investment (net)	113.1	80.9	12.4	15.2	21.1	19.4	-9.8	-14.3	-14.8
Other investment (net)	23.5	10.8	20.1	13.9	30.0	29.8	41.7	38.9	41.5
Errors and Omissions	32.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
				(In percent of GDP)					
Current account balance	21.0	17.0	3.0	1.2	1.1	-0.4	-5.1	-4.9	-5.2
Trade balance	-32.0	-30.3	-28.9	-32.8	-30.8	-30.9	-28.1	-27.5	-27.5
Exports	11.7	14.4	13.0	13.2	15.6	16.1	15.9	15.9	15.9
Imports	43.7	44.7	42.0	46.0	46.4	47.0	44.0	43.4	43.4
Service	2.1	-11.6	-13.5	-14.4	-12.4	-12.1	-12.0	-11.8	-11.7
Income (net)	2.6	11.2	11.4	10.1	10.6	10.3	21.5	21.0	20.6
Receipts	19.6	19.0	19.2	18.0	18.5	18.1	29.3	28.8	28.3
of which: fishing license fees	17.4	17.5	17.8	16.3	16.9	16.5	15.4	15.3	15.1
Payments	17.0	7.8	7.9	7.8	7.9	7.8	7.8	7.7	7.7
Transfers	48.4	47.7	34.0	38.3	33.7	32.3	13.4	13.4	13.4
Private 2/	23.8	18.2	1.4	4.1	6.1	6.2	6.0	6.0	6.1
Official	31.6	29.5	32.6	34.2	27.6	26.1	7.4	7.4	7.4
Capital account balance	4.9	5.2	5.0	8.4	11.1	11.4	12.0	10.0	10.5
Capital grants	4.9	5.2	5.0	8.4	11.1	11.4	12.0	10.0	10.5
of which Compact capital grants	0.6	0.7	0.7	1.1	1.2	1.2	1.2	0.0	0.0
Financial account balance	33.9	22.2	7.9	9.6	12.2	11.1	6.8	5.1	5.4
Direct investment (net)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Portfolio investment (net)	28.1	19.6	3.1	3.8	5.1	4.4	-2.1	-3.0	-3.0
Other investment (net)	5.9	2.6	4.9	3.4	7.2	6.7	9.0	8.1	8.4
Errors and omissions	8.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Sources: FSM authorities and IMF staff estimates and calculations.

1/ Refers to passenger services transportation.

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

Table 4. Federated States of Micronesia: Deposit Money Banks, FY2015-20

(In millions of U.S. dollars, unless otherwise noted)

	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020
Assets and liabilities						
Assets	281.1	288.4	351.2	369.5	389.7	423.3
Foreign assets 1/	231.2	231.1	295.6	311.1	329.0	362.3
Claims on private sector	41.5	48.8	47.0	49.5	45.7	45.8
Consumer loans	31.1	35.3	34.5	32.2	32.4	31.4
Commercial loans	10.3	13.5	12.5	17.3	13.4	10.9
Claims on nonfinancial public enterprises	0.8	0.8	0.7	0.7	5.1	4.9
Others assets	7.6	7.6	7.9	8.2	9.8	10.4
Liabilities	281.1	288.4	351.2	369.5	389.7	423.3
Deposits	253.0	258.3	319.6	335.7	350.7	384.1
Of which: national government	57.9	62.2	60.2	71.4	82.7	80.5
Capital accounts	20.5	21.9	23.3	25.3	28.9	28.7
Other liabilities	7.6	8.2	8.3	8.5	10.1	10.4
Memorandum items:						
Loan/deposit ratio (in percent)	16.4	18.9	14.7	14.7	13.0	11.9
Deposits (percent change)	6.6	2.1	23.7	5.0	4.5	9.5
Loans (percent change)	11.2	17.7	-3.8	5.3	-7.6	0.2
Interest rates (percent) 2/						
Deposit rates						
Savings deposits 3/	0.3	0.2	0.2	0.2	0.2	0.1
CDs	0.6	0.4	0.4	0.4	0.3	0.1
Time Deposits	0.6	0.6	0.3	0.2	0.1	0.0
Loans rates 4/						
Consumer loans	16.0	15.7	15.7	15.4	14.7	14.7
Commercial loans	6.7	6.2	7.7	7.6	7.8	5.9

Sources: FSM authorities and IMF staff estimates and calculations.

1/ Includes loans to abroad.

2/ Calendar year average.

3/ Average rates offered by the deposit money banks.

4/ Average rates charged by the deposit money banks.

Table 5. Federated States of Micronesia: Vulnerability Indicators, FY2016-21

	FY2016	FY2017	FY2018	FY2019 Est.	FY2020 Est.	FY2021 Est.
Deposit money banks						
Deposits (in percent of GDP)	77.7	87.2	83.5	84.9	94.3	99.8
Deposits (Year-on-year percent change)	2.1	23.7	5.0	4.5	9.5	5.0
Loans (in percent of GDP)	14.7	12.8	12.3	11.1	11.2	10.8
Loans (Year-on-year percent change)	17.7	-3.8	5.3	-7.6	0.2	-5.0
Loan to deposit ratio (in percent)	18.9	14.7	14.7	13.0	11.9	10.8
Foreign assets (in percent of GDP)	69.6	80.6	77.4	79.7	88.9	...
Equity capital (in percent of total asset)	7.6	6.6	6.9	7.4	6.8	...
FSM Development Bank						
Loans (in percent of GDP) 1/	7.6	8.1	8.2	9.0	9.3	...
External indicators						
Exports (goods & services, y/y percent change)	7.3	19.6	29.8	-9.0	-24.6	0.0
Imports (goods & services, y/y percent change)	-2.1	7.5	0.8	15.2	-10.6	6.8
Current account balance (percent of GDP)						
Including official transfers	7.2	10.3	21.0	17.0	3.0	1.2
Excluding official transfers	-26.0	-25.1	-10.6	-12.5	-29.6	-33.1
Total external debt						
In millions of U.S. dollars	80.4	80.4	75.4	77.3	65.4	61.0
In percent of exports of goods and services	87.5	73.2	52.9	59.6	66.9	62.4
In percent of GDP	24.2	21.9	18.8	18.7	16.1	15.1
Debt service						
In millions of U.S. dollars	6.4	6.6	2.8	7.3	6.6	6.5
In percent of exports of goods and services	6.9	6.0	2.0	5.6	6.7	6.7
In percent of GDP	1.9	1.8	0.7	1.8	1.6	1.6

Sources: FSM authorities, FSMDB and IMF staff estimates and calculations.

1/ Loans are calendar year data.

Table 6. Federated States of Micronesia: Financial Soundness Indicators, 2017-20

(In percent)

	Dec-17	Jun-18	Dec-18	Jun-19	Dec-19	Jun-20	Dec-20
Capital adequacy							
Regulatory capital to risk-weighted assets	35.5	37.6	33.3	33.9	35.2	34.2	37.6
Regulatory Tier 1 capital to risk-weighted assets	35.5	37.6	33.3	33.9	35.2	34.2	37.6
Non-Performing Loans (NPL) net of provisions to capital	3.8	3.8	3.3	1.6	1.9	1.2	1.0
Asset quality							
NPL to total gross loans	0.4	0.4	0.3	0.2	0.3	0.6	0.1
Sectoral distribution of loans							
Residents	17.2	15.9	17.2	16.1	17.2	15.1	14.0
Deposit-takers	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Central bank	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial corporations	0.0	0.0	0.0	0.0	0.0	0.0	0.0
General government	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Nonfinancial corporations	16.9	15.7	15.4	14.5	15.6	13.7	11.7
Other domestic sectors	0.3	0.2	1.8	1.6	1.7	1.5	1.3
Nonresidents	82.8	84.1	82.9	83.9	82.8	84.9	87.0
Earnings and profitability							
Return on assets	1.1	1.6	1.8	2.0	2.0	1.2	0.9
Return on equity	15.2	23.1	25.6	27.0	26.2	15.5	13.3
Interest margin to gross income	84.1	86.4	87.0	87.0	86.6	86.5	85.1
Non-interest expenses to gross income	56.4	53.0	49.8	46.9	47.0	57.6	57.7
Personnel expenses to noninterest expenses	45.3	46.2	45.6	45.2	45.9	48.9	51.8
Liquidity							
Liquid assets to total assets	58.6	55.8	61.1	59.6	62.2	59.1	58.5
Other							
Capital to assets	6.2	5.8	6.0	6.0	6.1	6.0	5.6
Gross asset position in financial derivatives to capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross liability position in financial derivatives to capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Trading income to total income	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Customer deposits to total (non-interbank) loans	416.3	456.1	422.0	451.0	418.6	471.3	506.4
Foreign-currency-denominated loans to total loans	0.0	0.0	0.0	0.2	0.2	0.1	0.1
Foreign-currency-denominated liabilities to total liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial corporations (OFCs)							
OFC's financial assets to total financial assets	15.4	14.2	14.4	14.0	14.9	14.4	...
OFC's financial assets to gross domestic product	17.8	...	14.9	...	...	...	...

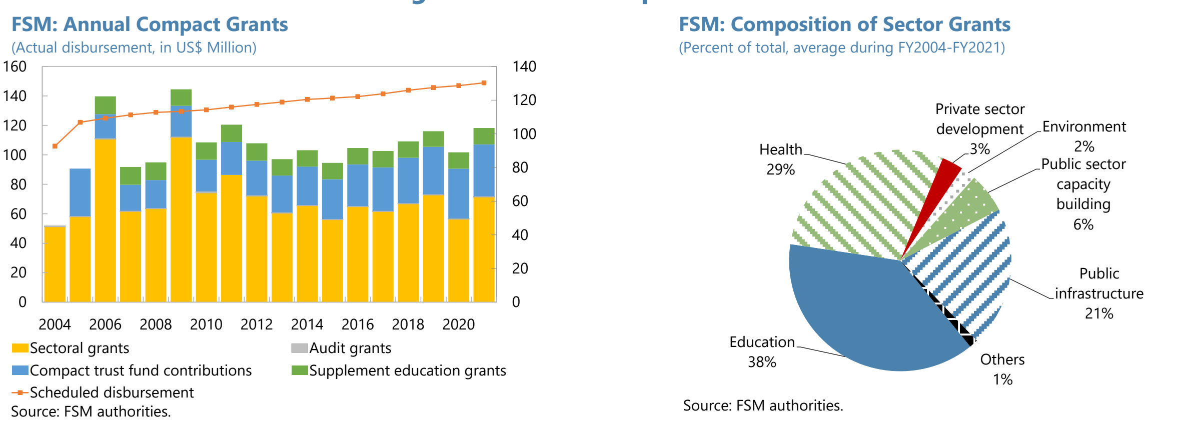
Source: IMF, Federated States of Micronesia: Technical Assistance Report-Financial Soundness Indicators Mission, June 2021. https://www.imf.org/en/Publications/CR/Issues/2021/06/02/Federated-States-of-Micronesia-Technical-Assistance-Report-Financial-Soundness-Indicators-50195

Appendix I. Compact of Free Association between the United States and the FSM and Post-FY2023 Arrangements[1]

1. The United States and the FSM signed the original Compact of Free Association (Compact) Agreement in 1986 and subsequently amended it in 2004. The Compact Agreement provides for the United States' responsibility for the security and defense of the FSM as well as the right of eligible FSM citizens to enter, study, and freely seek employment in the United States without visas.

2. In addition, the Compact Agreement provides the FSM with financial assistance and access to many U.S. domestic programs and other benefits. The key elements of financial assistance and other macro-critical public services include annual Compact grants, contributions to the Compact Trust Fund, and assistance for public services (Figure 1). These services include, for instance, special education programs, post-disaster relief and reconstruction by the Federal Emergency Management Agency (FEMA) and US Agency for International Development (USAID), deposit insurance and supervisory oversight for the Bank of FSM by the Federal Deposit Insurance Corporation (FDIC), among others. These elements are set to expire after FY2023[2].

Figure 1. FSM: Compact Grants



3. Under the Amended Compact, the Compact Trust Funds (CTFs) were established to contribute to economic advancement and long-term budgetary self-reliance by providing an annual source of revenue after FY2023. The CTFs are intended to be built up over 20 years until September 2023, and investment income from the CTFs would replace the annual Compact grants thereafter. The rules governing the CTFs only allow a yearly disbursement equal to the previous

[1] Prepared by Antoine Arnoud (APD).

[2] In addition, US postal services, civil aviation safety and economy programs and disaster preparedness and response programs will expire after FY2023 or will require reimbursement from the FSM. However, other programs may continue. These include weather services, telecommunication services, rural utilities service grants and loans, special education grants, tourism and marine resource related grants, single family housing loan program, public health and disease prevention grants, Department of Interior technical assistance grants, Department of Agriculture Technical assistance program, and access to the Pacific-American climate Fund.

year's investment return and up to the amount of Compact grants adjusted for inflation that will be disbursed in FY2023, approximately US$96 million or 22 percent of FY2023 GDP, in order to ensure a sustainable source of income and prevent the nominal value of the Funds to deplete over time. Alongside, the FSM created the FSM Trust Fund to ensure the long-term financial viability of the FSM and provide an additional source of revenue. The FSM Trust Fund is accumulated with unspent revenues from fishing license fees, fiscal revenue windfalls, and occasional foreign grants.

4. The renewal of the Compact Agreements between the U.S. and the FSM is being negotiated. Unless the Compact Agreement is renewed, the projected disbursements from CTFs are unlikely to provide sufficient fiscal revenue post FY2023. Assuming a 5 percent investment return, the projected disbursement from CTFs would amount to 11 percent of GDP in FY2024, compared to annual Compact grants of 22 percent of GDP projected for FY2023—the last disbursement prior to the expected expiration of the agreements. The post-FY2023 distributions from the CTFs are also subject to investment returns, which will result in large fiscal revenue volatility. On the other hand, the negotiation could lead to a scenario with continuation of the status-quo or a partial renewal of the existing arrangements. This would help alleviate fiscal pressures and risks to long-term fiscal sustainability (Box 1).

Appendix II. Main Recommendations of the 2019 Article IV Consultation

Fund Recommendations	Policy Actions
Fiscal policy	
Implement a gradual medium-term fiscal adjustment through growth-friendly measures, including tax policy reforms such as introducing a VAT, and rationalizing nonessential expenditure, while preserving spending on essential social spending.	**Partially implemented.** The authorities established the National Tax Reform Commission in July 2021 to conduct a study on the tax system in the FSM and identify options to expand the revenue base and avenues to reform the tax system. The findings and recommendations, including legislative proposals for consideration by the FSM Congress and State Legislatures, are expected by January 1, 2022.
Implement PFM reforms by upgrading PFM regulations and the IT system.	**Partially implemented.** The authorities adopted a PFM reform roadmap for FY2017–20 and passed the updated Financial Management Regulations in FY2019. Due to international travel disruptions caused by the pandemic, the process has been stalled since 2020.
Save revenue windfalls to build up the FSMTF.	**Partially implemented.** Revenue windfalls had been saved to the FSMTF in FY2019 and the first half of FY2020. However, owing to increased pandemic spending, contributions to the FSMTF have declined below the commitment in the FY2023 Action Plan.
Climate policies	
Develop an overarching National Adaptation Plan and a comprehensive disaster resilience strategy. Strengthen public investment management (PIM) to increase execution capacity of adaptation projects.	**Not implemented.**
Structural reforms, financial sector supervision, and statistics	
Strengthen banking sector supervision by upgrading the legal and regulatory framework for prudential supervision, strengthen monitoring of commercial banks, and develop a reform roadmap with actions needed to maintain financial sector stability and correspondent banking relationships. The FSMDB and credit unions should be placed under the supervision of the FSM Banking Board.	**Not implemented.** Work on upgrading the Banking Act supported by IMF and PFTAC TA has been underway before the pandemic but was disrupted by the extended border closure. It is expected that this work will resume after border reopening.

Fund Recommendations	Policy Actions
Improve access to finance through: i) using land lease as collateral; ii) strengthening business climate and enhancing financial literacy.	**Not implemented.**
Improve business and investment climate by lowering business license fees; reducing the time and cost for settling a commercial dispute; improving the quality of the judicial process; and digitalizing land registry.	**Not implemented.**
Clarify the FDI regime and reduce undue regulatory burdens. Upgrade the Foreign Investment Act to harmonize FDI laws and regulations across states, expand the list of national priority sectors, streamline licensing processes, and establish a national single window.	**Not implemented.**
Compile macroeconomic statistics in a timely manner.	**Not implemented.** Efforts to improve these statistics are ongoing with support from PFTAC.

Appendix III. External Sector Assessment[1]

Based on preliminary data and EBA-lite model results, the FSM's external position is assessed to be broadly consistent with the level implied by fundamentals and desirable policies. However, because of data gaps for FY2020, substantial uncertainty regarding the impact of the COVID-19 pandemic, as well as the FSM's heavy dependence on volatile foreign grants and fishing license fees, these results should be interpreted with caution. Gradual fiscal adjustment and structural reforms to promote private sector development and the diversification of the economy should help improve competitiveness and avoid a future worsening of the external balance, particularly if economic support under the Compact Agreement with the United States is not renewed after its possible expiration in September 2023.

1. External position. The current account balance has remained in a surplus in recent years, averaging over 13 percent of GDP during FY2016-FY2019, as the inflows of donor grants, fishing license fees and occasional corporate income tax windfalls helped finance a large trade deficit. The current account surplus is estimated to have narrowed to 3 percent of GDP in FY2020, mostly due to the normalization of corporate tax windfalls[2]. Since early 2020, the COVID-19 pandemic and related containment measures have severely disrupted international travel, leading to a sharp decline in services trade balance and remittances. At the same time, subdued domestic activity and a sharp fall in international oil prices helped contain imports. The FSM had a positive net international investment position (NIIP) of 154 percent of GDP at end-FY2018, mainly reflecting a large share of bank deposits invested abroad and the buildup of the FSM Trust Fund[3].

2. The external balance assessment (EBA)[4] suggests that the external sector position of the FSM is broadly consistent with the level implied by fundamentals and desirable policies.

- The underlying current account balance in FY2020 is estimated at a surplus of 2.1 percent of GDP after adjusting for the temporary effects of COVID-19 on oil balance, tourism, and remittance as well as a below-trend corporate tax revenue from investment companies domiciled in the FSM. The EBA-lite methodology estimates the FSM's current account norm, the level consistent with fundamentals and desirable policies with the envisaged expiration of the U.S. Compact grants, to be 2.6 percent of GDP. This implies a model-estimated current account gap of around -0.6 percent of GDP. The EBA-lite identified policy gaps of about 1.2 percent of GDP on account of the relatively tight fiscal stance vis-à-vis the rest of world. The negative

[1] Prepared by Fan Qi (APD).

[2] The corporate tax windfalls have originated from occasional sales of foreign assets by investment companies and associated profits. In FY2018, a one-off revenue windfall in corporate income tax accounted for nearly 21 percent of GDP.

[3] The NIIP does not include accumulated U.S. contributions to the Compact Trust Fund.

[4] The Real Effective Exchange Rate approach is not applied due to data limitations. This approach is also not suitable to address the structural break associated with the possible expiration of the U.S. Compact grants. Furthermore, the external sustainability approach is not applicable, due to the FSM's positive NIIP in both historical and projection years.

model residual of about 1.8 percent of GDP partly reflects structural factors and country-specific factors not included in the model.

- On balance, staff assesses the external position in FY2020 to be broadly consistent with the level implied by fundamentals and desirable policies, while noting the large uncertainties surrounding the model estimates and the special characteristics of the FSM economy. The FY2020 current account surplus was supported by official inflows from the Compact Agreement and the scaled-up grants from development partners in response to the COVID-19 pandemic. After the winding-down of COVID-19 related assistance and the possible expiration of the Compact grants, the current account balance would sharply turn into a deficit and the external sector positions would weaken without the recommended fiscal adjustment over the medium term. A gradual fiscal adjustment is warranted to help keep the current account in surplus post-FY2023, in line with the EBA-lite current account norm.

Micronesia Fed. States of: Model Estimates for 2020 (in percent of GDP)

	CA model
CA-Actual	**3.0**
Cyclical contributions (from model) (-)	-1.0
COVID-19 adjustor (+) 1/	-2.7
Additional temporary/statistical factors (+) 2/	0.7
Natural disasters and conflicts (-)	0.0
Adjusted CA	**2.1**
CA Norm (from model) 3/	**2.6**
Adjustments to the norm (+)	0.0
Adjusted CA Norm	**2.6**
CA Gap	**-0.6**
o/w Relative policy gap	1.2
Elasticity	-0.3
REER Gap (in percent)	**1.7**

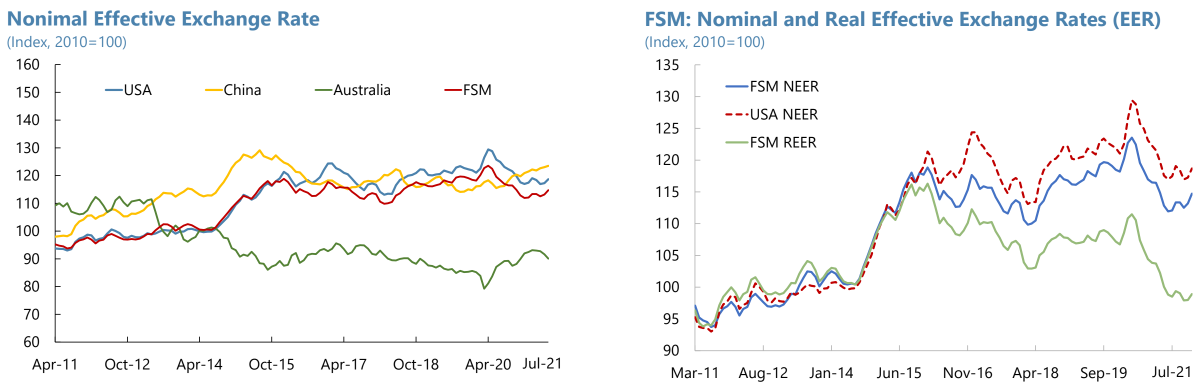
Source: IMF staff estimates.
1/ Additional cyclical adjustment to account for the temporary impact of the pandemic on oil balances (-5.7 percent of GDP), on tourism (1.9 percent of GDP), on remittances (1 percent of GDP).
2/ Additional temporary factor to adjust for a temporary reversal of revenue windfalls from investment companies domiciled the FSM.
3/ Cyclically adjusted, including multilateral consistency adjustments.

3. **Exchange rate regime.** The use of the U.S. dollar as the official currency is appropriate given the small size of the economy, close financial and trade linkages with the United States, and limited administrative capacity for independent monetary and exchange rate policies.

4. **Reserves.** The FSM does not have a central bank or foreign exchange reserves, but government deposits could play a role in absorbing short-term liquidity shocks. The national government's bank deposits were around 20 percent of GDP at end-FY2020, which corresponds to 3.6 months of imports and 4.4 months of general government current spending.

5. Competitiveness. The FSM's nominal and real effective exchange rates appreciated in FY2019 (Figure 1). In FY2020, the FSM's nominal effective exchange rate appreciated by 1.8 precent, following the trend of the U.S. dollar amid heightened global risk aversion since the onset of the COVID-19 pandemic. The FSM's real effective exchange rate was broadly unchanged in FY2020. In the first ten months of FY2021, the nominal and real effective exchange rates sharply depreciated by around 5 and 7 percent respectively. The current account gap in FY2020 implies an estimated REER gap of about 1.7 percent, applying a standard trade elasticity of 0.3. Looking ahead, swift implementation of structural reforms to promote private sector development and the diversification of the economy should help improve competitiveness and avoid a future worsening of the external balance, particularly if economic support under the Compact Agreement with the United States is not renewed after its possible expiration in September 2023.

Figure 1. Nominal and Real Effective Exchange Rates



Source: IMF staff estimates.

Source: IMF staff estimates.

Appendix IV. Risk Assessment Matrix[1]

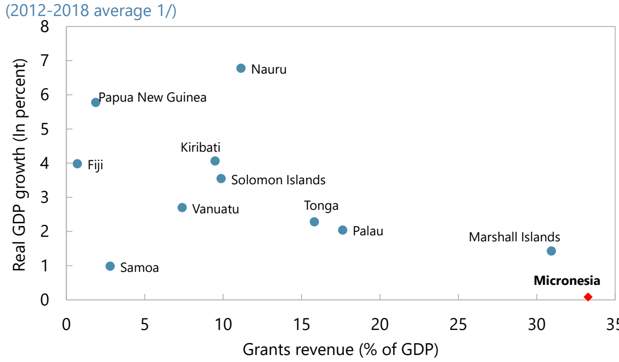
Source of Risk	Relative Likelihood	Source	Time Horizon	Expected Impact	Direction of Impact	Main Impacts → Recommended Policy Actions
Global resurgence of the COVID-19 pandemic	Medium	External	ST, MT	High	↓	As the access to and the deployment of vaccines in some countries could take longer than expected and the disease may prove harder to eradicate, further extensions of the border closure and mobility restrictions may be needed and would dampen economic activity. → Provide relief to vulnerable households and affected businesses.
Uncertainty surrounding the renewal of the Compact of Free Association (COFA)	Medium	Domestic, External	ST, MT	High	↓ ↑	Growth prospects and the fiscal position are weighed down by the uncertainty. An agreement on a new COFA between the FSM and the U.S. governments with favorable terms would help relieve fiscal pressures and enhance economic outcomes. → Mobilize domestic revenue, contain government spending pressures, and align spending with sustainable revenues.
Natural disasters and climate change	High	Domestic	MT	High	↓	Climate change can lead to a higher frequency and severity of natural disasters, damaging existing infrastructure and impairing activities especially agriculture and fishing. → Develop an overarching National Adaptation Plan, speed up implementation of adaptation investment projects, strengthen capacity for public investment management, and mobilize external grant financing.
De-anchoring of inflation expectations in the U.S. leads to rising core yields and risk premia	Medium	External	ST, MT	Medium	↓	Earlier than expected tightening by the Fed could trigger a front-loaded tightening of financial conditions and higher risk premia, resulting in losses of investment returns and lower the balances of trust funds over the medium-to-longer term. → Mobilize domestic revenue to reduce the reliance on the trust funds to finance government spending.
Delays in implementation of key structural reforms and infrastructure projects	Medium	Domestic	MT	High	↓	Slow implementation of growth-friendly structural reforms and infrastructure projects to address growth bottlenecks will depress potential growth. → Prioritize reforms to improve the business environment and facilitate private sector development.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("L" (low) is meant to indicate a probability below 10 percent, "M" (medium) a probability between 10 percent and 30 percent, and "H" (high) a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Appendix V. Foreign Aid Effectiveness[1]

1. Despite abundant foreign grants, FSM's economic performance lags its peers. During FY 2012-2018, FSM received approximately US$2.3 billion in foreign grants (about 33 percent of GDP annually), mainly through the U.S. Compact Agreement. Nevertheless, FSM's growth on average has been the lowest among the Pacific Islands countries.

Pacific Islands: Growth and Grants
(2012-2018 average 1/)



Sources: IMF WEO Outlook database; IMF GFS; and IMF staff calculations.
1/ 2013-2018 average for Tonga, and 2014-2018 average for Nauru and Papua New Guinea

2. Grant disbursements have been underutilized due to the weak implementation capacity. Difficulties to agree on priorities and coordinate projects between states and federal government, limited capacity to implement capital projects, as well as land disputes, have prevented or delayed implementation of some projects and left the FSM with a large amount of committed but unused capital grants. The governments' limited capacity also leads to inadequate maintenance and follow up actions, making the benefits of projects less sustainable. The lack of nationwide consensus further diminishes the benefits, as relevant agencies fail to receive sufficient support from sub-national governments for implementation. Other hurdles[2] include the lack of reliable performance data that prevents a proper assessment of the implementation progress, setting priorities, and improving performances, particularly in high-priority sectors such as the education and health. For example, FSM does not report data for public and private schools separately which would be useful to assess the efficiency of public expenditure.

3. A more effective and centralized mechanism for overseeing implementation should be adopted.

- *Performance indicators*: The resource or budget allocation should not only be anchored by the need of each economic sector but also its performance evaluation. For example, although expenditure in the education sector is relatively high (12.5 percent of GDP), net enrollment in primary education, at 85 percent, is much lower than in some peer countries. Data on other indicators, such as enrollment in secondary education or expenditure per student is not available. Similarly, expenditures in the health sector should be informed by outcome indicators such as mortality rates, immunization coverage, drug inventories, and hospitalizations. In this regard, the availability of timely and reliable data would enable the authorities to set the right

[1] Prepared by Antoine Arnoud (APD) and Shinya Kotera (OAP).

[2] United States Government Accountability Office, 2016, Compacts of Free Association, Issues Associated with Implementation in Palau, Micronesia, and the Marshall Islands, (Washington, D.C.: Apr. 5, 2016), GAO-16-550T; 2013, Compacts of Free Association, Micronesia and the Marshall Islands Continue to Face Challenges Measuring Progress and Ensuring Accountability, GAO-13-675.

priorities and allocate the resources where they are needed the most and utilized most effectively.

- *Monitoring system*: Grant utilization and implementation should be systemically monitored and assessed. Utilizing ICT technologies would also facilitate data compilation and monitor real-time progress. The FSM national government could step up its efforts for overseeing implementation and build a centralized long-term grant utilization strategy that integrates national and state priorities. The data and performance analysis should be shared among the relevant authorities and across the national and state governments. This should help build a consensus across different authorities and allow for concerted development actions.

- *Capacity constraints*: Human resources should be strengthened, especially for the local authorities, as most of the Compact grants go directly to the state governments. The lack of staff in divisions of the Office of Statistics in charge of oversight of the Compact implementation should be resolved. Improved communication with other institutions, such as the U.S. government and the Joint Economic Management Committee (JEMCO), as well as better trained personnel, should help enhance the efficiency of internal controls and financial accountability and help prevent waste of funds.

4. Strengthening public financial management (PFM) and public investment management (PIM) would be critical to enhance the effectiveness of foreign aids. PFM and PIM reforms, including regulations and IT systems, would help identify the higher priority projects and address the weakness in implementation capacity and expenditure efficiency. Areas for improvement should include initial diagnostic and project design, monitoring, and implementation. Instead of a manual and paper-based system, adopting digital technology can provide a shared digital platform, rationalize expenditure, help monitor the progress of projects, and enhance data collection. Building a common digital platform and formulating standardized practices across the national and states governments will improve nationwide coordination and speed up projects' execution.

Appendix VI. Unlocking Digital Potential[1]

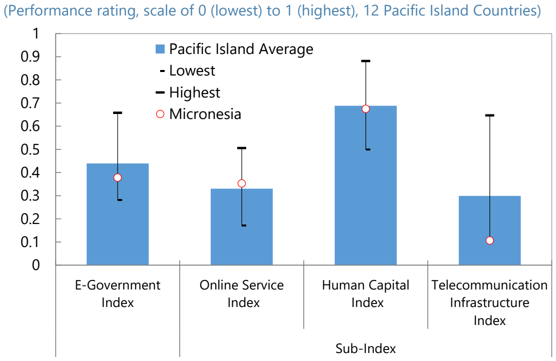
Despite its importance to connect people and promote growth opportunities, digitalization in the FSM is constrained by low network coverage and affordability. Efforts should be enhanced to expedite ICT infrastructure investment and adopt an overarching ICT plan to provide universal and affordable digital services.

1. **Given the FSM's remoteness and dispersion, improved digital connectivity is essential to help overcome its geographical bottlenecks and expand the economic opportunity.** The FSM is an archipelago of more than 600 islands. While its land area is small, it occupies more than 2.6 million square kilometers and disperses across a longitudinal distance of nearly 2,700 kilometers in the Northern Pacific Ocean. Challenges related to its small size, remoteness, geographical dispersion, and environmental fragility emphasize a critical need for connectivity infrastructure to connect people and businesses. The COVID-19 pandemic and international border closures highlight the need for improved infrastructure for information and communications technology (ICT). Improved digital connectivity will also help maximize economic opportunities, as digital connectivity has the potential to expand business markets, boost productivity, improve efficiency for public service delivery, and enhance financial inclusion.

Figure 1. FSM: Digitalization 1/

FSM: E-Government Index in 2020

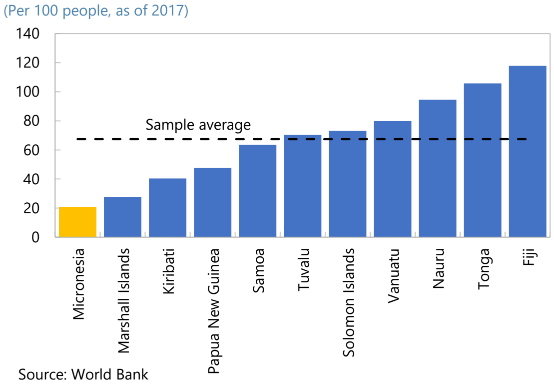
(Performance rating, scale of 0 (lowest) to 1 (highest), 12 Pacific Island Countries)



Source: United Nations

Mobile Cellular Subscriptions

(Per 100 people, as of 2017)



Source: World Bank

1/ The E-Government Development Index presents the state of E-Government Development, including the access characteristics, such as the infrastructure and educational levels, to reflect how a country is using information technologies to promote access and inclusion of its people.

2. **The FSM lags in connectivity infrastructure and digital literacy.** Access to internet and broadband remains low and the network performance in the FSM is poor, with only one third of the population using the internet, mobile penetration rate accounting for just 21 percent—the lowest among the Pacific Islands peers, and the fixed broadband subscriptions only around 3 out of 100 persons (Figure 1). According to the United Nations' (UN) International Telecommunication Union

[1] Prepared by Shinya Kotera (OAP).

(ITU, 2021), the connectivity costs in the FSM are estimated to be around 7 percent of monthly Gross National Income (GNI) per capita for fixed broadband and about 11 percent for mobile broadband. These estimates are significantly higher than the UN's target price of the entry-level broadband services which should be less than 2 percent of monthly GNI per capita. Existing digital infrastructure also has very low coverage for rural areas. The survey results by Redeker and Sturm (2019) suggest that ICT skills are relatively low and there is a large gap between gender and urban-rural areas, hindering the opportunity to tap digital's potential. The existing digital divide could also lead to rising inequality and social disparity.

3. Progress has been made to support ICT infrastructure development helped by development partners. In April 2018, the World Bank and Asian Development Bank provided financial assistance to support the construction of submarine cable systems to reduce the cost and increase the availability of international bandwidth for the FSM and other Pacific Island countries. In March 2020, the World Bank announced an additional grant of US$30.8 million or about 8 percent of GDP to improve the digital connectivity of the FSM. The project will help support the rollout of terrestrial fiber infrastructure, connect outer islands to basic broadband services, establish critical foundations for digital government services, and strengthen the legal and regulatory enabling environment for the digital economy in the FSM. In addition, the Telecommunications Act, enacted in 2014, liberalized the telecommunications sector and removed the monopoly of a state-owned incumbent operator, helping to facilitate competition among the network operators and service providers.

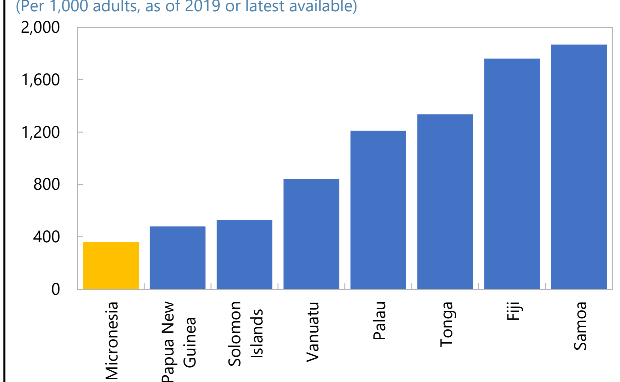
4. Digital transformation offers vast opportunities to support economic and financial development and improve government efficiency.

- **Digital identification and government platform.** The existing government transactional services are mostly manual and paper based, there is no standardized document management system, and data management is poor. A unique digital identity and digital identification platform could provide a secure way to prove identity and expand the use of digital fiscal tools. This would help enhance the delivery of government benefits, health services, as well as financial services, and promote the digital economy by facilitating compliance with Know Your Customer (KYC) regulation. A digital government platform could also help better target government spending, improve efficiency through online services, and raise higher revenue by reducing leakages and expanding the tax base.

- **Financial inclusion.** With only 8 branches from two commercial banks throughout the nation, financial access is very limited (see text chart) as residents from remote islands face difficulty reaching the banks physically. Improving digital connectivity can help enhance financial inclusion, as

Number of Deposit Accounts with Commercial Banks

(Per 1,000 adults, as of 2019 or latest available)



Source: IMF Financial Access Survey

remote technology can offer additional banking options including through digital banking and mobile wallets.

- **Economic opportunity.** The lack of sufficient infrastructure has hampered the FSM's readiness for E-commerce. Improved connectivity and widespread internet adoption could open up online business opportunity and enlarge domestic and international trade. Meanwhile, further trade facilitation could be introduced, such as a national single window system for customs, and upgraded screening equipments and process. The logistics ecosystem including cargo storage and warehousing facilities at air terminals and ports could be upgraded (PIF, 2020).

5. **Efforts should be made to expedite ICT infrastructure investment and adopt an overarching ICT plan to provide universal and affordable digital services.** Despite abundant financing for ICT infrastructure development, project implementation is often delayed due to weak implementation capacity. Enhancing public investment management and public financial management is therefore critical to advance digital connectivity investment. A clear digitalization strategy should also be developed, complemented by a roadmap to create an environment for the e-government and online transactions; a regulatory framework for privacy, data protection, cybersecurity and cybercrimes; and efforts to expand digital literacy.

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Appendix VII. Building a Climate Resilient Economy[1]

Enhancing climate resilience is an urgent task for the FSM, given significant climate change risks. Nevertheless, capacity constraints and large financing needs have constrained climate adaptation and disaster preparedness. Looking ahead, improving climate resilience would help support the recovery from the pandemic crisis, boost the FSM's long-term growth potential, and mitigate climate disaster risks. Efforts to develop a comprehensive disaster resilience strategy and strengthen public financial management and public investment management should be urgently enhanced.

Climate Risks and Impacts in the FSM

1. **The FSM is highly vulnerable to climate change and natural disaster risks.** The FSM has historically suffered a number of severe climate-related natural disasters—storms, floods, and droughts. Natural disaster risks induced by climate change will continue to rise. The Pacific-Australia Climate Change Science and Adaptation Planning Program (2014) projected that, FSM will increasingly be faced with a continuation of El Niño and La Niña events, rising temperature, more extreme rain events, a continuation of ocean acidification, increased risk of coral bleaching, and sea-level rise.

2. **Climate change will result in high macroeconomic costs.** Climate change will adversely affect the FSM by reducing crop productivity, changing the distribution of fishes, declining tuna catches, damaging tourism resources, and exacerbating human health (ADB, 2013). Impacts on agriculture and fisheries are especially critical for the FSM, due to their large share of labor utilization. The FSM's growth potential is projected to decline further to around 0.5 percent in the longer term in the absence of major structural reforms and rising climate change risks[2]. Given the uncertainty of the Compact arrangements post-FY2023, climate change may put additional stress on the FSM's fiscal positions in absence of disaster rehabilitation assistance through FEMA and USAID and additional foreign financing for reconstruction and disaster management costs and adaptation investment.

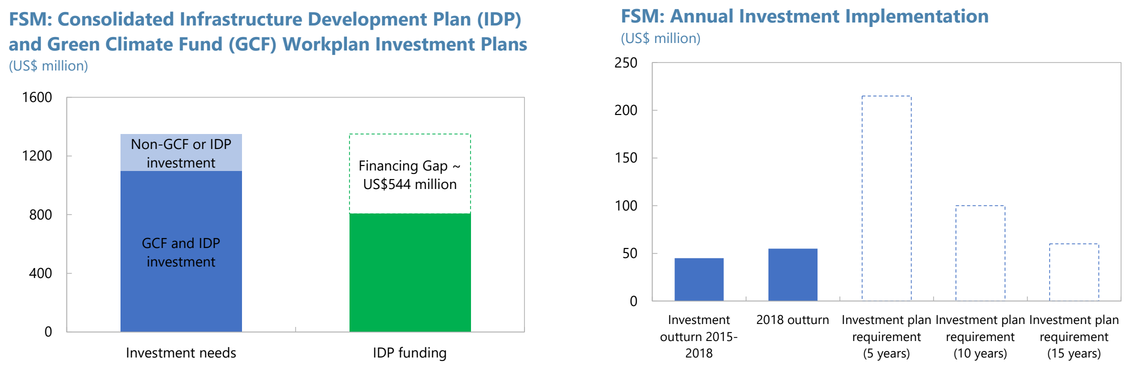
Challenges for Improving Resilience

3. **Improving climate resilience is a priority, but FSM needs to address large financing needs for adaptation investment.** According to IMF (2019b), the FSM has a financing gap of about \$550 million (137 percent of 2021 GDP) over the next 15 years between its ambitious climate change investment plan as envisaged in the Infrastructure Development Plan (IDP) 2016-2025 and Green Climate Fund (GCF) workplan, and currently available grant financing (Figure 1). Financing commitments so far include:

[1] Prepared by Shinya Kotera (OAP) based on the FSM's Climate Change Policy Assessment (IMF, 2019b).

[2] IMF (2019a) estimated 0.6 percent potential growth for the FSM, based on the annual average growth rate over the last two decades where the FSM experienced about eight natural disasters. While the likelihood of natural disasters per year was around 10 percent during 1980-1999, it increased to 40 percent during 2000-2019 and is expected to rise further in the longer term. The FSM's long-term potential growth is taken down further by 0.13 percentage point, incorporating an additional impact from rising climate change risks. The impact is calculated using the estimated impact of natural disasters on growth from Lee et al. (2018) and the updated probability of severe natural disasters from EM-DAT database. As a result, the FSM's potential growth rate is assumed to fall gradually from 0.6 percent in FY2029 and reach 0.47 percent in FY2041.

Figure 1. FSM: Investment Plans, Financing and Implementation



Sources: IDP (2016-2023), GCF workplan, and IMF (2019b)

Source: IMF (2019b)

- The FSM's first GCF project of US$ 9.4 million was announced in March 2021. The project aims to increase the resilience of food security to climate change by improving access to climate information, investing in climate-smart agriculture and livelihood practices, and developing agricultural markets and value chains.
- The World Bank approved US$ 40 million in May 2021 to improve climate resilience of the road network. The project will utilize spatial and sector planning tools including the asset management system, invest in climate resilient infrastructure, and strengthen the enabling environment.
- The Asian Development Bank (AsDB) established the Pacific Disaster Resilience Program in December 2017. In 2020, AsDB committed US$ 6 million from the program to support climate resilience in FSM.

4. **Hurdles to access climate finance remain large.** These include complex requirements and a lengthy and burdensome process for seeking national accreditation for direct access to international climate funds; project design and development hurdles; and the FSM's limited administrative capacity.

5. **Weak implementation capacity continues to be a major constraint for adaptation investment.** The implementation of investment projects has often been delayed due to limited implementation capacity. During the COVID-19 pandemic, the closure of international borders has restricted the movement of personnel and materials, thus halting most of the construction activities. The maintenance of existing infrastructure is also severely limited.

6. **Disaster risk management is another key challenge for the FSM, given the possible expiration of the assistance under the Compact Agreement in FY2023**. Under the Compact Agreement, the USAID and FEMA support the post-disaster reconstruction, which is currently the main self-insurance strategy for the FSM. Such assistance will expire after FY2023 if the Compact Agreement is not renewed. The FSM's Disaster Assistance Emergency Fund and Disaster Relief Fund have been established to facilitate disaster rehabilitation; nevertheless, the funds may not be sufficient if the reconstruction needs are significant.

Policy Priorities

7. **The FSM needs to develop an overarching National Adaptation Plan (NAP) and Disaster Resilience strategy.** An overarching NAP should reconcile the GCF workplan and the IDP. The NAP and disaster resilience strategy should prioritize the required infrastructure development and maintenance as well as necessary financial and institutional arrangements to respond to disasters.

8. **Public financial management (PFM) and public investment management (PIM) should be strengthened to accelerate adaptation investment**. Implementing adaptation investment would be highly beneficial in several aspects, including enhancing climate resilience, supporting the economic recovery from the pandemic, and boosting the longer-term potential growth rate. Strengthening PFM and PIM, especially for the local authorities, will be crucial to enhance coordination among stakeholders and project implementation. Improving access to climate finance requires the adequacy of PFM and PIM to expedite the project approval and disbursement. More training and establishing standardized practices and platforms across the FSM's states will also enhance project management and implementation capacity.

9. **There is scope to enhance climate mitigation.** The FSM's nationally determined contribution aims for a reduction in carbon dioxide (CO2) emissions by 28 percent below 2000 levels by 2025, in the energy and transport sectors. To meet its mitigation pledge, the FSM needs to expand renewables and reconfigure the fuel and carbon taxation system. With the support from the international community, progress has been made in the provision of renewable energy for power generation. The FSM could also reconfigure the tax system to promote energy efficient vehicles and products, including the introduction of excise tax on road fuels, a motor vehicle excise tax, and feebates on fuel-efficient vehicles and renewables (IMF, 2019b).

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INTERNATIONAL MONETARY FUND

FEDERATED STATES OF MICRONESIA

October 5, 2021

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

Asia and Pacific Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of August 31, 2021)

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

General Resources Account:

	SDR Million	Percent Quota
Quota	7.20	100.00
Fund holdings of currency	6.68	92.71
Reserve tranche position	0.53	7.30

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	11.71	100.00
Holdings	12.65	108.01

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to Fund[1]

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

	Forthcoming				
	2021	2022	2023	2024	2025
Principal					
Charges/Interest		0.00	0.00	0.00	0.00
Total		0.00	0.00	0.00	0.00

Exchange Rate Arrangement

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

Article IV Consultation

The Federated States of Micronesia is on a 24–month consultation cycle. The 2019 Article IV consultation discussions were held during June 4–17, 2019. The Executive Board discussed the staff report and concluded the consultation on August 28, 2019.

Technical Assistance: PFTAC, LEG, MCM, and STA have provided technical assistance on tax policy and administration, public financial management, banking supervision, financial soundness indicators compilation, and other statistics.

Resident Representative: The IMF Regional Resident Representative Office based in Suva, Fiji covers 12 IMF member countries in the Pacific, including the FSM. Ms. Leni Hunter is the current Resident Representative.

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

RELATIONS WITH OTHER IFIS

- World Bank Group: http://projects.worldbank.org/search?lang=en&searchTerm=&countrycode_exact=FM
- Asian Development Bank: https://www.adb.org/countries/micronesia/main

RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTER (PFTAC)

Background

FSM has been a modest user of PFTAC technical assistance (TA) in recent years. On average each year, six or seven TA missions are planned, but delivery has fallen short. At the onset of the COVID-19 crisis, delivery was low in FY2020 with just three of six planned missions delivered, two relating to financial sector reforms, and a GFS mission. Despite the temporary decline in direct TA delivery, FSM officials participated in and benefited from regional training events that all moved on-line from March 2020. Given the ongoing COVID-19 challenges, only one Government Finance Statistics (GFS) mission was delivered remotely in FY2021, with five other planned missions postponed at the authorities' request until a resumption of travel allows for in-person delivery. The experience of FSM in FY2021 was shared by the other six PFTAC member countries that are designed as Fragile or Conflict States (FCS), with their overall share of PFTAC resources falling from an average of 35 percent per year to less than 24 percent reflecting connectivity and remote delivery challenges, as well as shifting priorities arising from the crisis.

TA delivery to FSM is expected to rise substantially in FY2022, with plans to resume work on the new banking law; a long overdue tax administration diagnostic assessment plus follow-up TA; missions for both real sector statistics (GDP) and GFS; and missions planned under the PFM and Macroeconomic Analysis programs. The PFTAC workplan for FSM for FY2022 has been backloaded to the second half of the year on the expectation that regional travel may resume to facilitate in-person delivery as preferred by the authorities. However, if COVID travel restrictions are not lifted, the authorities should consider receiving the planned TA by remote engagement. Remote TA has been successfully provided to most other PFTAC members notwithstanding connectivity and other challenges.

PFTAC TA will support the authorities efforts to move towards long-term fiscal sustainability, building on the foundations laid by previous assistance and training:

- **In the PFM area,** the focus of past support has been to assist the authorities with implementation of their PFM roadmap, but most recently the authorities' efforts have been directed to the planning and implementation of a Financial Management Information System (FMIS) funded by the World Bank. Provision has been made in the workplan for an in-person mission late in FY2022 to help improve the coverage and quality of fiscal reporting, which is a priority identified in the PFM Roadmap.

- **Regarding tax administration,** the authorities have had a long-standing request for a diagnostic assessment that was rescheduled at the authorities' request and ultimately postponed due to the COVID-related travel restrictions. It was proposed that the diagnostic assessment be done remotely, however, in October 2020 the authorities requested this mission to be deferred until the review team can be in-country to meet and gather the information in person. Once completed, the findings will be crucial for finalizing follow-up assistance plans, which are tentatively expected to include support in developing a tax administration modernization plan, strengthening of core tax administration functions particularly with respect to maximizing the effectiveness of the new tax IT platform, and possible development of a Compliance Improvement Strategy.

In financial sector supervision, PFTAC continues to assist the Banking Board to enhance its regulatory framework for banks and providing training on supervision of key banking risks. The Banking Board and PFTAC initiated a Banking regulatory reform project in 2017, with a workshop providing advice on key components of banking law and regulations and undertaking a preliminary assessment of the banking regulatory framework. After some delays given constraints with availability of Legal experts in following-up from the workshop, a PFTAC/Legal (LEG) mission in June 2019 assisted the Banking Board to revise the banking law and regulations in line with international standards. The revision is pending and PFTAC has reached out to the Banking Board to finalize the amendments. In parallel, PFTAC arranged remote support in April 2020 to develop an outline and draft a suite of prudential standards, but progress is delayed given the challenges faced by the authorities who prefer in-person TA. The commencement of the banking reforms is likely to place additional burdens on the limited staff of the Banking Board that needs to be expanded. PFTAC stands ready to assist the Banking Commission if the work can be revived through remote support, or if travel resumes later in the year.

In the area of statistics, FSM implemented the enhanced General Data Dissemination System (e-GDDS) in July 2017, with support from the IMF’s Statistics Department. PFTAC will continue to provide annual capacity building training to allow for GDP compilation independent from the U.S. Graduate School, subject to staff resources remaining adequate in the FSM Statistics Office. This was most recently provided through a mission of the PFTAC real sector statistics advisor in April 2018, with missions planed in both FY2020 and FY2021 not materializing, but an in-person mission scheduled for late-FY2022. However, GDP compilation has become increasingly difficult as the Statistics Office no longer has access to administrative tax data due to confidentiality concerns.

The most recent GFS TA occurred in October 2020 when a remote mission provided hands on training to compilers on how to use source data (annual financial statements) to derive the annual GFS statement of operations, stock data for the balance sheet and the functions of government for the budgetary central government (BCG) and state governments.

In macroeconomics, there has been no recent direct assistance provided, although the authorities have participated in a successful regional workshop on the effective management of fishing revenues. Subject to confirmation of the authorities’ needs, provision has been made in the FY2022 workplan for an in-person Macro program mission to assist with development of a macro-fiscal model. Furthermore, the PFTAC Macro advisor is expected to collaborate with a TA training program for FSM officials launched by the IMF’s Institute for Capacity Development (ICD) and the Singapore Training Institute (STI).

STATISTICAL ISSUES

(As of September 20, 2021)

I. Assessment of Data Adequacy for Surveillance
General: Data provision has serious shortcomings that significantly hamper surveillance. While coverage of key macroeconomic data is broadly sufficient, data lags make it difficult to undertake an accurate and timely evaluation of economic developments on an ongoing basis. The most affected areas are national accounts and external sector statistics, where data are compiled annually with a lag of nearly one year.
National accounts: National accounts have been prepared, with the support of the U.S. Graduate School (USGS), dating back to FY1995. Annual GDP estimates based on the production and income approaches have been compiled and disseminated with a lag of about a year. GDP data have not been rebased for more than 10 years (current base year is FY2004). A national census was conducted in 2010, a household survey in 2013 and 2014 and an Integrated Agriculture Census in 2016. GDP estimates based on the expenditure approach are not compiled. Currently the production of GDP estimates is being constrained by the lack of sharing of tax data from the Finance Ministry, which delays the finalization of FY2019 GDP and increases the risk of interrupting GDP compilation from FY2020.
Employment: Data on employment and wages are available on an annual basis and classified by sectors based on the filings to the Social Security Administration. However, no unemployment data are available except for 2013 when the household survey was conducted.
Price statistics: A quarterly consumer price index (CPI) is published for the FSM and for each state. The CPI was recently rebased to 2017Q1 and utilizes expenditure weights derived from an earlier household survey. However, data releases are often delayed.
Government finance statistics: Fiscal data for the budgetary central government and 4 state governments have been prepared, with the support of U.S. Graduate School, going back to FY2004. Data are compiled in line with *Government Finance Statistics Manual 2014 (GFSM 2014)* based on annual audit reports of the budgetary central and 4 state governments. The fiscal accounts are consolidated between the national and state governments. However, government agencies and local governments (municipalities) are not covered. There is potential to expand the coverage to the general government by including extrabudgetary units of the central government and the social security funds as the source information is available from the annual financial statements. Financial information is also readily available for public corporations and compilation of public sector GFS may commence, taking into consideration local capacity.
Monetary statistics: The Banking Board compiles monthly monetary data with a three-month lag. The data comprise interest rates, the accounts of commercial banks, and the FSM Development Bank. The depository survey data are not compiled based on IMF's standardized report forms (SRFs), hindering international comparability. The FSM also reports some data and indicators of the Financial Access Survey (FAS), including the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).
Financial sector surveillance. The FSM started compiling Financial Soundness Indicators (FSIs) data in 2016 with a twenty-month lag. As a result of the FSIs technical assistance mission provided by STA in November 2020, the FSM is expected to report shortly quarterly FSIs in line with the 2019 FSI Guide and with an improved timeliness.

External sector statistics: The authorities have been compiling annual balance of payments and international investment position (IIP) statistics in broad conformity with the sixth edition of the *Balance of Payments and International Investment Position Manual (BPM6),* with assistance from the USGS since 2006. The balance of payments data are regularly published on the FSM Division of Statistics website and available up to FY 2018. Large errors and omissions in the balance of payments undermine the usability of these data for assessment of external sustainability. A PFTAC technical assistance mission in April 2018 recommended enhancements to the source data and estimation methods for re-exports of fuel, imports, travel credits/debits, personal transfers, interest payments, transactions and positions of direct and other investment liabilities to enhance the quality of the balance of payments and IIP. The mission noted the requirement of further TA and training covering the financial account, IIP, and external debt statistics.

II. Data Standards and Quality	
Participant in the Fund's General Data Dissemination System (GDDS) since November 2014. Implemented the enhanced GDDS (e-GDDS) in July 2017. The National Summary Data Page (NSDP) is available at: https://www.fsmstatistics.fm/fsm-national-summary-data-page-nsdp/[1]	Data ROSC is not available.

[1] Summary of dissemination practices under the eGDDS is available here: https://dsbb.imf.org/e-gdds/country/FSM/summary-of-dissemination

Federated States of Micronesia: Table of Common Indicators Required for Surveillance

(As of September 20, 2021)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates[1]	NA	NA	NA	NA	NA
International Reserve Assets and Reserve Liabilities of the Monetary Authorities	NA	NA	NA	NA	NA
Reserve/Base Money	NA	NA	NA	NA	NA
Broad Money	FY2018	Sep 2019	Q	Q	Q
Central Bank Balance Sheet	NA	NA	NA	NA	NA
Consolidated Balance Sheet of the Banking System	Dec 2018	Sep 2019	Q	Q	Q
Interest Rates[2]	FY2018	Sep 2019	A	A	A
Consumer Price Index	2018Q4	Sep 2019	Q	Q	Q
Revenue, Expenditure, Balance/Composition of Financing[3] General Government[4] and Central Government	FY2018	Nov 2018	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	NA	NA	NA	NA	NA
External Current Account Balance	FY2018	Sep 2019	A	A	A
Exports and Imports of Goods and Services	FY2018	Sep 2019	A	A	A
GDP/GNP	FY2018	Sep 2019	A	A	A
Gross External Debt	FY2018	Sep 2019	A	A	A
International Investment Position[6]	FY2018	Sep 2019	A	A	A

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

FEDERATED STATES OF MICRONESIA

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

October 5, 2021

Approved By
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Prepared by the staff of the International Monetary Fund and the International Development Association (IDA)[1,2]

Risk of external debt distress	High
Overall risk of debt distress	High
Granularity in the risk rating	Sustainable: Despite a continuous upward debt trajectory, the FSM's national assets including the FSM Trust Fund provide sufficient safeguards for debt sustainability.
Application of judgment	Yes: the forecast horizon informing mechanical risk signals is extended to 20 years to take account of the longer-term implications of a possible fiscal cliff in FY2023.

The Federated States of Micronesia (FSM) remains at high risk of debt distress under the Low-Income Country Debt Sustainability Framework (LIC DSF). The expected expiration of the U.S. Compact grants in FY2023 could result in a fiscal cliff. Under the baseline scenario without fiscal adjustment, the fiscal cliff would put debt on an upward trajectory from FY2024, with the external debt-to-GDP ratio reaching 44.2 percent in FY2031 and 81.1 percent in FY2041, and the public debt-to-GDP ratio reaching 45.1 percent in FY2031 and 82.3 percent in FY2041. As a result, the threshold of the present value of external debt-to-GDP ratio and the threshold of the public debt-to-GDP ratio are projected to be breached considering a 20-year horizon. While a mechanical

[1] The FSM's Composite Indicator of 1.67 indicates a weak debt-carrying capacity, based on the April 2021 IMF's World Economic Outlook (WEO) and the 2019 World Bank's Country Policy and Institutional Assessment (CPIA).

[2] This DSA has been prepared jointly by the IMF and World Bank, following the 2018 Guidance Note on the Bank-Fund Debt Sustainability Framework for Low Income Countries.

application of the DSF based on a 10-year forecast horizon would imply a moderate risk rating, the projected breach of the thresholds within a 20-year forecast warrants an assessment of high risk of external and overall debt distress. Debt is considered sustainable due to the availability of liquid assets, most importantly from the FSM trust fund. To lower the risk of debt distress and ensure debt sustainability, gradual fiscal consolidation, and steadfast structural reforms to promote private sector growth would be needed. The FSM's vulnerability to climate change and weather-related natural disasters constitutes a major risk and calls for strategies to strengthen climate change resilience.

PUBLIC SECTOR DEBT COVERAGE

1. **This Debt Sustainability Analysis (DSA) covers debt owed by the national and state governments of the FSM** (Text Table 1). As of May 2021, debt is primarily external and includes guaranteed debt from strategically important state-owned enterprises (SOEs). The legal framework in the FSM only allows for the central government on-lend to SOEs. There have been ongoing efforts by the authorities, supported by the FY2022 Performance and Policy Actions (PPAs) under IDA's Sustainable Development Finance Policy (SDFP), to enhance debt transparency, including reporting of both guarantees and non-guaranteed debt by SOEs. Against this background, the contingent liability stress test with default settings under the DSF is used to analyze public debt not covered by this DSA. The FSM uses the U.S. dollar as the legal tender and does not have a central bank. The external debt is defined based on the residency criteria.

Text Table 1. Coverage of Public Debt

	Subsectors of the public sector	Sub-sectors covered
1	Central government	X
2	State and local government	X
3	Other elements in the general government	
4	o/w: Social security fund	
5	o/w: Extra budgetary funds (EBFs)	
6	Guarantees (to other entities in the public and private sector, including to SOEs)	X
7	Central bank (borrowed on behalf of the government)	
8	Non-guaranteed SOE debt	

1	**The country's coverage of public debt**	The central, state, and local governments, government-guaranteed debt			
		Default		Used for the analysis	Reasons for deviations from the default settings
2	Other elements of the general government not captured in 1.	0	percent of GDP	0.0	
3	SoE's debt (guaranteed and not guaranteed by the government) 1/	2	percent of GDP	2.0	
4	PPP	35	percent of PPP stock	0.0	
5	Financial market (the default value of 5 percent of GDP is the minimum value)	5	percent of GDP	5.0	
	Total (2+3+4+5) (in percent of GDP)			7.0	

1/ The default shock of 2% of GDP will be triggered for countries whose government-guaranteed debt is not fully captured under the country's public debt definition (1.). If it is already included in the government debt (1.) and risks associated with SoE's debt not guaranteed by the government is assessed to be negligible, a country team may reduce this to 0%.

BACKGROUND ON DEBT

2. **The FSM's public sector debt declined to 15.4 percent of GDP at end-May 2021, from a peak of 30.7 percent of GDP in FY2009.** Most of the debt is concessional and is contracted with official lenders (Text Table 2). As of May 2021, about 70.5 percent of the debt is from the Asian Development Bank (AsDB). The share of the U.S. Department of Agriculture declined to 18.1 percent, from 27 percent in the previous DSA, due to principal repayments and some write-offs. The remaining debt (11.4 percent of total) comprises the European Investment Bank (EIB), a commercial private lender, and domestic entities. All loans except from the EIB are denominated in U.S. dollars. Because the FSM has been running budget surpluses and

principal repayments have been proceeding, public sector debt shows a downward trajectory since FY2009. Total external debt service reached 6.7 percent of exports in FY2020 and is expected to remain broadly stable over the medium term. Nevertheless, it would rise in the long run, as most concessional loans enter repayment periods.

Text Table 2. FSM: Stock of Debt owed by the National and State Governments

	End-FY2018	May-21		
	In millions of U.S. dollars 1/	In millions of U.S. dollars	As a share of total debt	In percent of GDP
Total public debt	88.1	61.8	100.0	15.3
External	83.7	61.1	98.9	15.1
Multilateral	53.4	44.0	71.3	10.9
Asian Development Bank	52.5	43.6	70.5	10.8
European Investment Bank	0.9	0.5	0.8	0.1
Bilateral	20.7	11.2	18.1	2.8
U.S. Department of Agriculture	20.7	11.2	18.1	2.8
Commercial	9.6	5.8	9.4	1.4
Telecom vendor	5.0	3.2	5.2	0.8
Petrocorp	4.6	2.6	4.2	0.6
Domestic	4.4	0.7	1.1	0.2
Memorandum item:				
of which: SOE debt 2/	31.2	17.5	28.3	4.3

Source: FSM authorities and IMF staff estimates and calculations.
1/ Debt stock at end-FY2018 in the previous DSA amounted to US$ 76 million. The data revision of debt stock at end-FY2018 was mainly due to improved accounting of debt statistics.
2/ SOE debt comprises those of European Investment Bank, U.S. Department of Agriculture, Telecom Vendor, and Petrocorp.

BACKGROUND ON MACROECONOMIC FORECASTS

3. **The fallout from the COVID-19 pandemic has resulted in an economic downturn in the near term, while fiscal and current account balances are expected to deteriorate from FY2024 onward as the Compact Agreement is expected to expire after FY2023 under the baseline projection** (Box 1). Amid the COVID-19 pandemic, growth is expected to be negative during FY2020 and FY2021. A gradual recovery is expected from FY2022, driven by a pick-up in domestic activities due to the reopening of the economy. Potential growth is estimated to gradually decline from 0.6 percent in the medium term to 0.5 percent in the longer term, weighed down by the likely impact of rising climate change risks. Inflation is projected to converge to 2 percent over the longer term, in line with the U.S. inflation. Due to the possible expiration of grants under the Compact Agreement with the United States in 2023, the fiscal and current account balances are projected to turn sharply into deficits from FY2024. Despite the near-term disruptions, these projections are broadly in line with the previous DSA that accompanied the 2019 Article IV staff report for the FSM. The financing mix envisages a combination of external debt and domestic debt. The realism tools suggest that macroeconomic and fiscal assumptions are broadly reasonable (Figure 3 and 4)[3].

[3] The changes in the contribution of fiscal account balance to debt during the projection periods are due to significantly lower corporate tax revenue projections, as opposed to the large revenue windfalls seen in recent years, as well as the expected expiration of the Compact grants. In addition, a gradual recovery in FY2022 is expected to be driven by a broad recovery of domestic activities in line with a border reopening, which will be more than offset the negative growth impact of fiscal tightening in FY2022.

Box 1. Federated States of Micronesia: Key Macroeconomic Assumptions

- **Real GDP growth** is projected to fall to -1.8 percent and -3.2 percent in FY2020 and FY2021 respectively, amid the COVID-19 pandemic and related containment policies. The FSM has made good progress in vaccination efforts supported by the United States, with about 61 percent of the eligible population fully vaccinated as of September 13. Herd immunity will likely be achieved by end-2021. A slow recovery is expected for FY2022, driven by a gradual border reopening. Potential growth is estimated to be 0.6 percent in the medium term, in line with the FSM's growth performance over the last two decades. The estimate also accounts for the likely impact of rising climate change risks, as the FSM has experienced an increased frequency in natural disasters during this period. Based on Lee et al (2018)[1], the FSM's high vulnerability to natural disasters and rising climate change risks warrants further downward adjustment for GDP growth by 0.13 percentage point in the longer run.

- **Inflation** was moderate in FY2020 owing to low energy prices and downward price pressures from subdued economic activity. Due to higher import prices including for commodities, inflation is expected to rise from FY2022 on but would converge to 2 percent in the long term in line with inflation in the United States (the U.S. dollar is the FSM's legal tender). The GDP deflator is assumed to move in tandem with inflation.

- **The fiscal balance** is projected to be in a small surplus during FY2020-23. A sharp rise in COVID-19 related spending is expected to be fully financed by foreign grants and fishing license fees. Nonetheless, unless the Compact Agreement or parts of it are renewed, the Compact grants from the United States amounting to 22 percent of GDP will expire in FY2023 and be replaced by investment returns accruing to the Compact Trust Fund, projected at around 11 percent of GDP in FY2024. The baseline projection assumes no fiscal consolidation efforts between FY2021 and FY2024 leading to a possible fiscal cliff starting in 2024. The longer-term fiscal revenue is also subject to large fiscal revenue volatility related to investment returns and declining fishing license fees due to uncertain weather patterns.

- **The current account balance** is projected to remain in a small surplus prior to FY2023, amid the normalization of some one-offs related to corporate tax revenue windfalls during FY2017-2018. Nevertheless, the current account balance would turn into a deficit of around 4 percent of GDP on average during FY2024 and FY2041, resulting from the possible fiscal cliff.

- **FSM Trust Fund.** The FSM Trust Fund is accumulated with unspent revenues from fishing license fees, fiscal revenue windfalls, and occasional foreign grants. The FSM Trust Fund balance stood at US$307 million or about 75 percent of GDP at the end of FY2020. Under the baseline, the balance of the fund will moderately increase to around 130 percent of GDP by end-FY2041, as the rate of investment return is assumed to be higher than nominal GDP growth rate and a drawdown from the FSM Trust Fund is not considered. This assumption is in line with the authorities' intention to continue building the trust fund beyond FY2023 for the benefits of future generations.

- **Financing mix.** With the fiscal balance remaining in surplus and grants still abundant, no new debt incurrence is projected until FY2023. For instance, the World Bank has provided sizeable financial support to the FSM (as at end-June 2021, net commitments stood at around 55 percent of GDP and total disbursements were around 15 percent of GDP) and, consistent with the IDA grant allocation framework, such support has been provided as grants. Beyond this, the paths of external and public debt are determined by projected fiscal deficits, GDP growth, interest rates for new debt, and the financing mix for fiscal gross financing needs. The financing mix envisages external project loans financing 80 percent of gross financing needs, while the remaining 20 percent is assumed to be financed by domestic borrowing from banks. Such domestic borrowing would unlikely crowd out private sector credit, given the very low loan-to-deposit ratio in the FSM. New foreign grants are not assumed for the baseline, other than those already committed.

FSM: Macroeconomic Assumptions

	Current DSA (2021 Article IV)				Previous DSA (2019 Article IV)			
	2020	2021	2022-23	2024-41	2020	2021	2022-23	2024-39
Real GDP (y/y growth)	-1.8	-3.2	1.9	0.6	0.8	0.7	0.6	0.6
Inflation (y/y growth)	0.5	2.6	2.6	2.1	2.0	2.0	2.0	2.0
Fiscal balance (percent of GDP)	0.6	1.3	2.6	-5.0	6.7	6.4	4.9	-5.3
Current account balance (percent of GDI	3.0	1.2	0.4	-4.6	2.6	2.4	2.2	-4.2

Sources: FSM authorities and IMF staff estimates and calculations.

[1] See Lee and others, 2018, "The Economic Impacts of Natural Disasters in Pacific Island Countries: Adaptation and Preparedness," IMF Working Paper No. 18/108.

COUNTRY CLASSIFICATION AND DETERMINATION OF SCENARIO STRESS TEST

4. **The FSM's debt carrying capacity is assessed as weak.** The country's Composite Indicator (CI) index is 1.67, based on April 2021 WEO and 2019 CPIA (Text Table 3). The CI indicates a weak debt-carrying capacity, similar to the previous vintage classification. The DSA thresholds applicable for the FSM are: 30 percent for the present value (PV) of external debt-to-GDP ratio, 140 percent for the PV of external debt-to-exports ratio, 10 percent for the external debt service-to-exports ratio, 14 percent for the external debt service-to-revenue ratio, and 35 percent for the PV of public debt-to GDP ratio.

Text Table 3. FSM's Composite Indicator and Applicable Thresholds

Calculation of the CI Index

Components	Coefficients (A)	10-year average values (B)	CI Score components (A*B) = (C)	Contribution of components
CPIA	0.385	2.738	1.05	63%
Real growth rate (in percent)	2.719	0.573	0.02	1%
Import coverage of reserves (in percent)	4.052	0.759	0.03	2%
Import coverage of reserves^2 (in percent)	-3.990	0.006	0.00	0%
Remittances (in percent)	2.022	7.427	0.15	9%
World economic growth (in percent)	13.520	3.078	0.42	25%
CI Score			1.67	100%
CI rating			Weak	

Applicable Thresholds

Applicable	
External debt burden thresholds	
PV of debt in % of	
Exports	140
GDP	30
Debt service in % of	
Exports	10
Revenue	14

Applicable	
Total public debt benchmark	
PV of total public debt in percent of GDP	35

5. **Given the severity and frequency of natural disasters in the FSM, a tailored stress test for a natural disaster shock is added to the standard set of stress test scenarios.** In the natural disaster scenario, a one-off shock of 10 percentage points to debt-GDP ratio in FY2021 is assumed, with real GDP growth and exports growth lowered by 5.0 and 3.5 percentage points, respectively, in

the year of the shock.[4] Shocks related to contingent liabilities are considered, using the default shock parameters, while the scenario with exchange rate depreciation is not considered as the U.S. dollar is the FSM's legal tender.

DEBT SUSTAINABILITY

A. External Debt Sustainability Analysis

6. **Under the baseline scenario, multiple debt indicators are projected to breach their respective thresholds after the standard projection horizon (2031).** Due to the loss of grants and the resulting current account deficits post FY2023, the ratio of external debt to GDP is projected to rise from 13.6 percent in FY2023 to 81.1 percent in FY2041. As a result, the PV of external debt to GDP ratio breaches its threshold from FY2034 onward, while the ratio of the PV of external debt to exports breaches its threshold starting from FY2038. The external debt path is projected to deteriorate relative to the previous DSA, due to the lower current account surpluses resulting from the negative impact of the COVID-19 pandemic in the near term and a faster rise in external borrowing over the medium- and longer-term[5]. The debt trajectory under the historical scenario is significantly different from that of the baseline scenario, as it does not reflect the possible expiration of the Compact grants and widening fiscal deficits after FY2023.

7. **Stress tests point to the vulnerability of the FSM's external debt dynamics to natural disasters and exports.** The FSM is highly vulnerable to natural disaster shocks, which would raise the PV of external debt-to-GDP ratio above the threshold five years earlier than in the baseline and lead to an explosive debt path. Among the standardized tests, export shocks would result in the highest PV of external PPG debt-to-GDP ratio, breaching its threshold seven years after the shock.

B. Public Sector Debt Sustainability Analysis

8. **Public sector debt follows closely the dynamics of external debt.** Due to the fiscal cliff, the fiscal deficit is expected to remain sizable from FY2024 onward. The ratio of public debt to GDP is projected to rise from 13.6 percent of GDP in FY2023 to 82.3 percent in FY2041. Reflecting a gradually rising share of domestic debt in the government financing mix, public debt rises faster than external debt. The PV of the public debt-to-GDP ratio breaches the threshold under the baseline starting in FY2035. Stress tests indicate vulnerability of public debt dynamics to growth.

[4] The size of the shock on GDP growth (-5.0 percent), which is larger than the default value of the DSF framework (-1.5 percent), is based on cross-country regression results of Lee and others, 2018, "The Economic Impact of Natural Disasters in Pacific Island Countries: Adaptation and Preparedness," IMF Working Paper No.18/108.

[5] The previous DSA assumed a distribution from the FSM trust fund of about US$20 million per year after FY2030. Nevertheless, the current DSA does not make this assumption as the authorities do not intend any withdrawal.

RISK RATING AND VULNERABILITIES

9. The FSM remains at high risk of external and overall debt distress. The DSA's mechanical external and overall debt-distress ratings are moderate, as none of the DSA thresholds is breached within the standard 10-year horizon. Nevertheless, following the DSA guideline, the horizon for the FSM is extended to 20 years, accounting for sizeable fiscal deficits and sharp increases of debt post-FY2023. The projected breach of the thresholds within a 20-year forecast warrants an assessment of high risk of external and overall debt distress. The stress tests highlight the FSM's debt vulnerability to shocks in exports, growth, and natural disasters. The high-risk rating underscores the urgent need to implement fiscal adjustments and broader structural reforms to boost growth, develop a strategy for climate change resilience, and improve debt management capacity.

10. The debt dynamics is assessed to be sustainable. Despite a continuous upward debt trajectory, the FSM's national assets including the FSM Trust Fund provides an additional safeguard for debt repaying capacity and debt sustainability. Reflecting the authorities' intention, drawing from the FSM Trust Fund is not considered as part of the FSM's financing strategy. However, the trust fund remains a significant part of the national assets, thus facilitating the authorities' capacity to repay the public debt. Overall, steadfast fiscal adjustment and continued grant disbursements to support the FSM's large development needs would be necessary to keep debt on a sustainable path.

11. The future assessment of the risk of debt distress will critically depend on the outcome of the Compact renegotiation, including the size, composition, and duration of any grant support. The renewal of the Compact Agreements between the U.S. and the FSM will not be known before 2022. The continuation of grant support would help alleviate fiscal pressures and risks to long-term fiscal and external debt sustainability.

AUTHORITIES' VIEWS

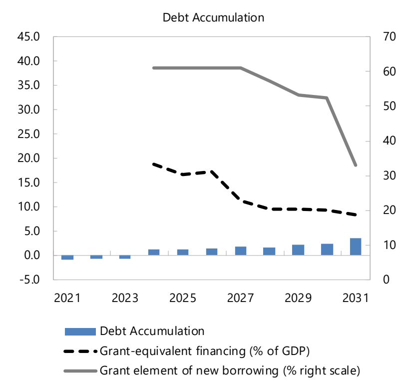
12. The authorities agreed with Staff's assessment that FSM remains at high risk of debt distress. They supported the use of a 20-year forecast horizon due to the pressure that the end of the Compact grants would put on the debt trajectory after FY2023. They emphasized that the government is unlikely to be able to borrow more than 10 percent of financing needs domestically after FY2023.

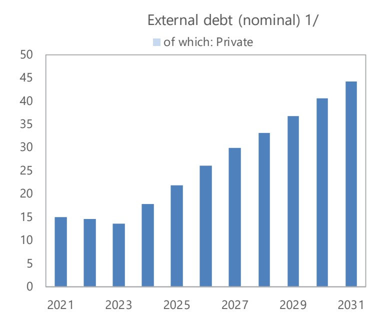
Table 1. Federated States of Micronesia: External Debt Sustainability Framework, Baseline Scenario, 2020-2041

(In percent of GDP, unless otherwise indicated)

	Actual	Projections								Average 8/	
	2020	2021	2022	2023	2024	2025	2026	2031	2041	Historical	Projections
External debt (nominal) 1/	16.1	15.1	14.6	13.6	17.8	21.9	26.0	44.2	81.1	23.6	26.7
of which: public and publicly guaranteed (PPG)	16.1	15.1	14.6	13.6	17.8	21.9	26.0	44.2	81.1	23.6	26.7
Change in external debt	-2.7	-1.0	-0.5	-1.0	4.2	4.1	4.1	3.7	3.1		
Identified net debt-creating flows	-2.7	-0.6	-1.2	0.0	5.0	4.9	5.1	4.8	4.8	-3.3	3.3
Non-interest current account deficit	-3.4	-1.6	-1.6	-0.1	4.8	4.5	4.8	4.6	3.6	-3.3	3.0
Deficit in balance of goods and services	42.4	47.3	43.2	43.0	40.1	39.4	39.2	37.5	34.7	45.6	40.1
Exports	24.0	24.2	31.7	32.2	32.1	32.1	32.1	32.1	32.1		
Imports	66.4	71.5	75.0	75.2	72.2	71.4	71.2	69.5	66.7		
Net current transfers (negative = inflow)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
of which: official	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Other current account flows (negative = net inflow)	-45.9	-48.9	-44.8	-43.1	-35.3	-34.8	-34.4	-32.9	-31.1	-48.8	-37.1
Net FDI (negative = inflow)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Endogenous debt dynamics 2/	0.7	1.0	0.4	0.0	0.1	0.3	0.3	0.2	1.2		
Contribution from nominal interest rate	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4	1.5		
Contribution from real GDP growth	0.3	0.5	-0.1	-0.4	-0.2	-0.1	-0.1	-0.2	-0.4		
Contribution from price and exchange rate changes	-0.1	...	...	...	...	...	...	...	...		
Residual 3/	0.0	-0.4	0.6	-0.9	-0.7	-0.8	-1.0	-1.1	-1.7	2.0	-0.8
of which: exceptional financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Sustainability indicators											
PV of PPG external debt-to-GDP ratio	14.3	13.5	12.5	11.1	11.9	12.7	13.8	23.1	56.7		
PV of PPG external debt-to-exports ratio	59.4	55.8	39.2	34.3	36.9	39.7	43.1	71.9	176.7		
PPG debt service-to-exports ratio	6.7	6.7	5.6	5.3	5.1	5.0	4.3	3.4	8.1		
PPG debt service-to-revenue ratio	4.8	5.2	5.6	5.5	3.9	3.9	3.4	2.7	7.0		
Gross external financing need (Million of U.S. dollars)	-7.2	0.2	0.9	7.5	29.8	29.7	30.6	32.2	44.8		
Key macroeconomic assumptions											
Real GDP growth (in percent)	-1.8	-3.2	0.6	3.2	1.9	0.8	0.6	0.6	0.5	0.3	0.6
GDP deflator in US dollar terms (change in percent)	0.5	2.6	2.6	2.6	2.6	2.5	2.4	2.0	2.0	3.0	2.3
Effective interest rate (percent) 4/	2.5	2.8	3.3	3.2	3.0	2.3	1.9	1.0	2.0	2.6	1.9
Growth of exports of G&S (US dollar terms, in percent)	-24.6	0.0	35.4	7.6	4.1	3.3	3.0	2.6	2.5	4.8	6.1
Growth of imports of G&S (US dollar terms, in percent)	-10.6	6.8	8.3	6.3	0.3	2.3	2.7	2.4	2.3	1.3	3.4
Grant element of new public sector borrowing (in percent)	...	53.7	61.0	61.0	61.0	61.0	61.0	32.9	28.7	...	55.9
Government revenues (excluding grants, in percent of GDP)	33.5	31.0	31.6	31.0	42.2	41.6	41.1	39.2	37.0	35.4	38.0
Aid flows (in Million of US dollars) 5/	146.2	169.5	155.7	153.4	97.4	90.8	95.6	46.9	56.1		
Grant-equivalent financing (in percent of GDP) 6/	...	41.9	36.8	34.2	18.7	16.7	17.2	8.4	8.1	...	19.4
Grant-equivalent financing (in percent of external financing) 6/	...	99.9	98.7	98.7	88.7	87.9	88.5	69.7	65.3	...	86.9
Nominal GDP (Million of US dollars)	407	404	417	442	462	478	492	561	720		
Nominal dollar GDP growth	-1.3	-0.8	3.2	6.0	4.6	3.3	3.0	2.6	2.5	3.3	3.0
Memorandum items:											
PV of external debt 7/	14.3	13.5	12.5	11.1	11.9	12.7	13.8	23.1	56.7		
In percent of exports	59.4	55.8	39.2	34.3	36.9	39.7	43.1	71.9	176.7		
Total external debt service-to-exports ratio	6.7	6.7	5.6	5.3	5.1	5.0	4.3	3.4	8.1		
PV of PPG external debt (in Million of US dollars)	58.1	54.6	52.0	48.9	54.8	60.8	68.0	129.5	407.9		
(PVt-PVt-1)/GDPt-1 (in percent)		-0.9	-0.7	-0.7	1.3	1.3	1.5	3.6	4.5		
Non-interest current account deficit that stabilizes debt ratio	-0.8	-0.7	-1.1	0.9	0.5	0.5	0.7	0.9	0.5		

Definition of external/domestic debt	Residency-based
Is there a material difference between the two criteria?	Yes





Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g) + Ɛα (1+r)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, ρ = growth rate of GDP deflator in U.S. dollar terms, Ɛ=nominal appreciation of the local currency, and α= share of local currency-denominated external debt in total external debt.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

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

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

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

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

8/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

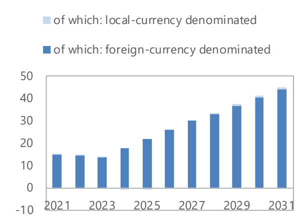
Table 2. Federated States of Micronesia: Public Sector Debt Sustainability Framework, Baseline Scenario, 2020-2041

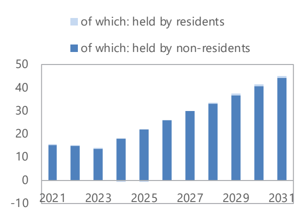
(In percent of GDP, unless otherwise indicated)

	Actual	Projections								Average 6/	
	2020	2021	2022	2023	2024	2025	2026	2031	2041	Historical	Projections
Public sector debt 1/	16.5	15.3	14.6	13.6	17.1	21.3	25.6	45.1	82.3	23.8	26.8
of which: external debt	16.1	15.1	14.6	13.6	17.8	21.9	26.0	44.2	81.1	23.6	26.7
Change in public sector debt	-3.1	-1.2	-0.7	-0.9	3.5	4.2	4.3	3.8	3.1		
Identified debt-creating flows	-0.3	-0.9	-3.2	-3.1	3.5	4.3	4.4	3.8	3.1	-9.3	2.2
Primary deficit	-1.1	-1.8	-3.3	-2.8	3.7	4.5	4.6	4.4	3.4	-9.2	2.5
Revenue and grants	69.3	72.8	67.7	64.6	57.2	54.7	54.8	45.8	43.4	69.8	55.0
of which: grants	35.9	41.9	36.1	33.5	15.0	13.1	13.7	6.6	6.4		
Primary (noninterest) expenditure	68.3	71.1	64.3	61.8	60.9	59.2	59.4	50.2	46.8	60.7	57.5
Automatic debt dynamics	0.8	0.8	0.1	-0.3	-0.2	-0.1	-0.2	-0.6	-0.3		
Contribution from interest rate/growth differential	0.5	0.8	0.1	-0.3	-0.2	-0.1	-0.2	-0.6	-0.3		
of which: contribution from average real interest rate	0.2	0.3	0.2	0.1	0.1	0.0	-0.1	-0.4	0.1		
of which: contribution from real GDP growth	0.4	0.6	-0.1	-0.5	-0.3	-0.1	-0.1	-0.2	-0.4		
Contribution from real exchange rate depreciation	0.2	...	...	...	...	...	...	...	...		
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Recognition of contingent liabilities (e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Debt relief (HIPC and other)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Other debt creating or reducing flow (please specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Residual	-2.9	-0.2	2.5	2.2	0.0	-0.1	-0.1	0.0	0.0	8.0	0.4
Sustainability indicators											
PV of public debt-to-GDP ratio 2/	14.7	13.7	12.5	11.1	11.1	12.1	13.4	24.0	57.9		
PV of public debt-to-revenue and grants ratio	21.1	18.8	18.4	17.1	19.4	22.1	24.5	52.4	133.4		
Debt service-to-revenue and grants ratio 3/	3.1	2.6	2.9	2.7	2.9	1.9	1.8	3.5	7.6		
Gross financing need 4/	1.1	0.1	-1.4	-1.1	5.3	5.5	5.5	6.0	6.7		
Key macroeconomic and fiscal assumptions											
Real GDP growth (in percent)	-1.8	-3.2	0.6	3.2	1.9	0.8	0.6	0.6	0.5	0.3	0.6
Average nominal interest rate on external debt (in percent)	2.5	2.8	3.3	3.2	3.0	2.3	1.9	1.0	2.0	2.6	1.9
Average real interest rate on domestic debt (in percent)	4.5	2.4	2.3	6.6	6.4	5.7	6.8	5.8	6.2	0.0	5.6
Real exchange rate depreciation (in percent, + indicates depreciation)	1.3	...	...	...	...	...	...	...	...	-1.1	...
Inflation rate (GDP deflator, in percent)	0.5	2.6	2.6	2.6	2.6	2.5	2.4	2.0	2.0	3.0	2.3
Growth of real primary spending (deflated by GDP deflator, in percent)	12.0	0.7	-8.9	-0.8	0.4	-2.1	0.9	0.2	-0.4	0.9	-2.1
Primary deficit that stabilizes the debt-to-GDP ratio 5/	2.1	-0.6	-2.6	-1.8	0.2	0.2	0.3	0.6	0.3	-12.6	-0.2
PV of contingent liabilities (not included in public sector debt)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		

Definition of external/domestic debt	**Residency-based**
Is there a material difference between the two criteria?	**Yes**

Public sector debt 1/





Sources: Country authorities; and staff estimates and projections.

1/ Coverage of debt: The central, state, and local governments, government-guaranteed debt . Definition of external debt is Residency-based.

2/ The underlying PV of external debt-to-GDP ratio under the public DSA differs from the external DSA with the size of differences depending on exchange rates projections.

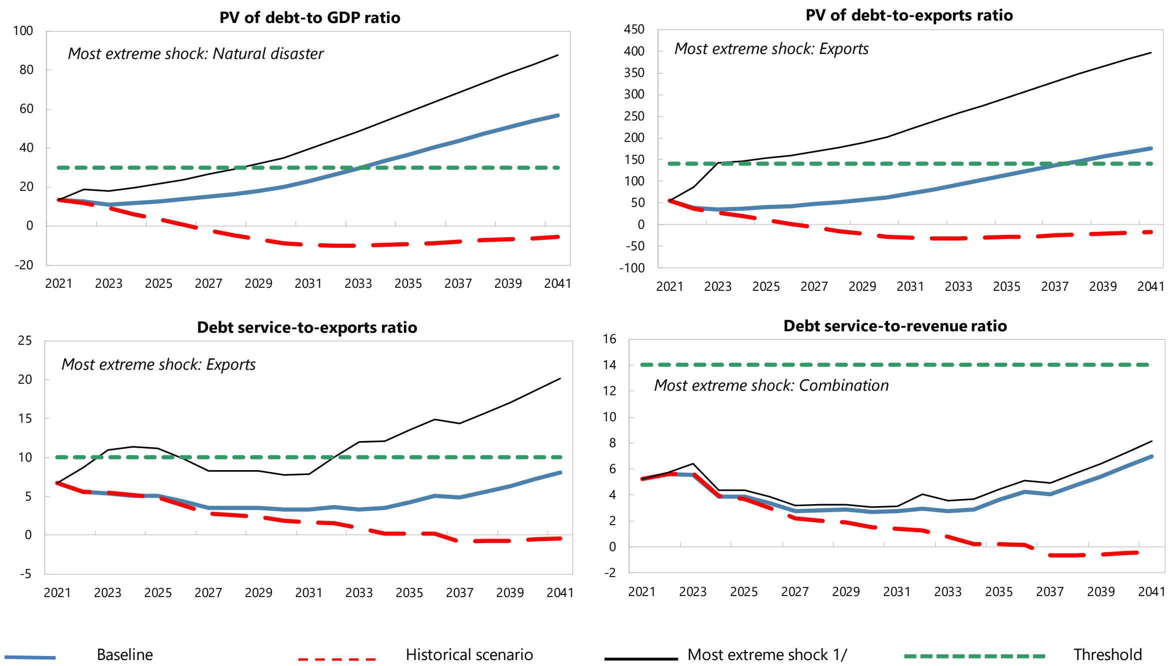
3/ Debt service is defined as the sum of interest and amortization of medium and long-term, and short-term debt.

4/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period and other debt creating/reducing flows.

5/ Defined as a primary deficit minus a change in the public debt-to-GDP ratio ((-): a primary surplus), which would stabilizes the debt ratio only in the year in question.

6/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

Figure 1. Federated States of Micronesia: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2021-2041



Customization of Default Settings		
	Size	Interactions
Standardized Tests	Yes	
Tailored Stress		
Combined CL	Yes	
Natural disaster	No	Yes
Commodity price	n.a.	n.a.
Market financing	n.a.	n.a.

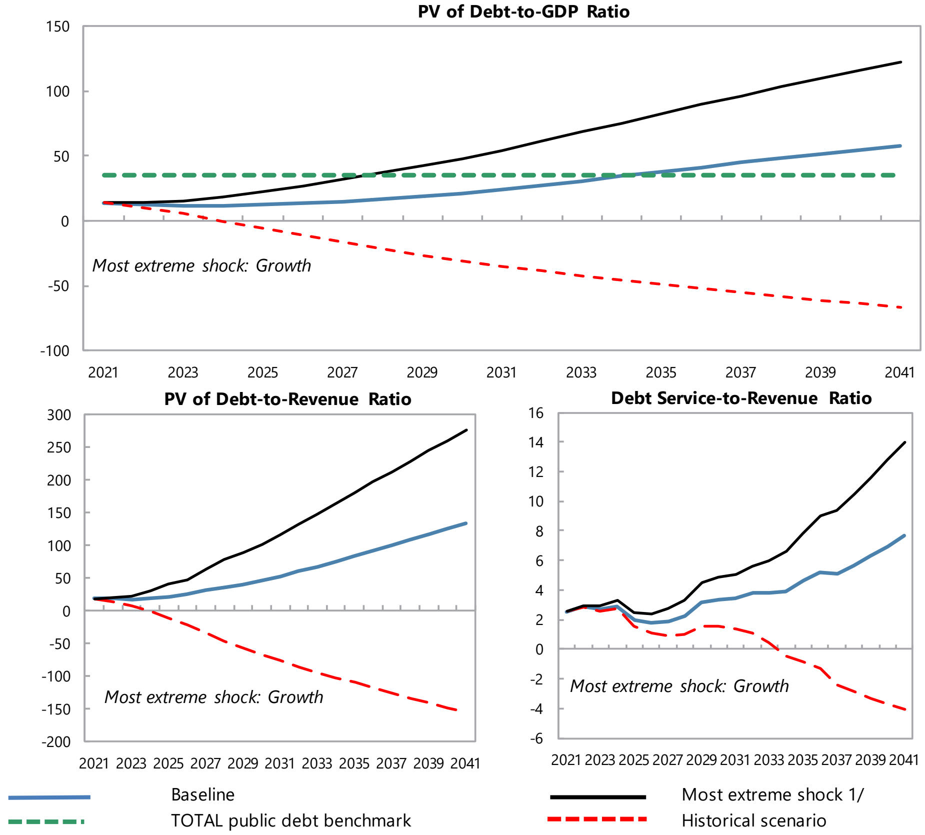
Note: "Yes" indicates any change to the size or interactions of the default settings for the stress tests. "n.a." indicates that the stress test does not apply.

Borrowing assumptions on additional financing needs resulting from the stress tests*		
	Default	User defined
Shares of marginal debt		
External PPG MLT debt	100%	
Terms of marginal debt		
Avg. nominal interest rate on new borrowing in USD	1.0%	1.0%
USD Discount rate	5.0%	5.0%
Avg. maturity (incl. grace period)	37	37
Avg. grace period	9	9

* Note: All the additional financing needs generated by the shocks under the stress tests are assumed to be covered by PPG external MLT debt in the external DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio in or before 2031. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

Figure 2. Federated States of Micronesia: Indicators of Public Debt under Alternative Scenarios, 2021-2041



Borrowing assumptions on additional financing needs resulting from the stress tests*	Default	User defined
Shares of marginal debt		
External PPG medium and long-term	99%	99%
Domestic medium and long-term	0%	0%
Domestic short-term	1%	1%
Terms of marginal debt		
External MLT debt		
Avg. nominal interest rate on new borrowing in USD	1.0%	1.0%
Avg. maturity (incl. grace period)	37	37
Avg. grace period	9	9
Domestic MLT debt		
Avg. real interest rate on new borrowing	7.9%	7.9%
Avg. maturity (incl. grace period)	3	3
Avg. grace period	2	2
Domestic short-term debt		
Avg. real interest rate	4.7%	4.7%

* Note: The public DSA allows for domestic financing to cover the additional financing needs generated by the shocks under the stress tests in the public DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2031. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

Table 3. Federated States of Micronesia: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2021-2041

(In percent)

	Projections 1/											
	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2041
PV of debt-to GDP ratio												
Baseline	14	12	11	12	13	14	15	16	18	20	23	**57**
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2021-2031 2/	14	12	9	6	3	0	-2	-5	-7	-9	-10	-6
B. Bound Tests												
B1. Real GDP growth	14	13	13	14	15	16	17	19	21	23	26	**65**
B2. Primary balance	14	16	19	19	20	22	23	24	26	28	**31**	**64**
B3. Exports	14	18	25	26	27	28	29	**31**	**33**	**35**	**39**	**69**
B4. Other flows 3/	14	13	11	12	13	14	15	17	18	20	23	**57**
B5. Depreciation	14	12	11	12	13	14	15	16	18	20	23	**57**
B6. Combination of B1-B5	14	17	15	16	17	18	20	21	23	25	28	**64**
C. Tailored Tests												
C1. Combined contingent liabilities	14	15	13	14	15	16	18	19	21	23	26	**60**
C2. Natural disaster	14	19	18	20	22	24	26	29	**32**	**35**	**39**	**87**
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	30	30	30	30	30	30	30	30	30	30	30	30
PV of debt-to-exports ratio												
Baseline	56	39	34	37	40	43	47	51	57	62	72	**177**
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2021-2031 2/	56	37	28	19	10	1	-7	-14	-21	-28	-31	-18
B. Bound Tests												
B1. Real GDP growth	56	39	34	37	40	43	47	51	57	62	72	**177**
B2. Primary balance	56	51	58	61	64	67	72	76	82	88	98	**200**
B3. Exports	56	88	**142**	**147**	**153**	**160**	**169**	**178**	**189**	**202**	**221**	**397**
B4. Other flows 3/	56	39	35	37	40	44	48	52	57	63	72	**177**
B5. Depreciation	56	39	35	37	40	43	47	51	57	63	72	**177**
B6. Combination of B1-B5	56	75	42	71	76	81	88	94	103	113	128	**289**
C. Tailored Tests												
C1. Combined contingent liabilities	56	47	42	44	47	50	55	59	64	70	80	**186**
C2. Natural disaster	56	57	54	60	66	73	80	88	97	106	120	**266**
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	140	140	140	140	140	140	140	140	140	140	140	140
Debt service-to-exports ratio												
Baseline	7	6	5	5	5	4	4	4	4	3	3	8
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2021-2031 2/	7	6	5	5	5	4	3	3	2	2	2	0
B. Bound Tests												
B1. Real GDP growth	7	6	5	5	5	4	4	4	4	3	3	8
B2. Primary balance	7	6	6	6	5	5	4	4	4	4	4	10
B3. Exports	7	9	**11**	**11**	**11**	10	8	8	8	8	8	**20**
B4. Other flows 3/	7	6	5	5	5	4	4	4	4	3	3	8
B5. Depreciation	7	6	5	5	5	4	4	4	4	3	3	8
B6. Combination of B1-B5	7	8	9	8	8	7	6	6	6	5	6	**14**
C. Tailored Tests												
C1. Combined contingent liabilities	7	6	5	5	5	4	4	4	4	3	3	8
C2. Natural disaster	7	6	6	6	6	5	4	4	4	4	4	9
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	10	10	10	10	10	10	10	10	10	10	10	10
Debt service-to-revenue ratio												
Baseline	5	6	6	4	4	3	3	3	3	3	3	7
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2021-2031 2/	5	6	6	4	4	3	2	2	2	1	1	0
B. Bound Tests												
B1. Real GDP growth	5	6	6	4	4	4	3	3	3	3	3	8
B2. Primary balance	5	6	6	4	4	4	3	3	3	3	3	8
B3. Exports	5	6	6	5	5	4	4	4	4	3	3	10
B4. Other flows 3/	5	6	6	4	4	3	3	3	3	3	3	7
B5. Depreciation	5	6	6	4	4	3	3	3	3	3	3	7
B6. Combination of B1-B5	5	6	6	4	4	4	3	3	3	3	3	8
C. Tailored Tests												
C1. Combined contingent liabilities	5	6	6	4	4	3	3	3	3	3	3	7
C2. Natural disaster	5	6	6	4	4	4	3	3	3	3	3	8
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	14	14	14	14	14	14	14	14	14	14	14	14

Sources: Country authorities; and staff estimates and projections.
1/ A bold value indicates a breach of the threshold.
2/ Variables include real GDP growth, GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
3/ Includes official and private transfers and FDI.

Table 4. Federated States of Micronesia: Sensitivity Analysis for Key Indicators of Public Debt, 2021-2041

(In percent)

	Projections 1/											
	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2041
PV of Debt-to-GDP Ratio												
Baseline	14	12	11	11	12	13	15	17	19	21	24	**58**
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2021-2031 2/	14	10	6	-1	-6	-11	-17	-22	-26	-31	-35	-67
B. Bound Tests												
B1. Real GDP growth	14	14	16	19	23	27	32	**37**	**42**	**48**	**54**	**122**
B2. Primary balance	14	16	19	19	20	21	23	25	27	29	32	**65**
B3. Exports	14	18	24	24	25	26	28	30	32	34	**38**	**67**
B4. Other flows 3/	14	13	11	11	12	14	15	17	19	21	24	**58**
B5. Depreciation	14	12	11	11	12	13	15	17	19	21	24	**58**
B6. Combination of B1-B5	14	17	16	14	15	17	18	20	22	25	28	**64**
C. Tailored Tests												
C1. Combined contingent liabilities	14	15	13	13	14	16	17	19	21	23	27	**61**
C2. Natural disaster	14	19	18	19	21	24	26	29	33	**36**	**40**	**89**
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
TOTAL public debt benchmark	35	35	35	35	35	35	35	35	35	35	35	35
PV of Debt-to-Revenue Ratio												
Baseline	19	18	17	19	22	24	31	36	41	45	52	133
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2021-2031 2/	19	14	8	(1)	(11)	(21)	(34)	(46)	(57)	(68)	(76)	(155)
B. Bound Tests												
B1. Real GDP growth	19	20	23	31	40	48	64	78	90	102	116	276
B2. Primary balance	19	24	29	33	36	39	47	53	58	63	71	151
B3. Exports	19	26	37	41	45	48	57	64	69	74	82	155
B4. Other flows 3/	19	19	17	20	22	25	31	36	41	46	53	134
B5. Depreciation	19	18	17	19	22	24	31	36	41	45	52	133
B6. Combination of B1-B5	19	25	24	25	28	30	37	43	48	53	60	145
C. Tailored Tests												
C1. Combined contingent liabilities	19	22	21	23	26	29	36	41	46	51	58	140
C2. Natural disaster	19	27	27	33	38	42	54	62	70	77	88	203
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Debt Service-to-Revenue Ratio												
Baseline	3	3	3	3	2	2	2	2	3	3	3	8
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2021-2031 2/	3	3	3	3	2	1	1	1	2	2	1	(4)
B. Bound Tests												
B1. Real GDP growth	3	3	3	3	2	2	3	3	4	5	5	14
B2. Primary balance	3	3	3	3	2	2	2	3	3	4	4	9
B3. Exports	3	3	3	3	2	2	2	3	4	4	4	9
B4. Other flows 3/	3	3	3	3	2	2	2	2	3	3	3	8
B5. Depreciation	3	3	3	3	2	2	2	2	3	3	3	8
B6. Combination of B1-B5	3	3	3	3	2	2	2	2	3	4	4	8
C. Tailored Tests												
C1. Combined contingent liabilities	3	3	3	3	2	2	2	2	3	3	4	8
C2. Natural disaster	3	3	3	3	2	2	2	3	4	4	4	9
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Country authorities; and staff estimates and projections.

1/ A bold value indicates a breach of the benchmark.

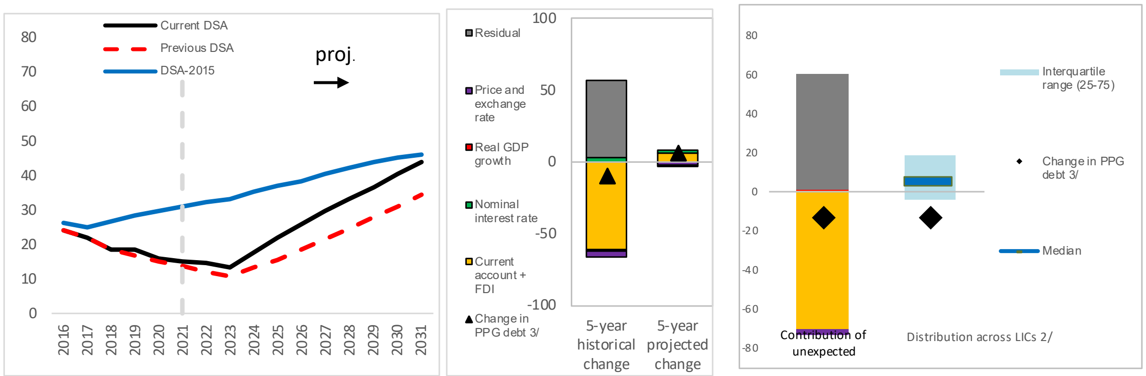
2/ Variables include real GDP growth, GDP deflator and primary deficit in percent of GDP.

3/ Includes official and private transfers and FDI.

Figure 3. Federated States of Micronesia: Drivers of Debt Dynamics—Baseline Scenario

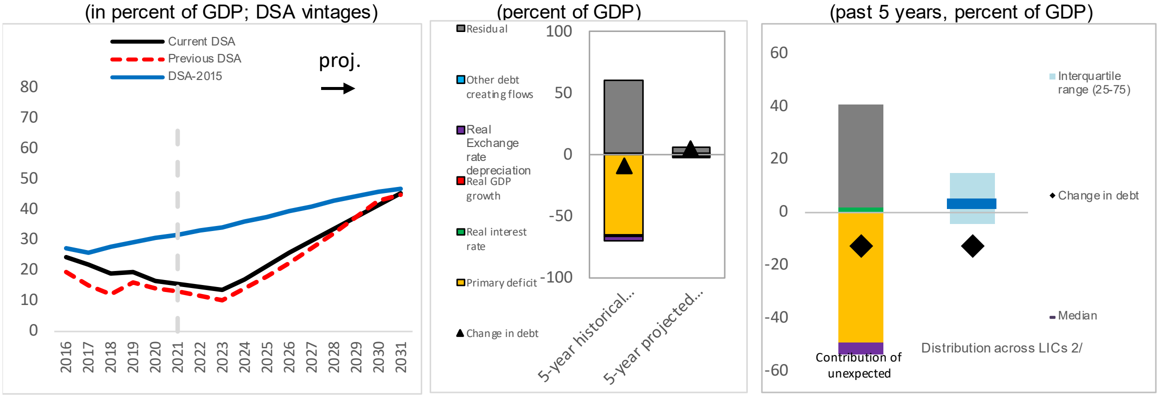
External Debt

Gross Nominal PPG External Debt (in percent of GDP; DSA vintages) | Debt-creating flows (percent of GDP) | Unexpected Changes in Debt 1/ (past 5 years, percent of GDP)



Public Debt

Gross Nominal Public Debt (in percent of GDP; DSA vintages) | Debt-creating flows (percent of GDP) | Unexpected Changes in Debt 1/ (past 5 years, percent of GDP)



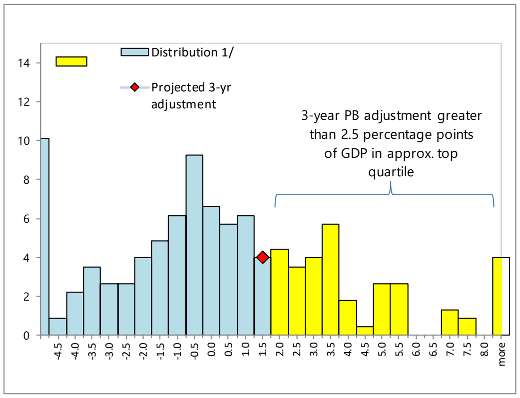
1/ Difference betw een anticipated and actual contributions on debt ratios.

2/ Distribution across LICs for w hich LIC DSAs w ere produced.

3/ Given the relatively low private external debt for average low -income countries, a ppt change in PPG external debt should be largely explained by the drivers of the external debt dynamics equation.

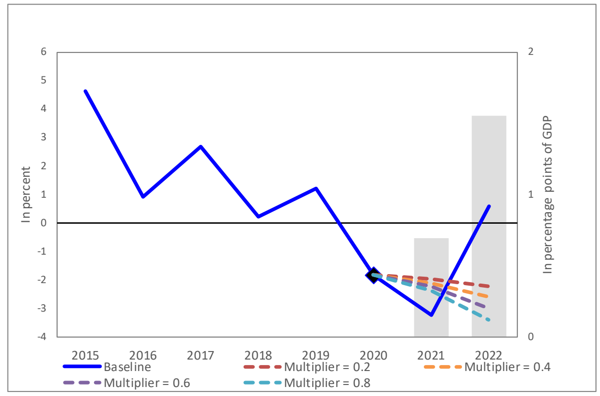
Figure 4. Federated States of Micronesia: Realism Tools 1/

3-Year Adjustment in Primary Balance
(Percentage points of GDP)



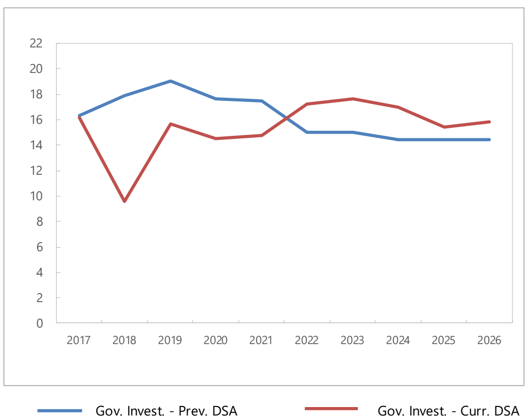
1/ Data cover Fund-supported programs for LICs (excluding emergency financing) approved since 1990. The size of 3-year adjustment from program inception is found on the horizontal axis; the percent of sample is found on the vertical axis.

Fiscal Adjustment and Possible Growth Paths 1/



1/ Bars refer to annual projected fiscal adjustment (right-hand side scale) and lines show possible real GDP growth paths under different fiscal multipliers (left-hand side scale).

Public and Private Investment Rates
(percent of GDP)



1/ The data needed to conduct the investment growth tool is not available for the DSA exercise.

Statement by Chang Huh, Executive Director for the Federated States of Micronesia and Lae Tui Siliva, Advisor to the Executive Director
October 27, 2021

Our FSM authorities are greatly appreciative of the very productive discussions with the mission team during the virtual Article IV consultations. The authorities highly value staff's analytical work and contributions to practical policy discussions and overall agree with the thrust of the 2021 Article IV Report.

The Federated States of Micronesia (FSM) is a small fragile island country spread out over the north western Pacific Ocean with more than 600 islands. The population is just over 110,000 inhabitants of four main island states – Pohnpei, Kosrae, Chuuk and Yap. The remoteness and disperse geography of the FSM hinders infrastructure development, tourism, and foreign direct investments, during this uncertainty period.

The FSM, like all Pacific small island states, is heavily dependent on foreign grants. The urgent challenge facing the country is the expiration of the related critical assistance under the Compact of Free Association (COFA) with the United States by end FY2023. The FSM has established the groundwork for policy adjustments to mitigate the downside risks, should the current (COFA) arrangement end in FY2023.

The ongoing long-term challenge is the vulnerability to climate change and frequent natural disasters. The fluctuating ocean currents and temperatures also shifts abundant tuna fisheries away from FSM, which is the country’s primary economic resource.

COVID-19 Response, Recent Developments and Outlook

The FSM declared a public health emergency from March 2020, extending through the end of January 2022, with the national and state governments enacting strict containment measures including the international border closure. The pandemic response focused on strengthening the health system, and assistance to affected firms and vulnerable groups. The effectiveness of the pandemic containment measures resulted in no COVID-19 cases in FSM so far and had commenced the repatriation flights successfully from abroad since May 2021. The authorities aim for achieving at least 70 percent vaccination coverage this year, mandating the vaccination for all 18 years and older citizens, achieving about 66 percent vaccination rate of the eligible population as of September 30, 2021.

The economic contraction of -3.2 percent is projected for FY2021, due to the international border closure, with slow recovery expected in FY2022 with the gradual border reopening. Staff projected the return to pre-pandemic real growth levels in FY2024.

The authorities noted the downside risks associated with the containment measures and longer border closure for the pandemic, and agreed with the economic contraction in FY2021, followed by a slow recovery in FY2022 on the premise of an expedited vaccination rate. The authorities are very cautious in the gradual reopening of the international border considering the capacity of the local health system. The policy support will continue for businesses and low-income households, to help counter the downside risks to the economy. The authorities will audit and publish the COVID-19 related spending reports.

Fiscal Policy

The FSM acknowledged staff analysis on the fiscal risks, rising debt levels under the current policies, over the medium term. The authorities will utilize the existing study of the taxation system conducted by the National Tax Reform Commission, at the national and state levels, to determine areas for improvements and adjustments, with the report recommendations to be submitted to the President by January 1st, 2022, and related proposed legislative developments and amendments to be considered by the FSM Congress and State Legislatures. The authorities also agree with staff on the introduction of VAT in a revenue neutral manner, though the revenue boost is expected through improved tax efficiency. The revised legislation to increase the excise taxes on cigarettes and tobacco has been submitted to the FSM Congress for consideration. These tax reforms are estimated to collectively raise the tax revenue-to-GDP to about 16 percent, from the current level of around 12 percent. There is also consideration of the changes to non-tax revenues, including to reassess the concessional domestic fishing license fees. The FSM would welcome the Fund TAs on these tax reform efforts.

The authorities also agreed, despite the need to provide support to the economy in the near-term, expenditure rationalization would be necessary going forward. The FSM established the Project Management Unit at the national level and the Project Management Offices at the state level to strengthen the project coordination and provide technical support. This should help accelerate the project implementation and grant disbursement. A medium-term fiscal framework would be beneficial, and the authorities are receiving EU support in this area.

Financial Sector

The banking system has remained sound and well contained financial stability risks. The authorities concurred with the need to extend near-term financial sector support and enhance monitoring. The interest payment relief and loan deferrals may need to be extended for the targeted groups if the border closure continues, with very close monitoring, and gradual phasing out of these support measures.

There is a need to upgrade banking laws, adopt prudential banking regulations, and strengthen the supervisory capacity. The authorities underscored that the banking regulation and supervision should be strengthened to cope with the possible expiration of FDIC oversight. The proposed amendments to the Banking Act will carefully consider extending the FSMBB's supervision to the non-deposit taking entities such as the FSMDB and credit unions. The strengthened risk-based supervision will monitor the CBRs, as well as compliance under the AML/CFT framework.

Structural Reforms

The FSM 2023 Action Plan continues to guide the implementation of the long-term structural reforms and sustainable growth strategies, with the emphasis on private sector led growth, and prepare the economy from FY2024 onwards. Some key actions for boosting investments include the amendments in the foreign investment bill, to simplify the FDI application process. The authorities aim to establish a one-stop shop to handle foreign investment.

The impacts of the pandemic have underscored the need for improved ICT infrastructure and digital connectivity in the FSM. The authorities acknowledged the importance of enhancing digital connectivity, given the constraint of available transportation among the islands. The development of a digitalization strategy and a roadmap to expand e-government is welcome. The ongoing digitalization project in partnership with the World Bank would improve connectivity and affordability, as well as promoting online business transactions and enhance financial inclusion.

Climate change

The FSM remain committed to strengthening resilience to climate change. The higher frequency and severity of natural disasters is experienced in the small island, damaging existing infrastructure and productive activities, particularly in agriculture and fishing. The authorities acknowledged the medium-term policy recommendations covering the development of an overarching National Adaptation Plan, speed up implementation of adaptation investment projects, strengthen capacity for public investment management, and mobilize external grant financing.

Efforts are ongoing to address gaps identified in the recent Climate Change Policy Assessment, including development of National Adaptation Plan and a Building Code Policy. The authorities have received two new grant approvals from the Green Climate Fund in calendar year 2021, a significant achievement for FSM by being the only Pacific country to have two projects approved this year by GCF, as well as the first Enhancing Direct Access project for the Pacific region. The authorities also launched this month, a $40million project financed by the World Bank to enhance climate resilience of the road transport infrastructure throughout the nation. Together, these programs would help with climate-smart agriculture, climate resilience infrastructures and further advance the enabling environment agenda. A new public law was passed by Congress in April 2021, mandating that the Investment portfolios in FSM's sovereign wealth funds shall seek investment opportunities associated with a global transition to a lower carbon economy, and banning investments in assets associated with high carbon emitting companies. The authorities call on all Small Island States with Sovereign Wealth Funds to follow the same path, to shift investment capital towards innovative firms aiming to protect the planet.

Capacity Development

The authorities appreciated the IMF and PFTAC TAs and requests the continuation of these technical support, preferably in-person TAs when international travel resumes. The authorities specifically request for longer term TAs on Statistics / National Accounts, Tax reforms and Economic Planning. Other TAs should continue for revenue management, public financial management and banking supervision.