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FEDERATED STATES OF MICRONESIA

May 2015

2015 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; 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 2015 Article IV consultation with the Federated States of Micronesia, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on May 11, 2015, following discussions that ended on March 20, 2015, 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 April 24, 2015.
- An **Informational Annex** prepared by the IMF.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Press Release** summarizing the views of the Executive Board as expressed during its May 11, 2015 consideration of the staff report that concluded the Article IV consultation with the Federated States of Micronesia.
- A **Statement by the Executive Director** for the Federated States of Micronesia.

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

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INTERNATIONAL MONETARY FUND

FEDERATED STATES OF MICRONESIA

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

April 24, 2015

KEY ISSUES

Context. Raising growth and ensuring long-term fiscal sustainability remain the two critical issues of the FSM. The reform agenda, in particular, the tax reform package and growth-enhancing reforms, hinges on achieving a national consensus in a loosely federated nation.

Outlook. The economy stagnated in FY2014 (ending September) with real growth estimated at 0.1 percent, reflecting a slowdown in the implementation of infrastructure projects. Inflation dropped to 0.7 percent in FY2014 on account of falling oil prices. The current account strengthened due to a tax windfall from a company's sale of shares launched on a foreign stock exchange and an increase in fishing license fees. Growth in FY2015 is expected to remain almost flat at 0.3 percent, while damages caused by the recent typhoon Maysak could dampen the economy.

Fiscal sector. The authorities have started some reforms in view of the expiration in 2023 of grants provided under the Compact of Free Association with the U.S. State governments have started fiscal consolidation while the Unified Revenue Authority (URA) has been established. The authorities agreed that more needs to be done to achieve fiscal sustainability, in particular, by implementing the tax reform package that includes replacing the state sales taxes with a VAT. They noted that further reforms hinge on achieving a national consensus.

Investment climate. Land tenure issues continue to constrain private sector development and the authorities should redouble efforts in expediting the land survey and registration process. On tourism, the authorities expressed optimism that the recent extension of the runway at the main island airport in Pohnpei could lead to more eco-tourism that preserves the cultural heritage and pristine nature of the country.

Financial sector. Credit unions are currently not being supervised and a new legislation is underway to put them under the supervision of the Banking Board. The authorities have requested further TA from PFTAC and the Legal Department of the Fund.

Approved By
Patrizia Tumbarello and Masato Miyazaki

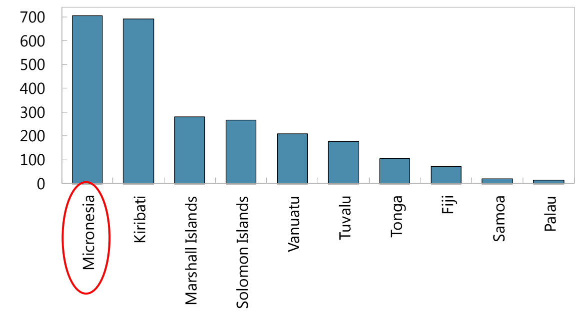
Discussions took place in Pohnpei from March 9–20, 2015. The mission comprised Messrs. Y. Yoneyama (head), I. Saito, M. Dalesio (all APD). H. Lim (OED), L. Pan (World Bank Group) and N. Usui (AsDB) participated in the key policy discussions.

CONTENTS

OVERVIEW

1. **Context.** The Federated States of Micronesia (FSM) is a microstate in the Pacific with one of the most dispersed population in the world. It is highly dependent on external aid, mainly from the United States. The FSM has a loosely federated structure, with four states each having its own executive and legislative bodies. This makes decision making at the national level difficult – a number of reform agendas are experiencing protracted delays.

Geographical Dispersion: Average Sea Distance Between Two Inhabitants of the Same Country
(In kilometers)



Micronesia: Millenium Development Goals (MDGs) Progress

MDG 1. Eradicate extreme poverty and hunger Halve between 1990 and 2015 the proportion of people whose income is less than $1 per day.	Off track
MDG 2. Achieve universal primary education	Mixed
MDG 3. Promote gender equality and empowerment Eliminate gender disparities in primary and secondary education.	Mixed
MDG 4. Reduce child (under 5) mortality by two thirds	On track
MDG 5. Improve maternal health Reduce maternal mortality by three quarters.	Off track
MDG 6. Reverse the spread of HIV/AIDS, malaria and TB	Mixed
MDG 7. Ensure environmental sustainability Integrate principles of sustainable development into country policies.	On track

Source: 2013 Pacific Regional MDG Tracking Report, Pacific Islands Forum Secretariat.

2. **Growth and social indicators.** The private sector has yet to become the engine of growth for the economy, and caters largely to the needs of the public sector. FSM's average annual growth rate between FY2005[1] and 2013 was close to zero and is worse than other countries in the Pacific[2] (Figures 1 and 2). The FSM is endowed with bountiful natural resources and has a strong tradition of caring and sharing through the extended family. While there are no data to track hunger in the FSM, the fact that a relatively small proportion of the population (11 percent) live below the national food poverty line suggests that extreme poverty and poverty-caused hunger are not widespread[3], while the disappointing growth has had some negative impact on the progress of Millennium Development Goals.

3. **Long-term fiscal challenge.** The FSM faces a long-term fiscal challenge as US grants provided under the Compact of Free Association (Compact grants) will expire in FY2023. Compact grants disbursed in FY2013 for current and capital spending amounted to about 25 percent of GDP[4], accounting for more than 40 percent of the general government revenue. The authorities have recently produced the "2023 Action Plan" with the view to addressing the long-term fiscal challenge while accelerating the economic growth (Box 1). At this juncture, most of the policy actions included in the Action Plan, including the tax reform package that will play a critical role in enhancing the fiscal revenue, remain to be endorsed by the legislatures.

[1] The fiscal year runs from October to September (for example, FY2015 covers October 2014 to September 2015).

[2] Average annual growth rate in the Pacific during the same period was about 2 percent.

[3] Millennium Development Goals and the Federated States of Micronesia Status Report 2010, FSM Office of Statistics, Budget, and Economic Management, Overseas Development Assistance, and Compact Management.

[4] If contributions to the CTF are included, the ratio is more than 30 percent of GDP.

4. **Trust funds.** A portion of the Compact grants have been disbursed into the Compact Trust Fund (CTF), jointly managed by the US and the FSM, with the view that returns from the trust fund would be sufficient to enable Micronesia to become fiscally sustainable after FY2023. The FSM has also established its own trust fund (FSM Trust Fund). However, at current pace of accumulation, returns from these funds are expected to fall short of the expired Compact grants in FY2023 – hence the need to step up fiscal consolidation and growth-enhancing structural reforms.

ECONOMIC CONTEXT

5. **Growth.** The economy is stagnating. While delays in the compilation of economic data have hampered the assessment of the economy, staff estimates real GDP growth to be around 0.1 percent for FY2014. Externally-funded infrastructure projects are moving slowly: land tenure issues continue to hold back the implementation of some projects while delays in updating the infrastructure development plan of 2004 have resulted in the temporary suspension of Compact infrastructure grants for new projects. Falling oil prices resulted in the decline of CPI from 2.1 percent in FY2013 to 0.7 percent in FY2014.

Micronesia: Selected Economic Indicators, FY2011-15

	FY2011	FY2012	FY2013	FY2014 Est.	FY2015 Proj.
	(year-on-year percent change)				
Real GDP	1.8	0.1	-4.0	0.1	0.3
Consumer price index	4.3	6.3	2.1	0.7	-1.0
	(in percent of GDP)				
General government revenue	65.0	66.0	62.3	68.6	61.9
Tax revenues	12.1	11.6	12.2	19.5	13.0
Corporate tax	0.7	0.8	1.4	8.8	2.4
Foreign grants 1/	44.3	43.1	35.5	31.2	31.0
Current	27.2	25.2	25.6	25.4	25.2
Capital	17.1	18.0	9.9	5.7	5.8
Fishing license fees	6.1	8.1	11.1	14.9	14.9
General government expenditures	65.6	65.3	59.6	56.1	59.0
General government balance	-0.6	0.8	2.8	12.5	2.8
Current account balance	-17.9	-12.6	-10.1	2.5	-0.7
Trade balance	-43.4	-38.6	-41.7	-41.0	-37.7
Income (net, including fishing license fees)	3.5	5.0	8.7	14.1	14.2
Transfers (private and official)	36.0	33.9	35.3	41.8	35.3

Sources: FSM authorities and Fund staff estimates.

1/ Does not include contributions to the Compact Trust Fund.

6. **External balance.** The current account improved from a deficit of -10 percent of GDP in FY2013 to 2½ percent of GDP in FY2014. The main driving force behind this was a tax windfall from a company's sale of shares launched on a foreign stock exchange and an increase in fishing license fees. Staff projects that the fishing license fee will stay at the same level in the medium term. Export of goods, at around 15–16 percent of GDP, continues to be concentrated in exports of tuna to Thailand and other East Asian countries.

7. **Outlook.** The economy is expected to be sluggish in FY2015, as the difficult business climate will continue to hamper private sector growth while the implementation of externally-financed infrastructure projects is likely to experience further delays. Damages caused by the recent Typhoon

Maysak[5] could further dampen the economy. The continued pass through of low oil prices will result in further decline in consumer prices. In this context, staff projects growth at 0.3 percent for FY2015.

8. **Risks to the outlook.** Overall, risks are tilted to the downside (Appendix 2). The loosely federated structure of the country could result in further delays of the much-awaited reform agenda. While the "2023 Action Plan" shows a number of essential reforms for the future of the FSM, it remains a plan that needs to be underpinned by a multitude of legislative measures. Natural disasters such as tropical cyclones could cause damages that are significant compared to the small size of the economy. On the upside, further decline in oil prices and faster-than-expected implementation of structural reforms could boost the economy. As the Micronesian economy is heavily dependent on the public sector and foreign grant assistance, changes in the global economy would not have much impact. However, it may affect the tourism industry that the authorities are promoting.

9. **Authorities' view.** The authorities broadly agreed with staff on the outlook. They shared the view that achieving national consensus to implement the policy actions included in the "2023 Action Plan" will be the key to boost the economy and ensure long-term fiscal sustainability beyond the expiration of Compact grants in 2023. In this regard, the authorities noted that an extensive public awareness campaign has been put in place to gain a nationwide support, including in places outside of the country (e.g., Guam and Hawaii) where there is a large Micronesian community.

POLICIES TO ACHIEVE SUSTAINABLE GROWTH

A. Fiscal Policy

10. **Recent developments.** Fiscal revenue excluding foreign grants increased in FY2014 by 10 percent of GDP, on account mostly of higher fishing license fees (4 percent of GDP) and a tax windfall from a company's sale of shares launched on a foreign stock exchange (7 percent of GDP). Against this backdrop, the national government transferred $30 million (10 percent of GDP) to the trust funds out of the surplus realized in FY2014 and plans to allocate more funds for infrastructure in FY2015. State governments have started fiscal consolidation efforts under their respective Long-Term Fiscal Frameworks (LTFF), which envisages a contraction of current expenditures by 2 percent per year on average in real terms. Taking all these into account, staff estimates that the overall fiscal surplus will decline to 3 percent of GDP in FY2015 from 10 percent in FY2014.

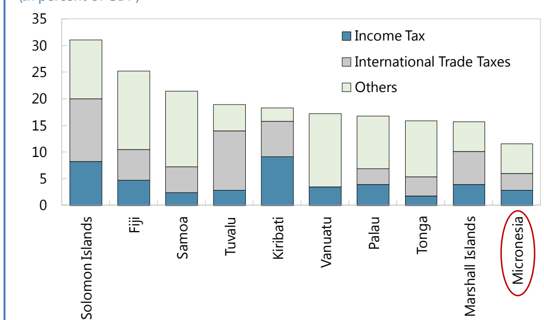
[5] Typhoon Maysak traversed the Chuuk and Yap states between March 29 and April 1, 2015. While assessments of the damages are still on-going, 4 fatalities resulting from the storm have been confirmed and about 30,000 people are affected in the states of Chuuk and Yap. In light of disaster assistance agreements between the FSM and the U.S. under the Compact of Free Association, the U.S. Agency for International Development (Office of U.S. Foreign Disaster Assistance) is providing humanitarian assistance to Micronesia (humanitarian assistance provided so far amounts to $2.3 million). United Nations and other countries, including Marshall Islands, Australia, China, and Japan, are also providing emergency assistance.

11. **Medium-term fiscal framework.** The authorities should formulate a medium- to long-term fiscal framework that covers both the national and state governments, with a view to achieving budgetary self-reliance in the post-2023 period. To this end, an inclusive process underpinned by extensive consultations with stakeholders across the country will be critically important – this will help ensure that the fiscal strategy can be implemented with the required legislative measures over a medium term. The framework should adopt the outstanding value of the trust funds (Compact Trust Fund and FSM Trust Fund) in percent of GDP as the fiscal anchor.

- *Target value of the trust funds asset* (see Box 2). The trust funds value should reach 340 percent of GDP in FY2023 through a combination of increased revenue efforts and expenditure reforms. At this level, the trust funds will be able to generate sufficient returns to make up for the expiration of the Compact grants in FY2024. Even after adjusting the annual draw downs with the inflation rate, trust funds value will remain around 300 percent of GDP in FY2034.

12. **Tax reform and tax administration.** The long-debated tax reform package should be implemented over a period of 4 years starting from FY2016, generating additional tax revenue of 4 percent of GDP when fully implemented (1 percent of GDP per year). Micronesia's tax revenue is low (12–13 percent of GDP), while the average in the Pacific is close to 20 percent of GDP. The mission welcomes the recent establishment of the Unified Revenue Authority (URA) by the national and 2 state governments (Chuuk and Kosrae). The URA should be extended to cover the remaining two states (Pohnpei and Yap) while further enhancing tax compliance, in particular of large tax payers. At the request of the authorities, PFTAC has recently started to provide TA in this area.

Tax Revenue, 2013
(In percent of GDP)

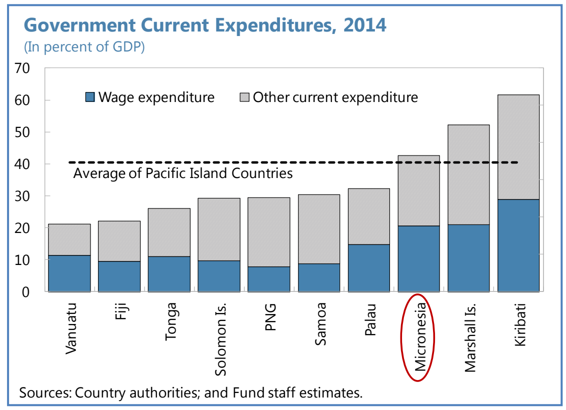


Source: Fund staff estimates.

Main elements of the tax reform package	
1. Indirect tax	Abolish import duties and state sales taxes Introduce a new VAT (at a rate of 10 percent)
2. Business tax	Abolish the Gross Revenue Tax (at a rate of 3 percent) Introduce a new Net Profit Tax (at a rate of 25 percent) 1/
3. Payroll tax	Reduce the Gross Wage and Salary Tax (6 percent for the first $11,000; 10 percent of amounts over $11,000) by introducing a $5,000 tax free threshold.
4. Tax administration	Establish a Unified Revenue Authority (URA) URA acts as an agent on behalf of the national and state governments

Source: FSM authorities

1/ Major corporations are already subject to a corporate income tax.



13. **Expenditure reform.** Staff welcomes the recent start of fiscal consolidation efforts at the state level under the LTFF. However, more needs to be done to achieve the targeted value of the trust funds (340 percent of GDP) in FY2023. This will require additional fiscal consolidation of 1 percent of GDP and the LTFF should be extended to the national government as well. Fiscal consolidation should be accompanied by improvement in the quality of public spending, so as to safeguard priority spending in the social sector and infrastructure investment with high development impact. Micronesia's overall wage expenditure, at 22 percent of GDP, is among the highest in the Pacific. Better coordination between the national and state governments could result in savings by minimizing redundancies of functions between the two levels of governments. While qualifications required for private and public sector may not be fully comparable, public sector wage should continuously be reviewed[6]. The national government is undertaking a public administration reform project, which includes the review of staff number, pay structure and staff grading. The state governments are reviewing their expenditure including the wage bill under the LTFFs. PFTAC is providing TA to strengthen Public Financial Management and improve the quality of spending with limited resources.

14. **Transfer of fiscal surplus to the trust funds.** Staff welcomes the recent transfer of $30 million to the FSM Trust Fund, thus saving the fiscal surplus resulting from the tax windfall from a company's sale of shares launched on a foreign stock exchange and the increase in the fishing license fee revenue in FY2014. Going forward, fiscal surpluses should continue to be transferred in full to the trust funds. The trust funds should continue to be managed prudently to ensure that funds are appropriately managed for the post-2023 period.

15. **Externally-funded infrastructure projects.** The unused balance of already allocated Compact grants for infrastructure projects reached almost US$ 140 million (about 40 percent of GDP) at the end of FY2014. Authorities should work closely with all the stakeholders to address the issue, including by updating the infrastructure development plan of 2004 with TA from the ADB in order to prioritize projects in light of their development effectiveness and implementation capacity of each state[7]. Improving the planning and management of the projects, in particular through better coordination between the national government and state governments, would also be important.

16. **Authorities' Views.** The authorities broadly agreed with the staff view of the overall strategy.

- The authorities emphasized that achieving national consensus across the four states and the national government for both the expenditure and revenue reforms will be critically important.

[6] Average wage of the public sector is twice the level of the private sector.

[7] Updating the infrastructure development plan of 2004 is also a requirement by the donor, along with other measures to ensure proper management of projects.

They noted that the "2023 Action Plan" calls for the implementation of a number of policy actions, including the tax reform package which should be implemented by FY2018 by both the national and state governments.

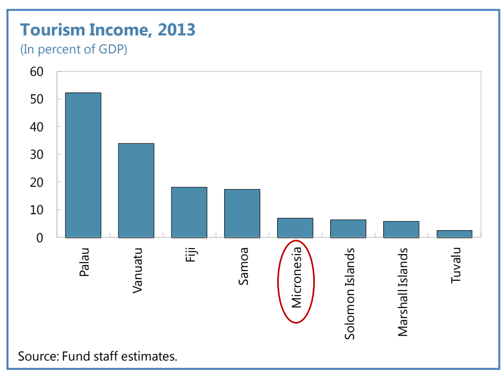
- The authorities noted that the national government has recently developed a Public Financial Management Roadmap to achieve improved transparency in accounting for public funds and increased availability of information on annual budgets and financial statements.

B. Enhancing Private Sector Growth

17. **Background.** Improving the investment climate is key in achieving private sector-led growth in the FSM. Currently, FSM's overall investment climate is ranked among the worst in the Pacific (145th among 189 economies in the world). Structural issues, including in the area of land ownership, combined with the remoteness of the country, are key bottlenecks for private sector development. Private sector is largely dependent on the public sector, and is not an engine of growth as of now.

- **Land tenure issue.** In the FSM, most properties are held as family trusts and land use rights are passed down from generation to generation within the extended family. This makes it difficult for potential investors to secure a long-term land lease. Use of land as collateral is also difficult due to family ownership of the land, which is compounded by uncertain boundaries and titles. While complex in nature and closely related to the local traditions, the authorities should redouble efforts at land reform, including by expediting the land survey and registration.

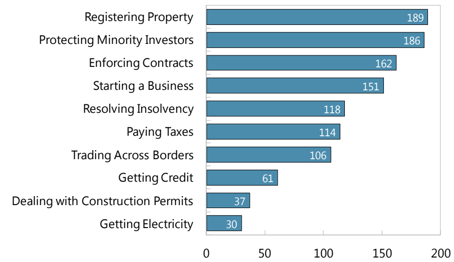
- **Tourism.** FSM's tourism income (7 percent of GDP in 2013) lags behind several of its peers in the Pacific. The recent grant-financed extension of the runway at Pohnpei Airport could open the way for expanding tourism. The authorities are making efforts to establish direct air connections to destinations in Asia, including by signing open sky agreements and arranging chartered flights. Nonetheless, the issue of land ownership will be a crucial factor in developing tourism, including the availability of land for new hotel investment. Also, attention needs to be paid to safeguard the cultural heritage and pristine nature of the country, key to achieving national consensus for the promotion of tourism.



Source: Fund staff estimates.

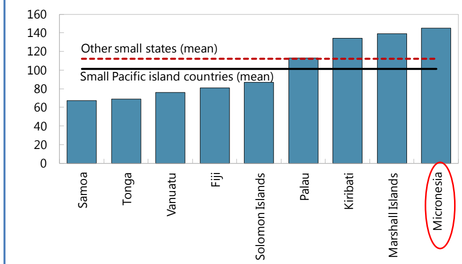
- **Others.** The "2023 Action Plan" reconfirms the challenges pointed out by the World Bank Group's Doing Business Report persist, including the time required in resolving a commercial dispute before local courts (5.3 years on average) and the elevated cost for creditors in recovering debt from insolvent debtors (average recovery rate is 3.3 cents on the dollar). Review of applications for inward foreign direct investment should be expedited.

Micronesia: Ease of Doing Business, 2015
(Rank out of 189 countries) 1/



Source: World Bank, *Doing Business 2015*.
1/ Highest rank = 1; lowest rank = 189.

Ease of Doing Business, 2015
(Rank out of 189 countries) 1/



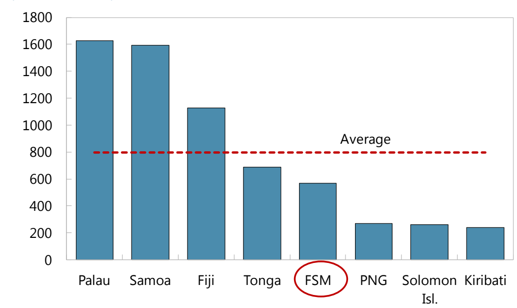
Source: World Bank, *Doing Business Report 2015*.
1/ Highest rank = 1; lowest rank = 189.

18. **Authorities' Views.** The authorities broadly agreed with the assessment by staff that a more robust private sector is indispensable for the future of the FSM, and emphasized that a number of policy actions are included in the "2023 Action Plan". They also explained that they plan to receive TA from the World Bank Group to review all investment and other relevant laws in the FSM to identify areas of discrepancies. To facilitate foreign direct investment, the authorities are considering establishing an Investment Promotion Agency at the national level to act as a one-stop-shop.

C. Preserving Financial Stability to Support Growth

19. **Background.** The difficult business environment, in particular, complexities in securing a land lease and using land as collateral, has resulted in the scarcity of bankable projects. At the same time, the number of deposit accounts with commercial banks[8] per 1,000 adults reached 565 in 2013[9], increasing by more than 30 percent since 2004. Reflecting the lack of bankable projects, the loan-to-deposit ratio of commercial banks is very low at 24 percent in FY2014 and the majority of deposits are invested overseas in safe financial assets[10] (Table 4).

Deposit accounts with commercial banks, 2013
(Per 1,000 adults)



Sources: IMF, *Financial Access Survey*.

20. **Credit unions.** While commercial banks are well-capitalized and have sufficient liquidity and subject to the supervision of the Banking Board, credit unions, while small in their size, are not subject to any prudential oversight. Staff welcomes on-going initiative by the authorities to enact a new Credit Union Act that will place credit unions under the supervision of the Banking Board, with TA provided by PFTAC and the Legal Department of the Fund.

21. **Authorities' views:** The authorities emphasized that they have been working closely with PFTAC and the Legal Department of the Fund to prepare a Credit Union Act that will expand the

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8 There are two commercial banks in the FSM: one local bank and a U.S. bank. The two banks are covered by the U.S. Federal Deposit Insurance Corporation.

9 The average in the Pacific in 2013 was about 800 accounts per 1,000 adults, though data was not available for 3 countries (Marshalls, Tuvalu and Vanuatu).

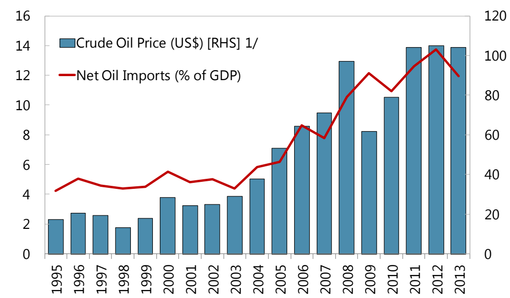
10 As deposits are mostly short term, so are the foreign assets. This helps reduce the market risk of the banks.

supervisory mandate of the Banking Board over credit unions. They also noted the need to achieve a national consensus in order to have the new law approved by the legislature. On the business environment, the authorities reiterated the importance of implementing the policy actions included in the "2023 Action Plan", in particular, those related to regulatory and land reforms.

D. External Stability

22. **Background.** Risks to external stability are limited, as current account deficits have mostly been financed by non-debt creating foreign capital grants for infrastructure projects. While the trade and service balance had a large deficit, it was partially offset by official transfers and fishing license fees. Compact-related grants will continue to provide a stable source of funding until FY2023. However, under the baseline scenario that does not envisage major policy actions, the authorities will have to take on concessional external loans from FY2024 onwards in order to safeguard priority developent spending, leading to the breach of some debt indicators (see DSA Annex).

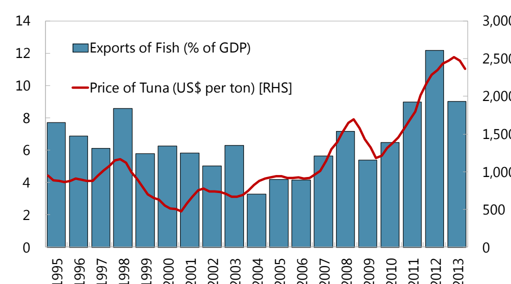
Micronesia: Net Oil Imports and International Prices



Sources: FSM authorities; and Bloomberg.
1/ Simple average of Brent, Dubai, and WTI.

23. **Impact of lower oil price.** The FSM is a net importer of petroleum products, thus benefitting from a recent decline in energy prices. Micronesia's net import of petroleum products have been increasing over the past two decades, rising from 4 percent of GDP in FY1995 to 12 percent in FY2013. This has partly reflected the increase in oil prices while changes in the way of life of Micronesians have led to a gradual shift to use of modern forms of energy. A decline in oil prices is expected to have positive impact as the FSM is a net oil importer – a 10 percent decline in the imported price of petroleum products is estimated to improve the current account balance by around 1 percent of GDP[11]. To reduce its reliance on imported petroleum products, the FSM has started to work with development partners to invest in renewable energy, in particular in outlying islands where the cost of electricity generation tends to be elevated.

Micronesia: Fish Exports and Prices 1/



1/ Four-quarter moving average.
Sources: Country authorities; Globe Fish, Ministry of Trade of Thailand; and Fund staff estimates.

24. **Real exchange rate.** Micronesia's real exchange rate has been evolving in line with its neighboring countries in the Pacific, and is driven by changes in the price of imported food and fuel. The real effective rate appreciated by 5 percent between 2010 and 2013, before stabilizing in 2014 (Figure 2), but does not seem to have had much impact on Micronesia's export that is heavily concentrated on tuna fish (see Box 3 on the fisheries sector). Fish export increased from 7 percent of

[11] Kazuaki Washimi, April 2015, "Small States of the Pacific – Impact of Lower Oil Prices", IMF Asia and Pacific Small States Monitor.

GDP in FY2010 to 9 percent of GDP in FY2013, reflecting the increase in the international price of tuna.

25. **Authorities' view.** The authorities broadly shared the view that lower oil prices would have some positive impact on the economy. They also noted that utilities companies have already started to lower the electricity tariff to pass on the lower price of imported diesel. The authorities mentioned that the use of the U.S. dollar as the domestic currency remains appropriate for the FSM given its limited administrative capacity for independent monetary and exchange rate policies.

E. Other Issues

26. **Statistics.** Improving the reliability, coverage, and timeliness of economics statistics is critically important to better guide policies. Staff notes ongoing efforts by authorities to improve data collection and management, including by the Office of Statistics, Budget and Economic Management, Overseas Development Assistance, and Compact Management (SBOC) and the Banking Board. Micronesia has started reporting to the Fund fiscal data using the Government Finance Statistics Manual 2001 (GFSM 2001) format since FY2013. Annual balance of payments and international investment position statistics are also reported to the Fund since 2014. The authorities are encouraged to further build statistical capacity, drawing on TA provided by the Statistical Department of the Fund and PFTAC.

STAFF APPRAISAL

27. **Outlook.** Medium-term growth prospects in the FSM remain weak as the private sector remains sluggish while fiscal challenges loom ahead, in particular, the expiration of Compact grants in FY2023. However, policy actions included in the "2023 Action Plan" can strengthen the economic prospects of the FSM, if they can be implemented by achieving countrywide consensus across the national and four state governments.

28. **Fiscal policy.** The authorities should formulate a realistic medium-term fiscal framework that covers both the national and state governments, with a view to achieving budgetary self-reliance in the post-2023 period. The outstanding value of the trust funds in FY2023 should be used as the fiscal anchor to guide policy actions, including the implementation of the long-debated tax reform package and the extension of the LTFF to the national government; the transfer of fiscal surplus to the trust funds; and the widening of the URA coverage to the remaining two state governments. Fiscal consolidation efforts should be accompanied by improvement in the quality of public spending, so as to safeguard priority spending in the social sector and infrastructure investment with high development impact. The infrastructure development plan of 2004 should be updated as soon as possible to help expedite the release of Compact funds for infrastructure projects.

29. **Private sector.** Improving the investment climate is key to achieving private sector-led growth in the FSM. Growth-enhancing policy actions need to be undertaken, including addressing land tenure issues by expediting the land survey and registration, and facilitating foreign direct investment while paying particular attention to safeguard the cultural heritage and pristine nature of the country.

30. **Financial sector.** The commercial banking sector is sound with adequate capital and ample liquidity. Staff welcomes the authorities' efforts to strengthen the regulatory framework of credit unions, including by preparing a new Credit Union Act to place them under the supervision of the Banking Board.

31. **External sector.** Risks to external stability are currently limited because the current account deficits are financed by official grants. The use of the U.S. dollar as the official currency remains appropriate given the small size of the economy and its close financial and trade linkages with the United States.

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

Box 1. Micronesia: The "2023 Action Plan" and Its Economic Growth Strategy

Context. The FSM is facing fiscal and economic challenges as grants from the United States under the Compact of Free Association will expire in 2023 while investment returns from the trust funds (Compact Trust Fund and the FSM Trust Fund) are expected to be insufficient to replace them. The Strategic Development Plan of 2004-2023, while comprehensive in the coverage of planned policy actions, has not materialized in most part and the average real growth rate between 2004 and 2013 is disappointing at -0.4 percent.

2023 Planning Committee. In March 2012, the authorities established the "2023 Planning Committee". Composed of the President and the four state Governors, with the secretariat provided by the national government (SBOC: Office of Statistics, Budget and Economic Management, Overseas Development Assistance, and Compact Management). Since the draft Action Plan was unveiled in November 2014, an extensive public awareness campaign has been launched to get a nationwide support, including in places outside of the country (e.g., Guam and Hawaii) where there is a large Micronesian community.

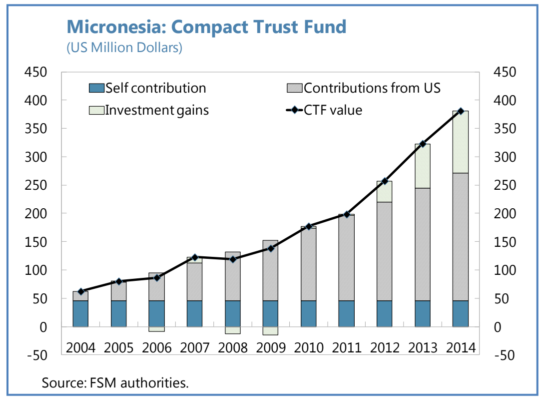
Scope and timeline. At the core of the Action Plan is the strengthening of the private sector while reducing reliance on the public sector as a driver of economic growth. In this context, the Action Plan aims at achieving a medium-term growth rate of 2 percent per year once all the proposed action plans are implemented, with the endorsement of the national and state legislatures. To this end, the Action Plan envisages policy actions in the following three areas: i) growth through structural reforms; ii) revenue mobilization (tax reforms to generate additional revenue of 4 percent of GDP); and iii) expenditure control (public administration reforms to have the expenditures track inflation levels). While the Action Plan has a time-bound results-based management matrix, a number of its policy actions, in particular, those in the fiscal and regulatory areas, require legislative measures. Achieving consensus in a nation with a loosely federated structure will be the key for the implementation of policy actions.

Key components of the economic growth strategy under the 2023 Action Plan

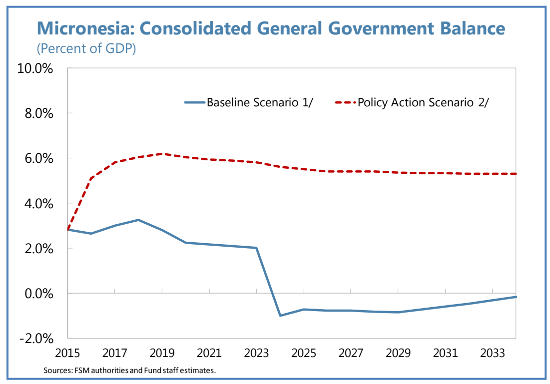
I. Cross-cutting agenda	
1. Regulatory reform	Enhance investor protection and transparency in investment (with IFC)
2. Land reform	Complete land survey and record land titles available for development
3. Capacity building of and financing to entrepreneurs	Support entrepreneurial development, including by providing training to SMEs for the development of managerial skills. Seed money could be provided from the new Investment Development Fund (to be established subject to legislative approval). The FSM Development Bank will further strengthen its focus on development lending, in particular to small businesses, in line with its Mission Statement.
II. Sector-specific agenda	
1. Tourism	Develop human resources and hotel capacity, including by attracting foreign investment
2. Agriculture	Increase subsistence production and local processing Increase production of speciality crops (e.g., pepper, coffee) for export
3. Fishery	Promote domestic fishing - both inland and coastal, processing and vessel servicing Develop acquaculture, including in the area of trochus shells
4. Energy	Develop renewable energy while enhancing efficiency of existing diesel-fueled power stations (with IDA and ADB)
5. Information and communications	Pursue more competition in the telecommunications sector FSM-Palau regional connectivity project (submarine cables, with IDA)
6. Infrastructure	Update the Infrastructure Development Plan of 2004 (with ADB) and pursue the gradual release of Compact infrastructure grants

Source: FSM authorities

Box 2. Micronesia: Long-term Outlook on Trust Funds



Context. Micronesia has two trust funds to better prepare for the post-2023 period: The Compact Trust Fund (CTF) [1] which is jointly managed by the US and the FSM; and the FSM Trust Fund which is managed by the national government. In FY2014, CTF had a balance of $381 million (120 percent of GDP) whereas the FSM Trust Fund had a balance of $33 million (11 percent of GDP). Returns from the trust funds have been volatile. In FY2008, CTF net return was negative 19 percent, substantially eroding the market value of the fund. It experienced further negative returns in FY2009 and 2011, while gains in FY2010 reached 13 percent. Average return between FY2012–14 was 12 percent, offsetting negative performances in FY2008, FY2009 and FY2011.



Scenarios: Two scenarios are considered to assess the long-term outlook and the implications for the FSM's fiscal sustainability. Long-term self-sufficiency is assumed to be achieved if after FY2023 the CTF, together with the FSM Trust Fund, can generate enough investment income to cover the reduction in Compact grants without eroding the real value of the trust funds.

Baseline Scenario

This scenario follows the assumptions adopted in the main text and the baseline in the DSA annex. Main assumptions include: a fiscal surplus of 2–3 percent of GDP until FY2023 on account of sustained fishing license fee revenue and some restraints on expenditures; half of the surplus will be transferred to the trust funds; and medium-term real GDP growth of 0.6 percent. Investment returns from the trust funds are assumed to average 6 percent, consistent with previous staff analysis. This is slightly higher than the average return (5.3 percent) since the CTF inception in 2004, which reflects the impact of unusually dismal earnings during the Global Financial Crisis.

Under the baseline scenario, investment returns from the trust funds in FY2024 (18 percent of GDP) will not be sufficient to cover the reduction in grants. While fiscal consolidation efforts by the state governments under the Long Term Fiscal Frameworks (LTFF) help constrain the expenditures, the fiscal balance of the general government will turn into a deficit of 1 percent of GDP in FY2024. The baseline assumes that the fiscal consolidation efforts are extended to the national government. This will result in smaller deficit in later years, resulting in a balanced budget in FY2034. Nominal amount of annual draw-downs from the trust funds will remain the same as in FY2024 ($70 million) – however, due to modest inflation, its real value as measured

[1] The CTF was created to contribute to the long-term budgetary self-reliance of the FSM and provide the FSM government with an ongoing source of revenue after FY2023. The amended Compacts and their subsidiary agreements contain no commitments, either express or implied, regarding the level of the revenue that will be generated by the trust fund, nor is there any commitment regarding the degree to which the revenue will contribute to the long-term budgetary self-reliance of the FSM.

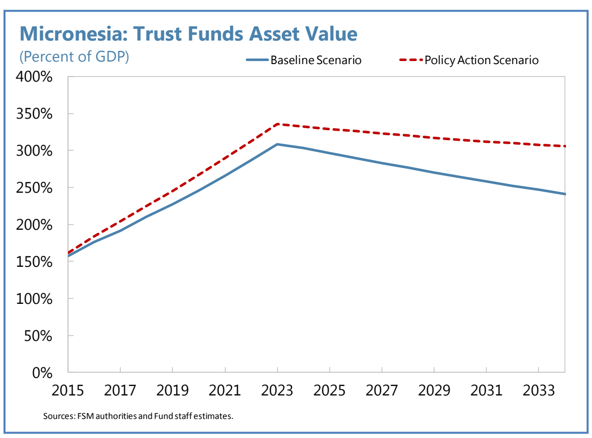
Box 2. Micronesia: Long-term Outlook on Trust Funds (concluded)

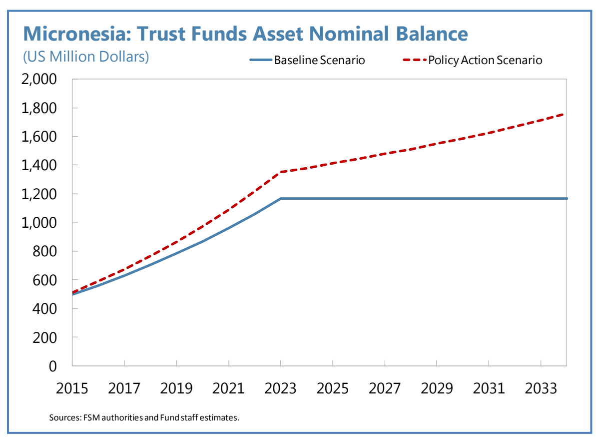
in percent of GDP will gradually decline (from 18 percent of GDP in FY2024 to 14 percent of GDP in FY2034). The real value of the trust funds balance will also decline (from 300 percent of GDP in FY2024 to 240 percent of GDP in FY2034), while their nominal amount will remain the same. In the meantime, the financing gap is assumed to be covered by additional borrowing on concessional terms to maintain priority spending in public infrastructure and social services with high development impact.

Policy Action Scenario

Under the policy action scenario, the authorities are assumed to undertake reforms to enhance economic growth and consolidate the fiscal balance. Medium-term growth rate rises by 1 percent per year from the baseline (from 0.6 to 1.6 percent). The tax reform package is implemented gradually between FY2016 and 2019, resulting in an increase of tax revenue by 4 percent of GDP in FY2019 and onwards. In addition to the fiscal consolidation efforts by the state governments under the LTFF, the policy action scenario assumes expenditure contraction by 1 percent of GDP. The entire fiscal surplus is transferred to the trust funds.

The trust funds balance will reach close to 340 percent of GDP in FY2023, generating sufficient investment returns to avoid fiscal deficit from FY2024[2]. With the view to keeping essential services of the Government, this scenario assumes that draw-downs from the trust funds are adjusted annually by the inflation rate (about 2 percent per year). The balance of the trust funds will remain above 300 percent throughout the projection period while the public debt will remain on a sustainable path on account of stronger fiscal balance and accelerated growth (see the DSA Appendix). This shows again the critical importance for the authorities to achieve a national consensus in a loosely federated nation – the key to implement policy actions contained in the 2023 Action Plan, in particular, growth-enhancing structural reforms and the long-debated tax reform package.





[2] If the assumed investment return drops from 6 to 5 percent, the trust funds balance in FY2023 will decline to about 310 percent of GDP. Lifting the trust funds value back to about 340 percent of GDP in FY2023 will require additional fiscal consolidation of 3 percent of GDP per year compared to the Policy Action Scenario. Generating the same amount of return in FY2024 as in the Policy Action Plan will require additional fiscal consolidation of 10 percent of GDP per year compared to the Policy Action Scenario (trust funds value in FY2023 will reach 400 percent of GDP).

Box 3. Micronesia: Fisheries Sector in the FSM Economy

Context. Micronesian seas are rich in fish resources, in particular, skipjack, yellowfin, and bigeye tuna. FSM's Exclusive Economic Zone (EEZ) covers an area of about 3 million square kilometers, close to the size of India. Fisheries sector is one of the pillars underpinning the economic growth strategy under the 2023 Action Plan. While employment in the sector is relatively small (2 percent of the total employment), fish export has been growing on account of rising international price of tuna and dominates Micronesia's exports (more than 85 percent of total exports of goods if excluding re-exports of petroleum products for foreign aircrafts re-fuelling at Micronesia's airports).

Subsectors. Fisheries in Micronesia can be categorized in 3 subsectors: i) subsistence fishery (mostly for home consumption and employment is informal); ii) locally-based commercial fishery (coastal and offshore); and iii) foreign-based offshore fishery. While the first two subsectors contribute directly to the GDP of the FSM (about 10 percent of GDP in total), the third subsector (foreign-based offshore fishery) contributes to the economy by way of paying fishing license fees to the National government.

Locally-based commercial fishery. Five fishing companies are incorporated in the FSM: two are relatively small and domestically-owned (wholly and minority-partially owned by state governments), two joint ventures (each 75 percent owned by Japanese companies), and one Chinese flagged company based in the FSM. Efforts to build locally-owned fishing industry have so far been disappointing on account mostly of lack of knowledge on international fish markets and low managerial capacities. Requirements for large upfront capital investment have also been an obstacle. Currently, the contribution to the development of the private sector and employment remains low, with formal employment in the fishing sector at less than 2 percent of total employment.

Foreign-based offshore fishery. Foreign-based vessels fishing in the Micronesian EEZ, mostly from China, Japan, South Korea, Taiwan, Province of China, and the U.S, pay fishing license fees to the national government. The fees are determined under the provisions in the Nauru Agreement[1], a regional agreement that introduced in 2012 minimum benchmark fees for foreign fishing companies operating in the region. Under this system, fishing companies pay a flat fee per vessel per day with adjustment for the size of the vessel (VDS: Vessels Day Scheme). Minimum benchmark fees under the vessel day scheme (VDS) rose from $5,000 a day in FY2012 to $6,000 in FY2014 and most recently to $8,000 in FY2015 – a sign that the regional agreement has enhanced the bargaining powers of the signatory countries. While fishing license fee revenue has so far been increasing in tandem with the upward revision of the benchmark fees under the VDS, uncertainties loom ahead as the recent plunge in the price of tuna (from the peak of $2,520 per ton in the third quarter of 2012 to $1,670 per ton in the fourth quarter of 2014) has started to have some impacts

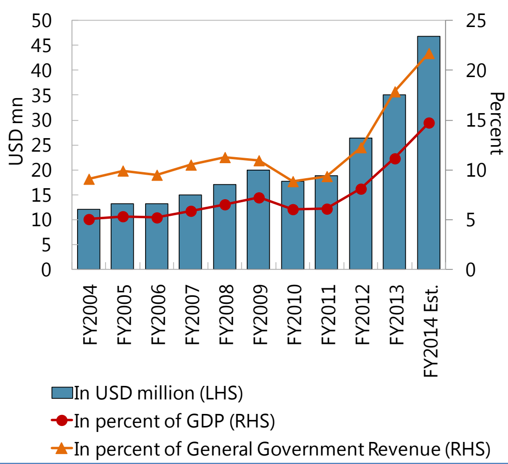
[1] "Nauru Agreement Concerning Cooperation in the Management of Fisheries of Common Interest" is a regional agreement between 8 signatories (PNA: Parties to the Nauru Agreement): FSM, Kiribati, Marshal Islands, Nauru, Palau, Papua New Guinea, Solomon Islands and Tuvalu.

Box 3. Micronesia: Fisheries Sector in the FSM Economy (concluded)

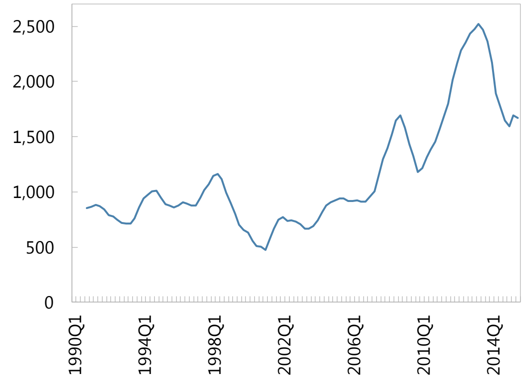
on foreign fishing companies that send their vessels to the EEZ of Micronesia. Also, changes in the climate, including the El Niño cycle, could affect fish movement in the Pacific. In FY2014, revenue from the fishing license fees was $47 million (15 percent of GDP), accounting for 22 percent of the general government revenue. Authorities assume that the fishing license fee revenue will remain at the same level in the coming years.

Future prospects. While the authorities see potentials in the fishery sector, they recognize the difficulty in building their own fishing industry as opposed to foreign fishing companies that are better connected to the international tuna markets with well-equipped vessels. In this context, they are pursuing to obtain more value added from foreign vessels operating in the region rather than making more investment in domestic fishing companies: more transshipment of fish and vessel servicing at Micronesian ports. The planned ADB-financed Pohnpei Port development project that envisages expanding the wharf to cater to larger and more vessels will play an important role in this respect. Also, the authorities are considering introducing lower fees for those foreign fishing companies that make investment in the FSM for processing their fish catches in the Micronesian EEZ.

Micronesia: Fishing License Fees



Price of Tuna[1]
(U.S. dollars per ton)

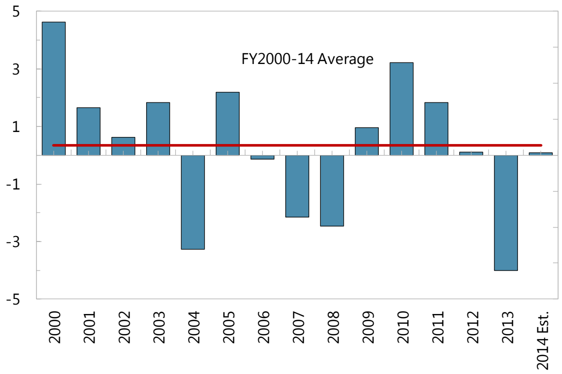


1/ Four-quarter moving average.
Sources: Globe Fish, Ministry of Trade of Thailand; and IMF staff estimates.

Figure 1. Micronesia: Economic Developments

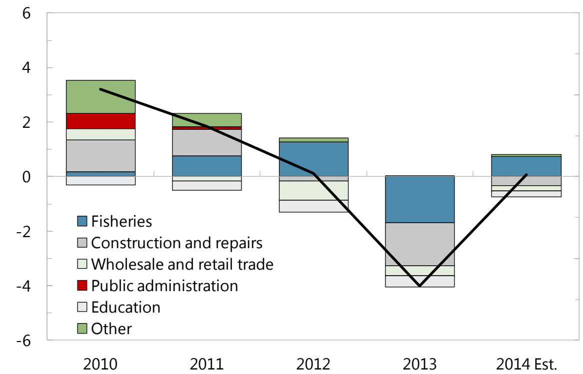
Micronesia's growth has been disappointing, as the delay in structural reforms holds back private sector development...

Real GDP Growth
(Year-on-year percent change)



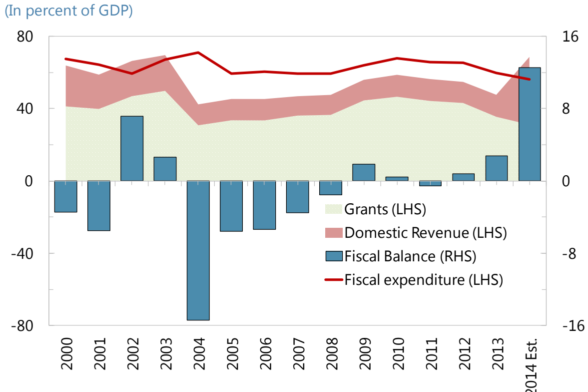
While growth in the fisheries sector has improved in FY2014, the construction sector continues to be sluggish.

Contribution to Growth
(As share to real GDP)



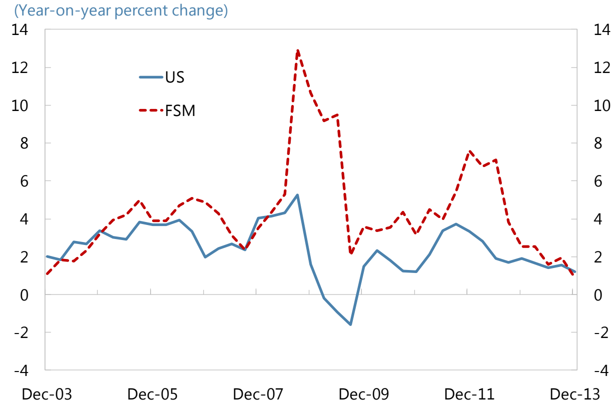
Fiscal balance has recently turned into surplus, on the back of increasing fishing license fee revenue.

Fiscal Balance 1/
(In percent of GDP)



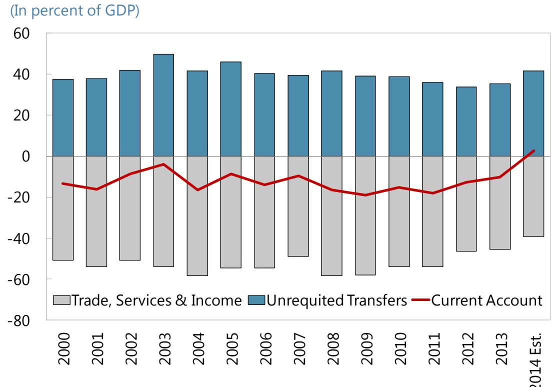
Inflation has eased since 2013s.

CPI Inflation
(Year-on-year percent change)



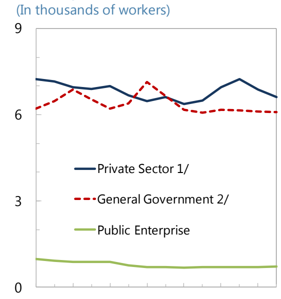
The current account has mostly been in deficit, but financed largely by capital grants from donors.

Balance of Payments
(In percent of GDP)



Public sector, including public enterprises, accounts for over half of the total employment.

Employment
(In thousands of workers)



1/ Does not include subsistence sector employment.
2/ National, state and local governments.

Employment by Sector, FY2013

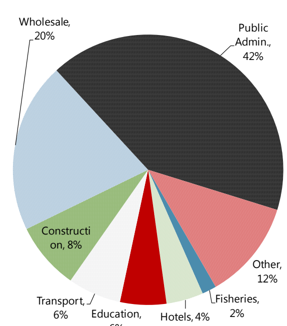
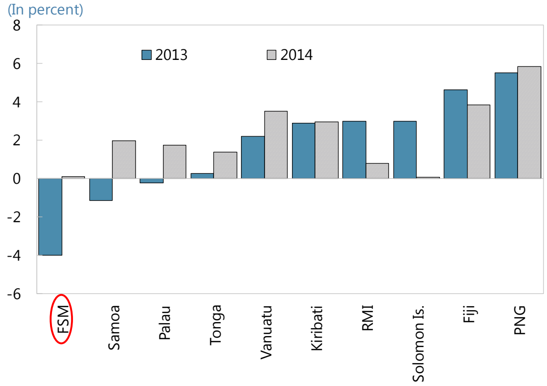


Figure 2. Micronesia: Regional Comparison of Recent Developments

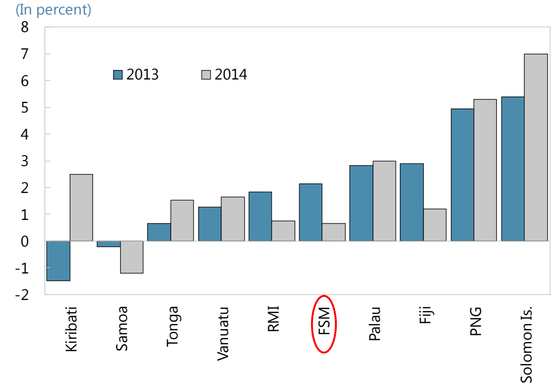
Micronesia's economy is stagnating and fares worse than the other Pacific Island Countries (PICs)…

Real GDP Growth
(In percent)



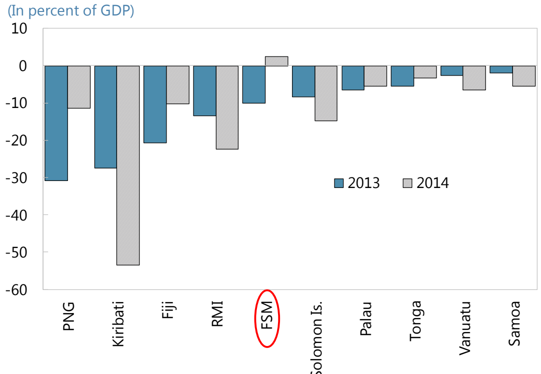
While inflation moderated in 2014 on the back of falling oil prices…

CPI Inflation
(In percent)



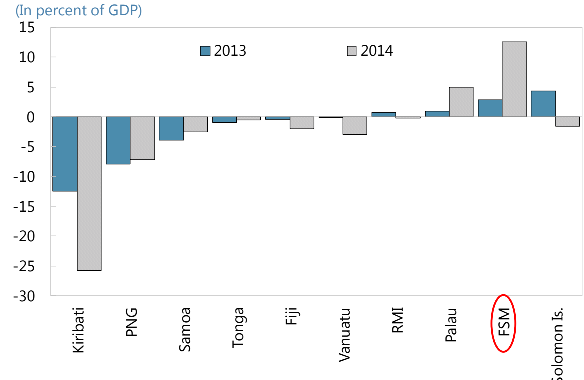
And the current account deficit improved in 2014, thanks to increasing fishing license fees and a tax windfall from a company's sale of shares launched on a foreign stock exchange.

Current Account Balance
(In percent of GDP)



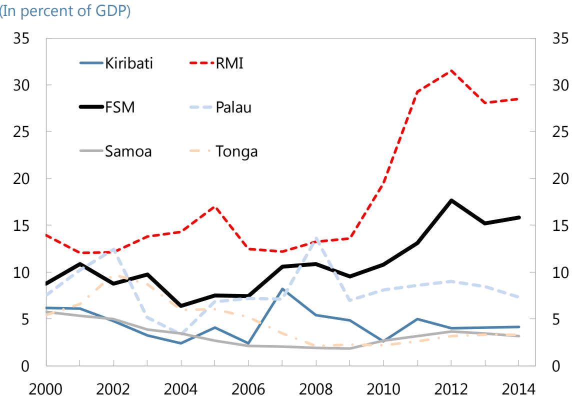
FSM had a large fiscal surplus in 2014, on the back of increasing fishing license fees and a tax windfall from a company's sale of shares launched on a foreign stock exchange.

General Government Overall Balance
(In percent of GDP)



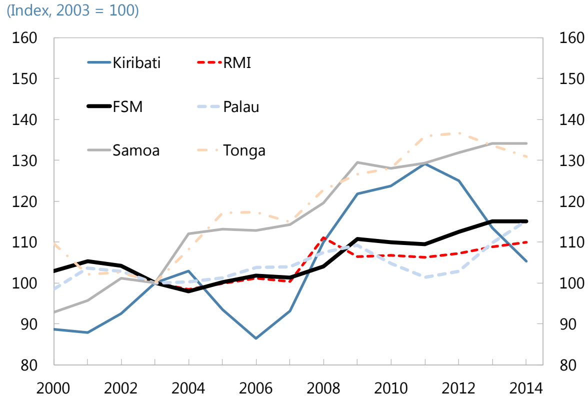
Exports have been stable in the last few years, as tuna price in the international market has been weakening…

Total Export of Goods
(In percent of GDP)



While the real effective exchange rate (REER) has somewhat appreciated recently, as in a number of PICs.

Real Effective Exchange Rates (REER)
(Index, 2003 = 100)



Source: FSM authorities and Fund staff calculations.

Table 1. Micronesia: Selected Economic Indicators, FY2010–15 1/

Nominal GDP (FY2013):	US$315 million
Population (FY2013):	103,679
GDP per capita (FY2013):	US$3,034
IMF Quota:	SDR 5.1 million

	FY2010	FY2011	FY2012	FY2013	FY2014 Est.	FY2015 Proj.
Real sector (annual percent change)						
Real GDP	3.2	1.8	0.1	-4.0	0.1	0.3
Consumer prices	3.7	4.3	6.3	2.1	0.7	-1.0
Employment	3.9	1.7	-2.6	-2.0	0.0	0.1
Public (incl. public enterprises)	1.1	-0.4	-0.8	-0.7	0.0	0.0
Private	7.1	3.8	-4.8	-3.9	0.1	0.2
Nominal wages	2.7	0.4	3.8	1.6	1.8	1.9
public average wage/private average wage	2.2	2.1	2.0	2.0	2.0	2.0
Consolidated government finance (in percent of GDP)						
Revenue and grants	68.2	65.0	66.0	62.3	68.6	61.9
Revenue	21.6	20.8	22.9	26.8	37.4	30.9
Grants 2/	46.6	44.3	43.1	35.5	31.2	31.0
Expenditure	67.8	65.6	65.3	59.6	56.1	59.0
Current	46.9	45.6	44.2	45.9	46.0	45.5
Capital	20.8	20.0	21.1	13.7	10.1	13.6
Overall balance	0.5	-0.6	0.8	2.8	12.5	2.8
Overall balance (exc. Grants)	-46.1	-44.8	-42.4	-32.8	-18.7	-28.2
Commercial banks (in percentage of GDP; end of period)						
Loans	19.0	17.9	17.4	17.2	18.0	…
Deposits	52.5	53.8	62.7	67.8	75.4	…
Interest rates (in percent, average for FY)						
Consumer loans	14.9	14.4	14.2	15.7	15.7	…
Commercial loans	6.6	6.6	6.4	6.4	6.4	…
Balance of payments (in millions of U.S. dollars)						
Trade balance	-128.4	-134.0	-125.7	-131.1	-129.2	-119.1
Net services and income	-29.8	-32.5	-25.8	-11.7	5.5	5.6
Private and official transfers	113.8	111.2	110.3	111.1	131.7	111.4
Current account	-44.4	-55.3	-41.2	-31.6	8.0	-2.1
(in percent of GDP)	-15.1	-17.9	-12.6	-10.1	2.5	-0.7
Current account excluding official transfers	-153.4	-158.9	-142.5	-129.6	-89.6	-99.4
(in percent of GDP)	-52.2	-51.4	-43.7	-41.2	-28.5	-31.5
External debt (in millions of U.S. dollars; end of period) 3/						
Stock	86.4	89.8	90.3	85.2	83.0	83.7
(in percent of GDP)	29.4	29.1	27.7	27.1	26.4	26.5
Debt service	4.4	5.0	5.1	5.9	7.1	7.0
(in percent of exports of goods and services)	6.3	6.7	5.3	6.7	7.9	8.0
Exchange rate regime	U.S. dollar is the official currency					
Real effective exchange rate 4/	109.9	109.5	112.4	115.1	115.8	n.a.

Sources: FSM authorities and IMF staff estimates.

1/ Fiscal year ending September 30.

2/ Excludes grants to the Compact Trust Fund.

3/ Government and public enterprise debt only.

4/ Calendar year. 2003=100.

Table 2. Micronesia: General Government Operations, FY2010–20 1/

	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020
					Est.	Projections					
	(In millions of U.S. dollars)										
Revenue	200.3	201.0	215.2	196.1	215.9	195.3	193.7	197.6	201.1	204.9	209.0
Tax revenue	35.6	37.3	38.0	38.2	61.5	41.0	41.3	42.5	43.4	44.6	45.7
Wage and salary tax	7.6	7.6	7.7	7.9	7.9	7.9	8.0	8.2	8.4	8.6	8.8
Gross revenue tax	16.8	17.6	18.1	17.2	17.2	17.3	17.4	17.9	18.3	18.8	19.3
Corporate Tax	0.8	2.1	2.6	4.4	27.6	7.6	7.7	7.9	8.1	8.3	8.5
Import taxes	10.0	9.8	9.4	8.5	8.5	7.9	8.0	8.2	8.4	8.6	8.8
Other taxes	0.3	0.3	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.3
Grants (from abroad) 2/	136.7	136.8	140.6	111.7	98.1	97.9	95.3	96.6	97.8	98.8	100.3
Current	86.1	84.0	82.0	80.4	80.0	79.7	79.3	79.1	78.9	78.7	78.5
Compact general	66.1	66.9	65.2	63.8	63.8	63.9	64.0	64.2	64.4	64.6	64.7
Capital	50.7	52.8	58.6	31.3	18.1	18.2	16.0	17.4	18.9	20.1	21.8
Non-tax revenue	28.0	26.8	36.6	46.1	56.3	56.5	57.0	58.6	59.9	61.5	63.0
Fishing license fees	17.7	18.8	26.4	35.0	46.9	47.0	47.5	48.8	49.9	51.2	52.4
Expenditure	198.9	202.8	212.7	187.4	176.6	186.4	185.2	187.8	190.3	195.3	201.1
Expense	137.8	141.1	144.1	144.3	144.9	143.5	144.8	147.2	149.7	152.5	155.3
Goods and services	131.2	133.6	137.2	138.3	138.9	137.5	138.8	141.0	143.4	146.1	148.8
Wages and salaries	68.0	68.0	68.3	69.5	70.0	69.3	70.6	72.0	73.5	75.0	76.5
Travel	10.4	10.1	9.5	8.8	9.7	9.7	9.7	9.7	9.7	9.7	0.1
Other	52.8	55.6	59.4	60.0	59.1	58.4	58.5	59.3	60.1	61.4	72.2
Interest payments	0.8	1.0	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Subsidies	1.0	0.7	1.0	0.6	0.6	0.6	0.7	0.7	0.7	0.7	0.7
Net transfers	4.8	5.8	4.8	4.2	4.2	4.2	4.2	4.3	4.4	4.5	4.7
Net acquisition of nonfinancial assets	61.1	61.7	68.6	43.1	31.7	42.9	40.5	40.5	40.6	42.7	45.8
Gross operating balance	62.5	59.9	71.1	51.7	71.1	51.9	48.9	50.4	51.5	52.4	53.7
Net lending/borrowing	1.4	-1.8	2.5	8.7	39.4	8.9	8.5	9.8	10.9	9.6	7.9
	(In percent of GDP)										
Revenue	68.2	65.0	66.0	62.3	68.6	61.9	60.8	60.4	60.1	59.6	59.4
Tax revenue	12.1	12.1	11.6	12.2	19.5	13.0	13.0	13.0	13.0	13.0	13.0
Grants (from abroad) 2/	46.6	44.3	43.1	35.5	31.2	31.0	29.9	29.5	29.2	28.8	28.5
Non-tax revenue	9.5	8.7	11.2	14.7	17.9	17.9	17.9	17.9	17.9	17.9	17.9
Expenditure	67.8	65.6	65.3	59.6	56.1	59.0	58.1	57.4	56.8	56.8	57.1
Expense	46.9	45.6	44.2	45.9	46.0	45.5	45.4	45.0	44.7	44.4	44.1
Net acquisition of nonfinancial assets	20.8	20.0	21.1	13.7	10.1	13.6	12.7	12.4	12.1	12.4	13.0
Gross operating balance	21.3	19.4	21.8	16.4	22.6	16.4	15.3	15.4	15.4	15.2	15.2
Net lending/borrowing	0.5	-0.6	0.8	2.8	12.5	2.8	2.7	3.0	3.2	2.8	2.2
Balance of trust funds (CTF and FSMTF)	71.7	71.7	82.5	107.0	131.5	157.8	175.9	192.0	210.0	227.6	246.3
Memorandum items:											
GDP in nominal prices	293.6	309.1	325.9	314.6	314.8	315.7	318.7	327.4	334.7	343.6	352.0

Sources: FSM authorities and IMF staff estimates.
1/ Fiscal year ending September. The consolidated fiscal accounts cover the national and four state governments.
2/ Excludes grants for the Compact Trust Fund.

Table 3. Micronesia: Indicators of Financial and External Vulnerability, FY2010–20

	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020
						Projections					
Commercial banks											
Deposits (in percent of GDP)	52.5	53.8	62.7	67.8	75.4	...	...	...	...	...	...
Deposits (Year-on-year percent change)	16.3	7.8	22.9	4.3	11.3	...	...	...	...	...	...
Loans (in percent of GDP)	19.0	17.9	17.4	17.2	18.0	...	...	...	...	...	...
Loans (Year-on-year percent change)	19.3	-0.9	2.9	-4.8	4.6	...	...	...	...	...	...
Loan to deposit ratio (in percent)	36.1	33.2	27.8	25.3	23.8	...	...	...	...	...	...
Foreign assets (in percent of GDP)	45.6	46.4	55.2	61.6	69.3	...	...	...	...	...	...
Equity capital (in percent of total asset)	9.4	9.1	7.8	7.6	7.2	...	...	...	...	...	...
Loss allowance (in percent of total loans) 1/	3.7	4.5	3.7	3.6	3.2	...	...	...	...	...	...
Noncurrent loan (in percent of total loans) 1/	3.0	5.6	5.3	4.4	3.5	...	...	...	...	...	...
FSM Development Bank											
Loans (in percent of GDP)	9.2	7.8	7.1	7.8	7.1	...	...	...	...	...	...
External indicators 2/											
Exports (goods & services, y/y percent change)	13.8	8.3	27.0	-7.7	2.4	-3.0	1.5	2.7	2.3	2.4	1.8
Imports (goods & services, y/y percent change)	0.2	5.8	4.3	-1.9	0.0	-4.9	1.0	2.7	2.2	2.7	2.4
Current account balance (percent of GDP)											
Including official transfers	-15.1	-17.9	-12.6	-10.1	2.5	-0.7	-0.8	-1.5	-2.0	-2.7	-3.4
Excluding official transfers	-52.2	-51.4	-43.7	-41.2	-28.5	-31.5	-31.3	-31.2	-31.2	-31.2	-31.3
Total external debt 3/											
In millions of U.S. dollars	86.4	89.8	90.3	85.2	83.0	83.7	85.1	83.7	91.3	99.0	106.4
In percent of exports of goods and services	124.2	119.2	94.3	96.4	91.8	95.4	95.5	91.5	97.5	103.2	109.1
In percent of GDP	29.4	29.1	27.7	27.1	26.4	26.5	26.7	25.6	27.3	28.8	30.2
Debt service											
In millions of U.S. dollars	4.4	5.0	5.1	5.9	7.1	7.0	6.3	5.9	5.8	5.7	5.9
In percent of exports of goods and services	6.3	6.7	5.3	6.7	7.9	8.0	7.1	6.4	6.2	5.9	6.0
In percent of GDP	1.5	1.6	1.6	1.9	2.3	2.2	2.0	1.8	1.7	1.7	1.7

Sources: FSM authorities and IMF staff estimates.

1/ Domestic bank. Data for FY2014 are as of December 31, 2014.

2/ Data for FY2014 are estimate.

3/ Most of the debt is concessional and to official lenders, of which about 2/3 is to the Asian Development Bank.

Table 4. Micronesia: Deposit Money Banks, FY2010–14

	FY2010	FY2011	FY2012	FY2013	FY2014
			(In millions of U.S. dollars)		
Assets and liabilities					
Assets	178.4	190.1	228.1	237.7	262.9
Foreign assets 1/	133.9	143.5	179.8	193.8	218.0
Claims on private sector	31.9	35.2	38.0	34.9	37.3
Consumer loans	21.7	22.2	25.3	24.6	…
Claims on the public sector	4.8	3.7	2.6	1.5	0.1
Others assets	7.4	7.7	7.7	7.5	7.5
Liabilities	178.4	190.1	228.1	237.7	262.9
Deposits	154.1	166.2	204.3	213.2	237.3
Central government deposits	29.0	37.2	62.1	63.7	34.0
Capital accounts	16.8	17.3	17.7	18.0	18.9
Other liabilities	7.5	6.5	6.0	6.5	6.8
Memorandum items					
Loan/deposit ratio (in percent)	36.1	33.2	27.8	25.3	23.8
Deposits (percent change)	16.3	7.8	22.9	4.3	11.3
Loans (percent change)	19.3	-0.9	2.9	-4.8	4.6
Consumer loans (in percent of total loans)					
Interest rates (percent) 2/					
Deposit rates					
Savings deposits 3/	1.4	1.2	1.0	0.9	0.6
CDs	1.3	0.9	0.6	0.4	0.4
Time Deposits	0.8	1.0	0.8	0.7	0.8
Loans rates 4/					
Consumer loans	14.9	14.4	14.2	15.7	15.7
Commercial loans	6.6	6.6	6.4	6.4	6.4

Sources: FSM authorities and IMF staff estimates.

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. Micronesia: Balance of Payments, FY2010–20

	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020
					Est.	Projections					
	(In millions of U.S. dollars)										
Current Account Balance	-44.4	-55.3	-41.2	-31.6	8.0	-2.1	-2.6	-4.9	-6.7	-9.2	-12.0
Trade balance	-128.4	-134.0	-125.7	-131.1	-129.2	-119.1	-119.8	-123.1	-125.8	-129.3	-133.1
Exports, f.o.b.	31.6	40.4	57.6	47.8	49.9	47.1	48.0	49.3	50.5	51.6	52.3
Imports, f.o.b.	-160.0	-174.4	-183.2	-178.9	-179.0	-166.2	-167.8	-172.4	-176.3	-181.0	-185.4
Petroleum products	-39.2	-45.7	-57.8	-52.6	-52.6	-39.4	-39.8	-40.9	-41.8	-42.9	-44.0
Services account	-40.8	-43.3	-42.1	-39.0	-39.0	-39.1	-39.4	-40.5	-41.4	-42.5	-43.6
Receipts	37.9	35.0	38.2	40.5	40.5	40.7	41.0	42.2	43.1	44.3	45.3
Travel	29.8	26.8	27.8	30.1	30.1	30.2	30.5	31.3	32.0	32.9	33.7
Payments	-78.7	-78.3	-80.2	-79.6	-79.5	-79.7	-80.5	-82.7	-84.5	-86.8	-88.9
Freight and insurance	-25.6	-28.4	-29.7	-27.8	-27.8	-27.9	-28.2	-28.9	-29.6	-30.4	-31.1
Transportation	-15.6	-15.4	-17.2	-16.8	-16.8	-16.9	-17.0	-17.5	-17.9	-18.4	-18.8
Income, net	11.0	10.8	16.2	27.4	44.5	44.7	45.3	46.7	47.9	49.4	50.8
Receipts	23.5	23.7	31.4	39.9	55.2	55.4	55.8	57.1	58.3	59.6	60.9
Fishing license fees	17.7	18.7	26.3	34.9	46.9	47.0	47.5	48.8	49.9	51.2	52.4
Payments	-12.5	-12.9	-15.2	-12.5	-10.8	-10.7	-10.6	-10.4	-10.4	-10.2	-10.1
Foreign workers earnings	-2.6	-2.7	-3.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1
Unrequited transfers	113.8	111.2	110.3	111.1	131.7	111.4	111.4	112.0	112.6	113.3	113.9
Private	3.5	6.3	7.7	12.2	32.5	12.5	12.6	13.0	13.3	13.6	14.0
Inflows 1/	18.8	22.0	24.1	28.2	48.6	28.6	28.9	29.7	30.4	31.2	31.9
Outflows	15.3	15.7	16.4	16.0	16.1	16.2	16.3	16.7	17.1	17.6	18.0
Official	109.0	103.6	101.3	98.0	97.6	97.3	97.1	97.4	97.6	97.9	98.2
Compact funds	66.1	66.9	65.2	63.8	63.8	63.9	64.0	64.2	64.4	64.6	64.7
Other	42.9	36.7	36.1	34.2	33.8	33.4	33.1	33.2	33.2	33.3	33.4
Capital Account Balance	85.7	84.4	91.6	66.6	65.7	67.1	69.9	72.7	75.6	78.2	81.4
Capital grants	64.2	62.0	68.3	42.2	40.1	40.2	41.6	43.1	44.6	45.7	47.5
CTF Grants	21.5	22.4	23.3	24.4	25.7	26.9	28.2	29.6	31.0	32.5	33.9
Financial Account Balance	41.4	30.5	57.7	40.2	73.7	65.0	62.4	65.4	69.0	69.5	69.5
Direct Investment (net)	-0.8	-0.8	-1.0	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.9
Portfolio investment (net)	30.0	22.2	24.3	28.0	65.2	36.0	36.8	39.3	41.7	41.5	41.2
of which: Contributions to CTF	21.5	22.4	23.3	24.4	25.7	26.9	28.2	29.6	31.0	32.5	33.9
Other investment (net)	12.2	9.1	34.5	13.0	9.3	29.8	26.5	26.9	28.1	28.9	29.1
Memorandum items	(In percent of GDP)										
Current account balance	-15.1	-17.9	-12.6	-10.1	2.5	-0.7	-0.8	-1.5	-2.0	-2.7	-3.4
Trade balance	-43.7	-43.4	-38.6	-41.7	-41.0	-37.7	-37.6	-37.6	-37.6	-37.6	-37.8
Exports	10.8	13.1	17.7	15.2	15.8	14.9	15.1	15.1	15.1	15.0	14.8
Imports	-54.5	-56.4	-56.2	-56.9	-56.9	-52.7	-52.7	-52.7	-52.7	-52.7	-52.7
Service	-13.9	-14.0	-12.9	-12.4	-12.4	-12.4	-12.4	-12.4	-12.4	-12.4	-12.4
Income (net)	3.7	3.5	5.0	8.7	14.1	14.2	14.2	14.3	14.3	14.4	14.4
Receipts	8.0	7.7	9.6	12.7	17.5	17.5	17.5	17.5	17.4	17.3	17.3
Fishing license fees	6.0	6.1	8.1	11.1	14.9	14.9	14.9	14.9	14.9	14.9	14.9
Payments	4.3	4.2	4.7	4.0	3.4	3.4	3.3	3.2	3.1	3.0	2.9
Transfers	38.8	36.0	33.9	35.3	41.8	35.3	35.0	34.2	33.6	33.0	32.4
Private 1/	1.2	2.0	2.4	3.9	10.3	4.0	4.0	4.0	4.0	4.0	4.0
Official	37.1	33.5	31.1	31.1	31.0	30.8	30.5	29.7	29.2	28.5	27.9
Capital account balance	29.2	27.3	28.1	21.2	20.9	21.3	21.9	22.2	22.6	22.8	23.1
Capital grants	21.9	20.1	21.0	13.4	12.7	12.7	13.1	13.2	13.3	13.3	13.5
CTF grants	7.3	7.2	7.1	7.8	8.1	8.5	8.9	9.0	9.3	9.4	9.6
Financial account balance	14.1	9.9	17.7	12.8	23.4	20.6	19.6	20.0	20.6	20.2	19.7
Direct investment (net)	-0.3	-0.3	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Portfolio investment (net)	10.2	7.2	7.5	8.9	20.7	11.4	11.5	12.0	12.5	12.1	11.7
of which: Contributions to CTF	7.3	7.2	7.1	7.8	8.1	8.5	8.9	9.0	9.3	9.4	9.6

Sources: FSM authorities and IMF staff estimates.

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

Table 6. Micronesia: Medium-Term Scenario, FY2013–25

	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025
		Est.	Projections										
Real sector													
Real GDP (percent change)	-4.0	0.1	0.3	1.0	0.9	0.9	0.8	0.7	0.6	0.6	0.6	0.6	0.6
Consumer prices (percent change)	2.1	0.7	-1.0	1.9	2.0	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.0
General government finance (in percent of GDP)													
Revenue and grants	62.3	68.6	61.9	60.8	60.4	60.1	59.6	59.4	58.7	58.1	57.4	53.5	53.0
Total domestic revenue	26.8	37.4	30.9	30.9	30.9	30.9	30.9	30.9	30.9	30.9	30.9	49.0	48.6
of which fishing license fees	11.1	14.9	14.9	14.9	14.9	14.9	14.9	14.9	14.9	14.9	14.9	14.9	14.9
Grants 1/	35.5	31.2	31.0	29.9	29.5	29.2	28.8	28.5	27.8	27.2	26.6	4.5	4.4
Expenditure	59.6	56.1	59.0	58.1	57.4	56.8	56.8	57.1	56.6	56.0	55.4	54.6	53.7
Current	45.9	46.0	45.5	45.4	45.0	44.7	44.4	44.1	43.7	43.3	42.9	42.3	41.7
Capital	13.7	10.1	13.6	12.7	12.4	12.1	12.4	13.0	12.8	12.7	12.5	12.3	12.0
Overall balance	2.8	12.5	2.8	2.7	3.0	3.2	2.8	2.2	2.2	2.1	2.0	-1.0	-0.7
Balance of trust funds (CTF and FSM TF)	336.5	414.0	498.2	560.6	628.7	702.9	782.3	867.2	958.5	1056.9	1168.5	1168.5	1168.5
(In percent of GDP)	107.0	131.5	157.8	175.9	192.0	210.0	227.6	246.3	266.1	286.8	310.0	303.0	296.2
Balance of payments (in millions of U.S. dollars)													
Trade balance	-131.1	-129.2	-119.1	-119.8	-123.1	-125.8	-129.3	-133.1	-136.8	-140.5	-144.4	-147.8	-151.3
Net services	-39.0	-39.0	-39.1	-39.4	-40.5	-41.4	-42.5	-43.6	-44.6	-45.6	-46.7	-47.4	-48.2
Net income	27.4	44.5	44.7	45.3	46.7	47.9	49.4	50.8	52.1	53.5	54.9	126.5	128.0
Private and official transfers	111.1	131.7	111.4	111.4	112.0	112.6	113.3	113.9	114.6	115.2	115.9	54.9	55.6
Current account	-31.6	8.0	-2.1	-2.6	-4.9	-6.7	-9.2	-12.0	-14.7	-17.4	-20.2	-13.8	-16.0
(In percent of GDP)	-10.1	2.5	-0.7	-0.8	-1.5	-2.0	-2.7	-3.4	-4.1	-4.7	-5.4	-3.6	-4.0
Current account excluding official transfers	-129.6	-89.6	-99.4	-99.7	-102.3	-104.3	-107.1	-110.1	-113.1	-116.1	-119.2	-51.4	-53.8
(In percent of GDP)	-41.2	-28.5	-31.5	-31.3	-31.2	-31.2	-31.2	-31.3	-31.4	-31.5	-31.6	-13.3	-13.6
External debt (in millions of US$; end of period) 2/													
Stock	85.2	83.0	83.7	85.1	83.7	91.3	99.0	106.4	113.9	121.1	128.1	138.8	148.4
(in percent of GDP)	27.1	26.4	26.5	26.7	25.6	27.3	28.8	30.2	31.6	32.9	34.0	36.0	37.6
Debt service	5.9	7.1	7.0	6.3	5.9	5.8	5.7	5.9	5.9	6.0	6.2	6.2	6.2
(in percent of exports of goods and services)	6.7	7.9	8.0	7.1	6.4	6.2	5.9	6.0	5.9	6.0	6.0	5.9	5.8

Sources: FSM authorities and IMF staff estimates.

1/ Excludes contributions to the Compact Trust Fund.

2/ Government and public enterprise debts only.

Table 7. Micronesia: Millennium Development Goals (MDGs) Indicators

	1990	2000	2004	2007	2011	2012	2013
Goal 1: Eradicate extreme proverty and hunger							
Poorest quintile's share in national income or consumption, percentage	...	1.6	...	...	...	...	...
Poverty headcount ratio at $1.25 a day (PPP) (% of population)	...	44.7	...	...	...	...	...
Goal 2: Achieve universal primary education							
Net enrolment ratio in primary education	...	...	...	...	...	...	...
Proportion of pupils starting grade 1 who reach last grade of primary	...	...	...	...	...	...	...
Goal 3: Promote gender equality and empower women							
Ratio of girls to boys in primary, secondary and tertiary education							
Gender Parity Index in primary level enrolment	...	...	0.98	1.01	...	...	...
Gender Parity Index in secondary level enrolment	...	...	1.06	...	...	...	...
Gender Parity Index in tertiary level enrolment	...	...	...	...	...	...	...
Share of women in wage employment in the non-agricultural sector	...	...	...	...	...	...	...
Proportion of seats held by women in national parliament	...	0	0	0	0	0	0
Goal 4: Reduce child mortality							
Children under five mortality rate per 1,000 live births	55.4	53.1	48	44.1	38.9	37.6	36.4
Infant mortality rate (0-1 year) per 1,000 live births	43.2	41.6	38.1	35.4	31.6	30.7	29.8
Children 1 year old immunized against measles, percentage	81	85	85	92	92	91	91
Goal 5: Improve maternal health							
Proportion of births attended by skilled health personnel, percentage	...	...	...	...	...	...	...
Current contraceptive use among married women 15-49 years old, percentage	...	...	23.0	...	...	...	...
Adolescent birth rate, per 1,000 women	50.4	38.5	30.7	25.4	19.9	18.6	...
Antenatal care coverage							
At least one visit, percentage	...	...	...	...	...	...	...
At least four visits, percentage	...	...	...	...	...	...	...
Unmet need for family planning, percentage	...	...	...	...	...	...	...
Goal 6: Combat HIV/AIDS, malaria and other diseases							
Men 15-24 years old with comprehensive correct knowledge of HIV/AIDS, percentage	...	...	...	...	...	...	...
Women 15-24 years old with comprehensive correct knowledge of HIV/AIDS, percentag	...	...	...	...	...	...	...
Tuberculosis incidence rate per year per 100,000 population (mid-point)	379	279	247	226	200	194	...
Tuberculosis detection rate under DOTS, percentage (mid-point)	100	30	45	59	72	72	...
Tuberculosis treatment success rate under DOTS, percentage	...	93	80	65	96	...	...
Goal 7: Ensure environmental sustainability							
Proportion of land area covered by forest, percentage	...	91	91	92	92	92	...
Carbon dioxide emissions (CO2), thousand metric tons of CO2 (CDIAC)	...	136	147	99	...	...	...
Carbon dioxide emissions (CO2), metric tons of CO2 per capita (CDIAC)	...	1.3	1.4	0.9	...	...	...
Proportion of marine areas protected, percentage	0.09	0.38	0.06	0.06	...	99.99	...
Proportion of terrestrial areas protected, percentage	2.7	4.0	4.0	4.0	...	4.0	...
Proportion of the population using improved drinking water sources	91	90	90	90	89	89	...
Proportion of the population using improved sanitation facilities	19	34	41	47	55	57	...
Goal 8: Develop a global partnership for development							
Net ODA received as a proportion of gross national income	...	42	35	43	42	34	...
Fixed telephone lines per 100 inhabitants	2.5	9.0	11.3	8.3	8.1	8.1	9.7
Mobile cellular subscriptions per 100 inhabitants	0.0	0.0	12.0	26.1	26.7	30.2	30.3
Internet users per 100 inhabitants	0.0	3.7	11.0	13.6	22.8	26.0	27.8

Source: United Nations Millennium Development Goals Indicators 2014.

Appendix I. Micronesia: Staff Policy Advice from the 2012 Article IV Consultation

Staff Advice	Policy Actions
Fiscal policy	
Develop a credible long-term fiscal strategy and secure wide buy-in across the nation, to better prepare for the post-2023 period.	The authorities produced the "2023 Action Plan" that includes a number of policy actions in the fiscal area, in particular, the implementation of the tax reform package. Most of them need to be underpinned by legislative measures. The authorities are launching a communication campaign across the nation.
Undertake expenditure reforms.	The state governments started implementing the Long-Term Fiscal Frameworks (LTFF) in FY2014.
Establish a Unified Revenue Authority (URA).	The URA started its operations from January 2015, by unifying revenue offices of the national and two state governments.
Private sector	
Improve the business environment and promote inward foreign direct investment.	The authorities plan to receive TA from the World Bank Group to review all investment and other relevant laws to identify areas of discrepancies.
Financial sector	
Strengthen the regulatory framework.	The authorities are preparing a new Credit Union Act that will expand the supervisory mandate of the Banking Board over credit unions, with TA from PFTAC and the Legal Department of the Fund.
Statistical capacity	
Improve the reliability, coverage, and timeliness of economic statistics, particularly in government finance and balance of payments statistics.	TA from the Fund and PFTAC is building the statistical capacity of the authorities. From FY2013, fiscal data for budgetary central government is produced following the Government Finance Statistics Manual 2001 format. From FY2014, balance of payments and international investment position statistics are reported to the Fund.

Appendix II. Micronesia: Risk Assessment Matrix[1]

Overall Level of Concern		
	Likelihood (Over next 1–3 years)	**Impact and Policy Response**
Global/external		
➢ **Sustained decline in energy prices, triggered by deceleration of global demand and coming-on-stream of excess capacity (medium-term)**	**Medium**	**Medium** A decline in oil prices would have a moderate positive impact on growth, while having somewhat larger impact on the current account (FSM's net oil import was 12 percent of GDP in FY2013, mostly used for the generation of electricity and fuel for ships). In addition, it would help lower the inflation rate. *Policy response*: The government needs to prepare for a potential rebound of oil prices, in particular by further investing in renewable energy in outer islands where the cost of electricity production using diesel generators tends to be high.
➢ **Natural disasters**	**Medium** Between 1980 and 2014, the FSM had 5 incidents of disaster storms with average damage of $1.3 million per tropical cyclone[2].	**Medium** Growth would slow as ongoing investment projects get delayed and fishing activities are impaired. Infrastructure could be damaged. *Policy response*: Disaster risk can be reduced by strengthening resilience, including through better training and infrastructure. The FSM needs to follow through the agreements made at the 1st Annual Disaster Risk Management Platform meeting held in June 2014. Under the U.S. Compact, the FSM has disaster assistance agreements that involve a significant role for the United States Agency for International Development (USAID).
Domestic		
➢ **Slow progress in structural and fiscal reforms**	**High** Declining reform momentum and political will would lead to delay in delivering the necessary growth and fiscal reforms	**Medium** A lack of timely progress in reforms (private sector development and fiscal reforms) would increase medium-term fiscal sustainability risks, possibly resulting in an acceleration of outmigration. Continued stagnation in the private sector growth would further weaken the financial position of the pension scheme. *Policy response*: Continue the outreach campaign on the 2023 Action Plan that includes a number of critically important actions plans, including the tax reform package and growth-enhancing structural reforms.
➢ **Delays in implementation of infrastructure projects, in particular at the planning stage**	**Medium**	**Medium** Short-term growth would be negatively affected. *Policy response*: Improve the planning process, in particular by enhancing coordination between the national and state governments. Update the infrastructure development plan of 2004 with TA from AsDB.

[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 staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "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.

[2] EM-DAT: The OFDA/CRED International Disaster Database, www.emdat.be – Université catholique de Louvain – Brussels - Belgium

INTERNATIONAL MONETARY FUND

FEDERATED STATES OF MICRONESIA

April 24, 2015

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

Asia and Pacific Department
(In Consultation with other Departments)

CONTENTS

FUND RELATIONS

(As of March 31, 2015)

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

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

SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	4.81	100.00
Holdings	6.23	129.60

Outstanding Purchases and Loans: None.

Financial Arrangements: None.

Projected Obligations to Fund: None.

Exchange Rate Arrangement:

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

Article IV Consultation:

The Federated States of Micronesia (FSM) is on the 24–month consultation cycle. The 2012 Article IV consultation discussions took place during November 9–19, 2012. The Executive Board discussed the staff report (Country Report No. 13/16) and concluded the consultation on January 14, 2013.

Technical Assistance, 1999–2014:

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

Resident Representative: The Regional Resident Representative Office for Pacific Island Countries based in Suva, Fiji was opened on September 13, 2010 and the office covers Fiji, Kiribati, Marshall Islands, Micronesia, Palau, Papua New Guinea, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu. Mr. Tubagus Feridhanusetyawan is the current resident representative.

BANK-FUND RELATIONSHIP

The Bank and the Fund country teams maintain a close working relationship and have an ongoing dialogue on a range of macroeconomic and structural issues. The teams agreed that FSM's main macroeconomic challenges are to prepare better for the expiration in FY2023 of the Compact support from the US. To achieve this goal, the FSM needs to continue prudent fiscal policy on both the expenditure and revenue sides and to enhance private sector development by further improving the business environment. Based on this shared assessment, the teams identified the following structural reform areas as macro-critical, in view of their central role in achieving long-term budgetary self-reliance and sustained growth:

(i) **Tax reform.** FSM has been working on a comprehensive tax reform package to generate additional revenue while enhancing the efficiency of tax administrations. The Fund, principally through the Pacific Financial Technical Assistance Center (PFTAC), is providing TA in this area, in collaboration with other donors.

(ii) **Investment climate.** Micronesia's investment climate remains difficult, hindering the private sector to become an engine of growth. World Bank Group is providing TA in this area, in cooperation with other donors.

The teams agreed to continue the close cooperation going forward. Appendix I details the specific activities planned by the two country teams in the coming year along with their expected deliveries.

Appendix I. Micronesia: Bank and Fund Planned Activities in Macro-Critical Structural Reform Areas

Title	Products	Provisional Timing of Missions	Expected Delivery Date (tentative)
A. Mutual information on relevant work programs			
Bank work program	Public Expenditure Review Investment Climate TA	May 2015 April 2015	June 2015 – June 2016 Late 2015
IMF work program	2015 Article IV Mission	March 2015	May 2015
B. Request for work program inputs			
Fund request to Bank	Assessment of macroeconomic developments and policies Information sharing	Semi-annual Semi-annual	Ongoing Ongoing
Bank request to Fund	Assessment of macroeconomic developments and policies Information and macro data sharing	Semi-annual Semi-annual	Ongoing Ongoing
C. Agreement on joint point products and missions			
Joint Work Program	Joint Bank-Fund DSA	March 2015	May 2015

RELATIONS WITH THE ASIAN DEVELOPMENT BANK (AsDB)

The AsDB has been working with the Federated States of Micronesia (FSM) since 1990, providing ten loans[1] totaling $84.2 million and 47 technical assistance projects worth $27.2 million. AsDB has historically supported good governance, with a focus on economic management and accountability, while also promoting development of the country's social and private sectors.

Among the priorities in the FSM's the Medium-term Development Framework (the Framework), released at the Development Partners' Forum in 2012, the AsDB's latest Country Operations Business Plan (COBP) for 2015–17 puts operational priorities in its support for: (i) developing key growth drivers; (ii) providing efficient and sustainable infrastructure; and (iii) establishing better public sector management. AsDB will focus on support for developing a sustainable tourism with continued support for improving investment and business environments. In infrastructure, AsDB continues to intervene in investments in water and sanitation, port development, renewable energy, and improvement of efficiency of the existing power infrastructure. Supports for preparing and implementing the Action Plan 2023 and public administration reforms are priorities in technical assistance and policy dialogues.

Key lending pipelines included in the COBP for 2015–17 are: (i) the Pohnpei Port Development Project; (ii) the Pohnpei Energy Sector Project; and (iii) the Leveraging the Economic Growth Potential of Sustainable Tourism Project. Ongoing technical assistance provide support for the preparation of the Action Plan 2023, update of the Infrastructure Investment Plan, preparation of sustainable tourism plans, and public administration reforms at the national government, AsDB plans to support public administration reforms at the state levels.

Currently there are two active loans. The Omnibus Infrastructure Development Project loans (totaling $19m), approved in 2004, addresses sanitation, water, and power needs in these states, with key achievements, including the introduction of 24-hour power supply and substantial improvements in access to potable water on Weno Island (Chuuk), along with the rehabilitation of the sewerage network in Kolonia (Pohnpei). This project has been complemented by technical assistance to strengthen the administration of public utility corporations in Chuuk, Kosrae, and Yap.

The Yap Renewable Energy Development Project (totaling $9m), approved in 2013, is underpinning the development of the energy network in Yap. The project focuses on the development of renewable energy to reduce dependency on imported diesel fuel, and to raise energy efficiencies on the supply side of the current electricity grid. Project resources are also being utilized to support capacity development of the Yap power utility and communities.

[1] The ten loans are for: (i) Fisheries Development Project; (ii) Public sector reform program; (iii) Water Supply and Sanitation Project; (iv) Basic Social Services Project; (v) Private sector development program; (vi) Private sector development project; (vii and viii) Omnibus infrastructure Development; and (iv and x) Yap Renewable Energy Development.

Table 1. Loans to the Federated States of Micronesia by Sector
(In millions of U.S. dollars, as of December 2014)

Sector	No.	Amount
Agriculture and Natural Resources	1	6.5
Energy	2	9.0
Industry and Nonfuel Minerals	0	0.0
Transportation	0	0.0
Communications	0	0.0
Law, Economic Management and Public Policy	3	31.0
Water Supply, Sanitation & Waste management	1	10.6
Multisector	3	27.0
Other	0	0.0
Total	10	84.2
Memorandum: Technical Assistance Provided	47	27.2

Table 2. Loan Approvals and Disbursements to the FSM, 2005–11
(In millions of U.S. dollars)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	1990-2014
Loan Approvals	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	9.0	0.0	84.2
Loan Disbursements	1.7	2.5	3.6	3.6	0.8	1.1	6.3	2.5	3.0	3.1	41.2
Undisbursed Balance (at the end of the year)	18.5	36.5	29.7	23.8	19.0	17.7	11.4	8.9	15.0	11.4	
Memorandum: TA Approval	0.0	0.6	0.4	0.8	0.0	0.0	0.7	1.1	0.2	0.6	27.2

Undisbursed balance includes only effective loans. The 2005 figure excludes loans not yet effective amounting to $18.6M.

RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTRE (PFTAC)—COUNTRY STRATEGY 2015–17

Background

After positive growth for the past 4 years (FY2009–12), the FSM experienced the largest contraction of 4.0 percent in FY2013 since FY1997. While growth is expected to pick up in FY2014 and 15, helped in part by a rebound in implementation of capital grants, persistent difficulties in the investment climate, combined the scheduled declines in Compact sector grants, are likely to hold the growth in the medium term. Continued efforts to advance tax reforms, targeted expenditure cuts, and structural reforms to spur private sector growth are essential to secure long-term fiscal and economic sustainability.

FSM has been a moderate user of PFTAC Technical Assistance (TA). The most significant input has been in the revenue area where PFTAC has supported the design of revenue policy and administration reforms, including the drafting of legislation that awaits approval. There has also been input in PFM, most recently through support for a PEFA assessment, and financial sector supervision including credit union reform.

Strategy 2015–17

PFTAC's TA strategy is guided by the Fund's overall capacity development framework and APD's Regional Strategy Note (RSN) and is consistent with the PFTAC's results framework.

PFTAC TA aims to support the authorities continue to move towards long-term fiscal sustainability. Activities will focus on assisting the authorities achieve tangible results from the foundations laid with previous PFTAC assistance, and will include strategic support in the PFM area and the modernization of tax compliance. Financial sector work will also continue, with technical advisory support with the on-site examinations of commercial banks. The IMF Legal department is completing the review of the Credit Union Act and PFTAC's Technical Advisor will be providing capacity building to the Banking Commission on how to adequately perform the oversight of credit unions.

In the Public Financial Management area, the focus will be on completing the PEFA assessment and supporting the authorities to develop a PFM roadmap. Activities to support the roadmap's implementation will be planned in coordination with other partners, in particular the ADB, but are expected to include strengthened cash management. In addition, PFTAC, together with IMF HQ, may consider providing TA to help ensure long-term sustainability of the pension system.

In the revenue area, the nature of assistance will be dependent on the progress in implementing the tax reform package, designed with PFTAC-assistance. The recent establishment of the Unified Revenue Authority, as per agreement between the national government and two state governments (Chuuk and Kosrae), is expected to open new possibilities for engaging with the FSM authorities and allow to keep the momentum in implementing the tax reform package in full. During the period of this strategy, PFTAC will focus on assisting the authorities in modernizing the tax administration, in particular, to improve tax compliance.

FSM's economic statistics are mainly produced by Compact-funded projects and input is therefore expected to be relatively limited in this area in the short-term. Provided adequate staffing remains available in the statistics office, PFTAC will look to support enhancements in the range of national accounts aggregates that are produced and provide hands-on training in compilation methods while IMF HQ will offer support on balance of payments development.

In financial sector supervision, PFTAC will continue providing assistance to the Banking Commission, in particular, to modernize legislations related to credit unions and to strengthen off-site reporting through the implementation of enhanced prudential returns and better, more-automated analysis. Emphasis will be on providing technical support with the preparedness and execution of on-site examinations of commercial banks, including strengthening its ability to assess banks using the CAMELS ratios analysis and composite rating approach. PFTAC will coordinate with IMF HQ and other TA providers to ensure that the insurance commission has access to suitable capacity building but is unlikely to be able to devote significant resources to this area given resource constraints and that insurance does not feature in PFTAC's Phase IV's results framework.

In macroeconomics, no direct input is currently anticipated. However, support to forecasting of long-term economic scenarios may be provided, in cooperation with other TA providers, in particular the ADB.

STATISTICAL ISSUES

As of March 31, 2015	
I. Assessment of Data Adequacy for Surveillance	
General: Data provision has serious shortcomings that significantly hamper surveillance. In particular, data on national accounts, government finance and balance of payment statistics are not released in a timely manner. The Fund, including through PFTAC, is providing TA to help build Micronesia's statistical capacity.	
National Accounts: External consultants funded by the U.S. Department of Interior (DoI) have prepared the national income accounts from FY1995 to FY2013. Some shortcomings remain, for instance, fixed ratios in estimating value added and the absence of investment/savings indicators. Significant progress has been made in improving staff capacity through PFTAC training, in collaboration with the DoI consultants.	
Price Statistics: A quarterly consumer price index (CPI), rebased to Q2 2008 and utilizing expenditure weights derived from an earlier household survey, is published for the Federated State of Micronesia (FSM) as a whole and for each state. However, the data releases are delayed, which makes it difficult to make accurate and timely evaluation of domestic price movements.	
Government Finance Statistics: The national and the state governments and public sector enterprises publish annual audit reports detailing their fiscal operations; consultants put these data in a GFS format, though with a lag of about one year. Further improvements in the quality and timeliness of the fiscal data depend on greater cooperation between the national and state governments. Micronesia has started to present fiscal data, including balance sheet and debt data, for budgetary central government using the Government Finance Statistics Manual 2001 (*GFSM 2001*) format since FY2013 through participation in the JSA regional GFS project. Work to expand coverage and improve periodicity is continuing.	
Monetary and Financial Statistics: The Banking Commissioner reports monthly monetary data. The data comprise interest rates, commercial banks, and the FSM Development Bank.	
Financial sector surveillance: Currently, Micronesia does not report FSIs to the Fund.	
External sector statistics Micronesia reported annual balance of payments and international investment position statistics to STA for the first time in 2014. The statistics were published in the 2014 Balance of Payments Statistics Yearbook. The Office of Statistics, Budget & Economic Management, Overseas Development Assistance and Compact Management (SBOC) is the agency responsible for the compilation of external sector statistics (ESS). Micronesia is a beneficiary of the JSA Project on the Improvement of ESS in the APD region. As part of this Project Micronesia has received four TA missions on ESS and taken part in four workshops on ESS compilation, and has been improving ESS by implementing the mission's recommendations.	
II. Data Standards and Quality	
Micronesia has been participating in the IMF's General Data Dissemination System since November 2014.	Data ROSC is not available.

MICRONESIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

As of March 31, 2015

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of publication[7]
International Reserve Assets and Reserve Liabilities of the Monetary Authorities	Jan. 2015	Mar. 2015	M	M	M
Reserve/Base Money	NA	NA	NA	NA	NA
Broad Money	Jan. 2015	Mar. 2015	M	M	M
Central Bank Balance Sheet	NA	NA	NA	NA	NA
Consolidated Balance Sheet of the Banking System	Nov. 2014	Jan. 2015	M	M	NA
Interest Rates[2]	Nov. 2014	Jan. 2015	M	M	M
Consumer Price Index	2015Q1	Mar. 2015	Q	A	I
Revenue, Expenditure, Balance/Composition of Financing[3] General Government[4] and Central Government	Nov 2014	Jan 2015	M	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	FY2013	Sep. 2014	A	A	A
External Current Account Balance	2013	Dec. 2014	A	A	A
Exports and Imports of Goods and Services	2013	Dec. 2014	A	A	A
GDP/GNP	FY2013	Aug. 2014	A	A	A
Gross External Debt	FY2013	Sep. 2014	A	A	A
International Investment Position[6]	Nov. 2014	Jan. 2015	M	A	A

1. U.S. dollar is circulating as the legal tender in Micronesia.
2. Include the interest rates on consumer loans and commercial loans. Deposit rates are received annually with latest observation for 2011.
3. Foreign, domestic bank, and domestic nonbank financing.
4. The General Government consists of the central government and state and local governments.
5. Government debt data disclosures do not include government debt guarantees to borrowing by states and public enterprises, mainly from the Asian Development Bank (ADB). Additionally, information on currency and maturity composition of debt is not disseminated. However, information related to borrowing from ADB can be obtained from the latter.
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 2015 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

April 24, 2015

Approved By
**Patrizia Tumbarello and Masato Miyazaki (IMF)
Satu Kahkonen (IDA)**

Prepared by Staff of the International Monetary Fund and the International Development Association.

The first joint Bank-Fund Debt Sustainability Analysis assesses the Federated States of Micronesia (FSM) to be at high risk of debt distress. Under the baseline scenario that does not assume the implementation of the long-debated tax and growth-enhancing structural reforms, two debt indicators, namely, the present value of debt-to-GDP and debt-to-exports ratios are projected to exceed the indicative thresholds in the medium term. PV of public debt-to-GDP ratio will also rise gradually, while remaining under the threshold during the projection period. This points to the importance of undertaking further reforms, in particular those critical to enhancing growth and revenue, in order to bring the debt trajectory to a sustainable level.

Background

1. **The FSM is a 607-island microstate in the Pacific, composed of four states with a total population of slightly above 100,000.** It is highly dependent on external aid provided mostly by the United States while adopting the U.S. dollar as legal tender. The loosely federated structure of the country makes policy decisions a complex task, as consensus across the national and the four state governments is required. This has hindered a number of critically important policy actions, including the long-debated tax reform package (introduction of a VAT in lieu of the state sales taxes and replacing the Gross Revenue Tax with a net income tax on corporations, among others, which will generate additional revenue of 4 percent of GDP) and growth-enhancing reforms, in particular, those related to address land tenure issues.

2. **The FSM faces a long-term fiscal challenge as U.S. grants provided under the Compact of Free Association (Compact grants) will expire in FY2023, while the private sector is yet to become an engine of growth.** A portion of the Compact grants has been disbursed into the Compact Trust Fund (CTF), jointly managed by the US and the FSM, with the intention that returns from the trust fund would

contribute to Micronesia's fiscal sustainability after FY2023.[1, 2] The FSM has also established its own trust fund (FSM Trust Fund). However, at current pace of accumulation, returns from the trust funds are expected to fall short of the expired Compact grants in FY2023.

3. The FSM's debt management has been relatively prudent. The FSM's external public and publicly guaranteed (PPG) debt has been declining slowly from the peak of 31 percent of GDP in FY2009 to 27 percent in FY2013 (22 percent on present value (PV) basis). Most of the debt is concessional and is contracted with official lenders. About two thirds is from the Asian Development Bank (ADB). Loans from the US Department of Agriculture (Rural Development Program) account for about one third of the total external PPG. The rest is from other bilateral and private lenders. Domestic debt is estimated to be less than 1 percent of GDP. All of the loans are denominated in U.S. dollars, legal tender in the FSM.

4. The analysis is based on the standard DSA framework for Low-Income Countries. Debt sustainability is assessed in relation to policy-dependent debt burden thresholds. The FSM, with an average score of 2.7 between 2011 and 2013 for the Country Policy and Institutional Assessment (CPIA), is considered to have weak capacity. The DSA uses the indicative thresholds on the external public debt for countries in this category whose remittances are not large[3]: 30 percent for the PV of debt-to-GDP ratio; 100 percent for the PV of debt-to-exports ratio; 200 percent for the PV of debt-to-revenue ratio; 15 percent for the debt service-to-exports ratio; and 18 percent for the debt service-to-revenue ratio.

5. The key assumptions are consistent with the macroeconomic framework set out in the Policy Note (Box 1). The baseline scenario assumes that the annual real GDP growth rate will be on average 0.6 percent in the medium term, which reflects the historical track record of the FSM. Despite the fiscal consolidation efforts under the Long-Term Fiscal Frameworks (LTFF) by all the state governments to reduce their expenditures by 1–2 percent per year in real terms throughout the projection period, the overall fiscal balance will worsen gradually, turning from surplus to deficit from FY2024. While the fiscal deficit is assumed to be phased out gradually during the remaining 10 years of the projection period through further fiscal consolidation, the financing gap is assumed to be filled by bilateral concessional

[1] The Compact Trust Fund (CTF) was created to contribute to the long-term budgetary self-reliance of the FSM and provide the FSM government with an ongoing source of revenue after FY2023. The amended Compacts and their subsidiary agreements contain no commitments, either express or implied, regarding the level of the revenue that will be generated by the trust fund, nor is there any commitment regarding the degree to which the revenue will contribute to the long-term budgetary self-reliance of the FSM.

[2] Compact grants disbursed in FY2013 for current and capital spending amounted to 25 percent of GDP. If contributions to the CTF are included, the ratio rises to more than 30 percent of GDP.

[3] Under the standard Debt Sustainability Framework for Low-Income Countries, large remittances are defined as both greater than 10 percent of GDP and greater than 20 percent of exports of goods and services. In the case of the FSM, the ratio of remittances-to-GDP is around 4 percent while that of remittances-to-exports of goods and services is around 15 percent.

external borrowing to safeguard priority development spending.[4] The baseline scenario does not assume major policy changes such as the implementation of the long-debated tax reform package.

6. Other assumptions under the baseline scenario include: gradual reduction of the financial assistance as scheduled under the Compact of Free Association with the US before expiring in FY2023; continued robust fishing license fee revenues (15 percent of GDP throughout the projection period[5]), which helps strengthen the fiscal balances compared to the historical track record; increased allocation of budget for infrastructure projects from the national to state governments (3 percent of GDP) starting from FY2015, on account of continued stronger fishing license fees than before; transfer of half of the annual fiscal surplus to trust funds established to generate revenue after the expiration of financial assistance under the Compact in FY2023, reflecting on-going discussions in the country.[6] Additionally, the baseline scenario assumes that the FSM authorities will continue to contract moderate amount of concessional loans to finance investment projects implemented by state enterprises in line with the newly adopted ODA Policy.

PPG External Debt Sustainability

7. Under the baseline scenario, two of the debt indicators are projected to breach the indicative thresholds from FY2027–30 and onwards. The ratio of PV of external PPG-to-GDP is expected to exceed the threshold of 30 percent in FY2030 while the ratio of PV of external PPG debt-to-exports is expected to exceed the threshold of 100 percent in FY2027. However, as the authorities will strengthen fiscal consolidation efforts while safeguarding priority spending, the debt indicators will be stabilized toward the end of the projection period, albeit at levels above the indicative thresholds. As the bulk of external PPG debt is on concessional terms, the debt service to export ratio will remain below the relevant threshold.

8. Stress tests confirm the vulnerability of the debt position relative to exports. In the most extreme shock scenario - with export value growth in FY2015–16 one standard deviation below the historical average - the PV of the external PPG debt-to-GDP will exceed the threshold of 30 percent in FY2023, 7 years earlier than the baseline scenario. The PV of the external PPG debt-to-exports ratio will exceed the threshold of 100 percent in FY2021, and will reach above 200 percent in FY2034.

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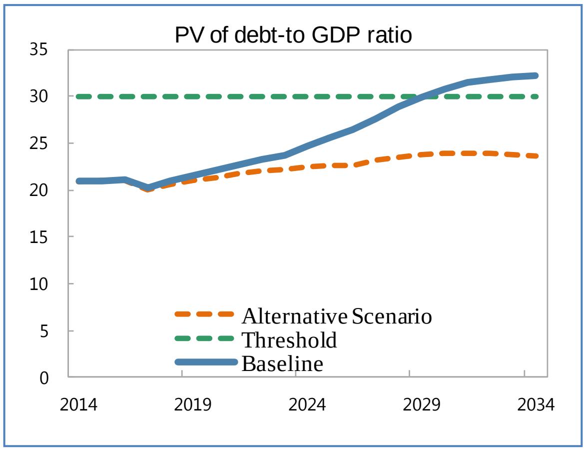
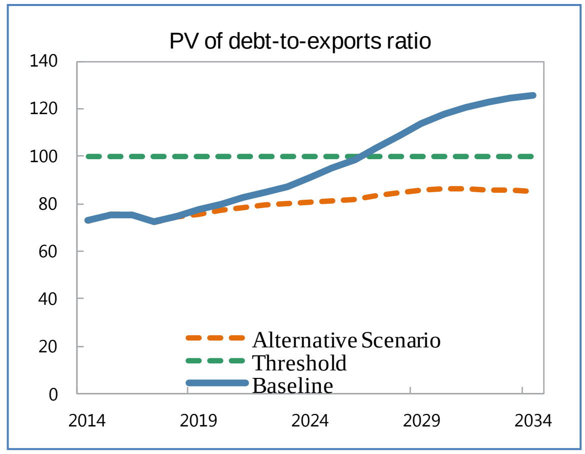
[4] The recently adopted "ODA Policy of the FSM" provides, among others, that loans, as means of financing initiatives, shall only be considered if concessional in nature and where the estimated economic returns outweigh debt obligations.

[5] Fishing license fee revenue increased from 6 percent of GDP in FY2011 to 15 percent of GDP in FY2014. The "Nauru Agreement Concerning Cooperation in the Management of Fisheries of Common Interest", a regional agreement that sets minimum benchmark fees for foreign fishing companies operating in the region, has strengthened the bargaining power of its signatories including the FSM. Under this system, fishing companies pay a flat fee per vessel per day with adjustment for the size of the vessel (VDS: Vessels Day Scheme). The FSM authorities assume that fishing license fee revenue will be sustained in the medium term, despite the recent plunge in the price of tuna (from the peak of $2,520 per ton in the third quarter of 2012 to $1,670 per ton in the fourth quarter of 2014).

[6] Another half is assumed to be used for other purposes, including the proposed "2023 Investment Development Fund" that envisages providing equity funds to private sector projects from a long-term perspective.

9. Policy actions, in particular, growth-enhancing and fiscal reforms, would greatly reduce the risk of debt distress. Under the alternative scenario with policy actions, GDP and exports growth rates are assumed to be stronger from the baseline by 1 percent per year. Furthermore, the implementation of further fiscal consolidation including the long-debated tax reform package will eliminate the financing gap in the post-2023 period, resulting in less borrowing.[7] Under this alternative scenario with policy actions, the debt indicators will remain well below the threshold throughout the projection period.





Public Sector Debt Sustainability

10. Total PPG debt follows very closely the dynamic of PPG external debt. Under the baseline scenario, the PV of PPG debt-to-GDP ratio is projected to increase gradually from 22 percent of GDP in FY2014 to reach 32 percent of GDP in FY2034, but still below the threshold of 38 percent. Continued robust fishing license fee revenues at 15 percent of GDP (see paragraph 6 and footnote 5), coupled with the fiscal consolidation efforts by the state governments under the LTFF, explain the significant improvement from the historical scenario.

Authorities' View

11. The authorities broadly concurred with the overall assessment of the Debt Sustainability Analysis. They saw the critical need for achieving a national consensus for implementing policy actions included in the recently adopted "2023 Action Plan", in particular, the tax reform package and improving

[7] Growth-enhancing policy actions include such measures as regulatory reform (investor protection and transparency in investment) and a land reform (completion of the land survey and record of land titles available for development). Regarding policy actions in the fiscal area, the policy action scenario assumes gradual implementation of the tax reform package between FY2016 and FY2019, generating additional revenue of 4 percent of GDP when implemented in full. In addition to the fiscal consolidation efforts by the state governments under the LTFF, the policy action scenario assumes additional expenditure contraction by 1 percent of GDP. The entire fiscal surplus is transferred to the trust funds. These actions lead to larger investment income from the trust funds in the post-2023 period, allowing the authorities to avoid additional borrowing.

the business environment. The authorities also noted the need for further consolidating the institutional capacity to manage debt, as called for in the "2023 Action Plan".

Conclusion

12. The standard DSA framework for LICs assesses the FSM to be at high risk of debt distress. The baseline scenario indicates that the PV of external debt-to-GDP and exports ratios could breach the threshold between FY2027–30 and onwards. PV of public debt-to-GDP ratio will also rise gradually, while remaining under the threshold during the projection period. Stress tests also confirm the vulnerability of the debt position relative to exports. However, FSM's vulnerability to debt distress is mitigated by a number of factors. Most debt is on concessional terms and from development partners, the decline in external support from the Compact will be gradual, sheltering the country from the risk of a sudden stop in foreign financing, and the authorities are building up trust funds that will provide a stable source of funding after FY2023.

13. The risk of debt distress is reduced under the alternative scenario where long-debated tax and growth-enhancing structural reforms are implemented. FSM's debt will be sustainable if the tax and growth-enhancing structural reforms are implemented, as called for in the recently published "Action Plan 2023", though this remains contingent on the achievement of nation-wide consensus in a country with a loosely federated structure.

Box 1. Micronesia: Baseline Assumptions

GDP growth over the medium term is projected to be around 0.6 percent, reflecting FSM's track record.[1] The loosely federated structure of the country will continue to weigh heavily on the implementation of long-debated reforms, particularly in the areas of tax and land tenure issues. In this context, the private sector will remain largely dependent on the public sector.

The GDP deflator is expected to average about 1.7 percent while the CPI inflation is assumed to average at around 2.0 percent in the medium term.

The overall fiscal surplus will decline gradually, and turn into deficit from FY2024 before recovering to balance towards the end of the projection period. Based on recent discussions in the country, half of the annual fiscal surplus is assumed to be transferred to trust funds to help sustain fiscal sufficiency after the expiration of financial assistance in FY2023 according to the Compact of Free Association with the United States. Authorities are assumed to continue the moderate fiscal consolidation efforts under the Long-Term Fiscal Framework in order to adjust to the declining Compact grants. No revenue increase from the proposed tax reforms (e.g., introduction of a VAT in lieu of the state sales taxes and the replacement of the Gross Revenue Tax with a net income tax on corporations) is assumed.

External Financing: Compact grants are assumed to decline as scheduled, while grants from other sources will remain stable in the medium term. Additional financing required to finance priority investment projects is assumed to be provided by bilateral and multilateral donors on concessional terms, in line with the recently adopted ODA Policy.

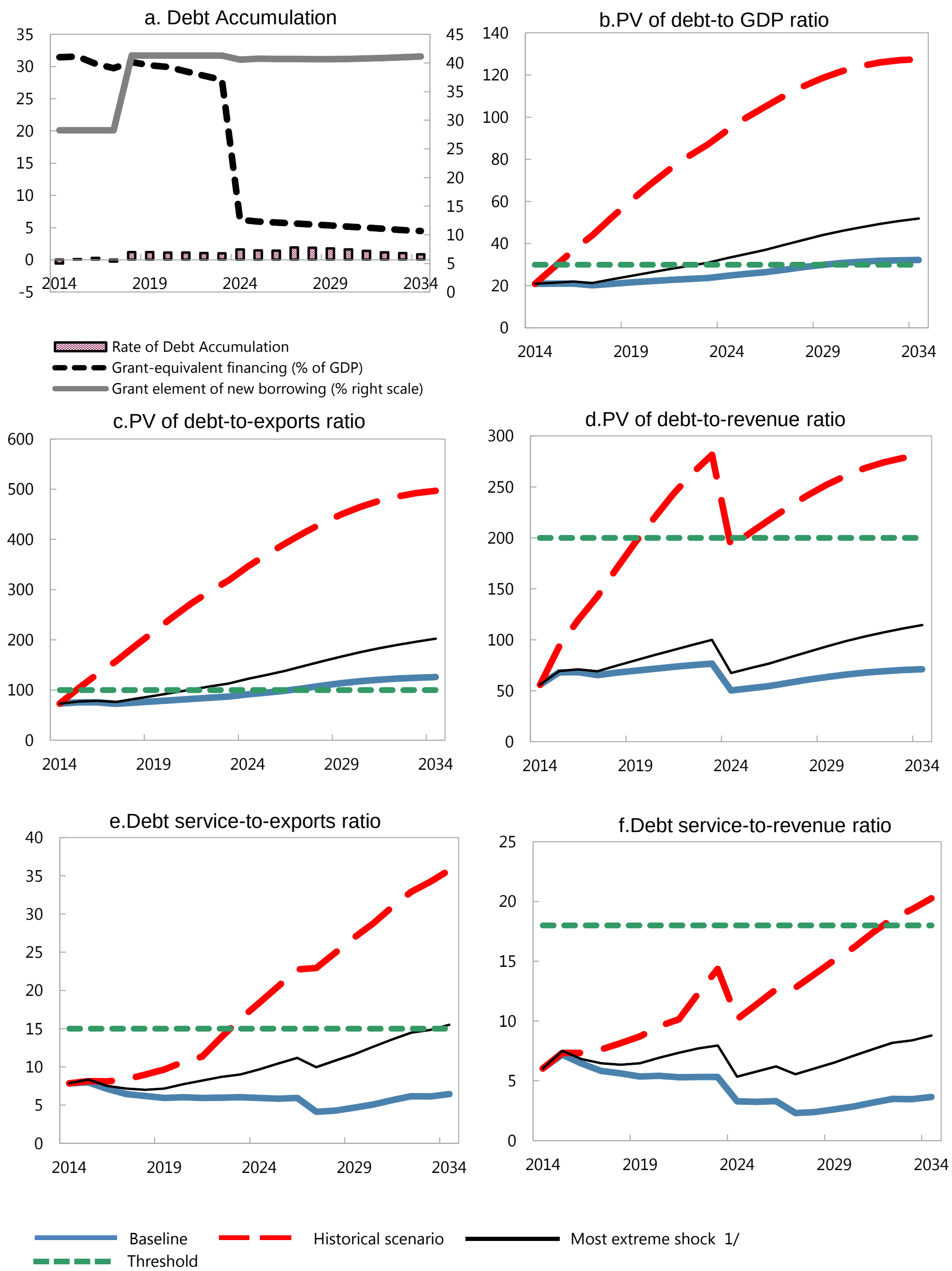
The Compact Trust Fund and the FSM Trust Fund are assumed to yield an average annual return of 6 percent.[2] Draw-downs from the trust funds will start from FY2024. While the baseline scenario assumes that only the annual investment returns are drawn down and that the nominal balance of the trust funds will be kept intact, the real value of the trust funds (balance of the trust funds in percentage of GDP) will decline over time.

The **current account deficit** is assumed to weaken in the medium term, on account mostly of declining grants. While the amount of annual draw downs from the trust funds in the post-2023 period will be the same, its ratio against GDP will decline – this will result in the further weakening of the current account.

[1] Average GDP growth between FY2000 and 2013 was 0.4 percent (0.7 percent if excluding FY2013 when the growth rate was exceptionally low at -4%).

[2] Returns from the trust funds have been volatile, reflecting the unusually dismal earnings during the Global Financial Crisis. In FY2008, CTF net return was negative 19 percent, substantially eroding the market value of the fund. It experienced further negative returns in FY2009 and 2011, while gain in FY2010 reached 13 percent. Average return between FY2012–14 reached 12 percent, bringing the average return of CTF since its inception in 2004 to 5.3 percent.

Figure 1. Micronesia: Indicators of Public and Publicly Guaranteed External Debt Baseline Scenario, 2014–34 1/

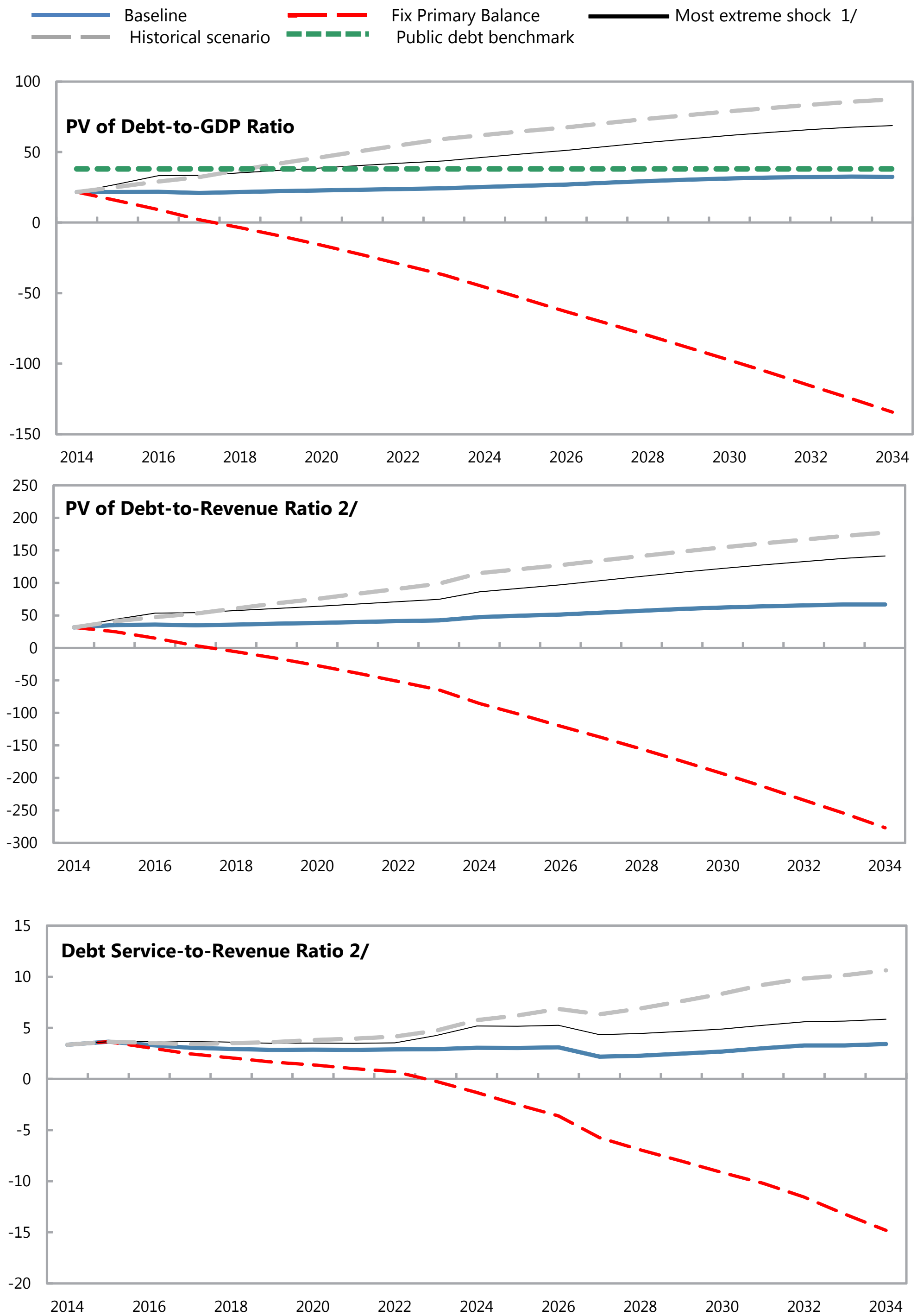


Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2024. In figure b. it corresponds to a Terms shock; in c. to a Terms shock; in d. to a Terms shock; in e. to a Terms shock and in figure f. to a Terms shock

2/ Tax reform package, generating additional revenue of 4 percent of GDP, is assumed to be gradually implemented at all levels of government between 2016 and 2018. To be implemented, the tax reform package needs to be endorsed by all the governments (national and state governments).

Figure 2. Micronesia: Indicators of Public Debt, Baseline Scenario, 2014–34 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2024.

2/ Revenues are defined inclusive of grants.

Table 1. Micronesia: External Debt Sustainability Framework, Baseline Scenario, 2011–34 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/ Average	Standard 6/ Deviation	Projections								
	2011	2012	2013			2014	2015	2016	2017	2018	2019	2024	2034	2020-2034 Average
External debt (nominal) 1/	**29.1**	**27.7**	**27.1**			**26.4**	**26.5**	**26.7**	**25.6**	**27.3**	**28.8**	**36.0**	**48.1**	
of which: public and publicly guaranteed (PPG)	29.1	27.7	27.1			26.4	26.5	26.7	25.6	27.3	28.8	36.0	48.1	
Change in external debt	-0.4	-1.4	-0.6			-0.7	0.2	0.2	-1.1	1.7	1.5	2.0	0.2	
Identified net debt-creating flows	16.7	11.4	11.3			-2.3	0.9	0.8	1.5	2.0	2.7	3.6	7.7	
Non-interest current account deficit	**17.2**	**12.0**	**9.4**	**13.3**	**3.6**	**-3.1**	**0.1**	**0.3**	**1.0**	**1.6**	**2.3**	**3.4**	**7.7**	5.2
Deficit in balance of goods and services	57.4	51.5	54.1			53.4	50.1	50.0	50.0	50.0	50.0	50.6	50.1	
Exports	24.4	29.4	28.1			28.7	27.8	28.0	27.9	28.0	27.9	27.1	25.7	
Imports	81.8	80.8	82.2			82.1	77.9	77.9	77.9	77.9	77.9	77.7	75.7	
Net current transfers (negative = inflow)	-36.0	-33.9	-35.3	-39.2	3.6	-41.8	-35.3	-35.0	-34.2	-33.6	-33.0	-14.2	-13.0	-18.4
of which: official	-33.5	-31.1	-31.1			-31.0	-30.8	-30.5	-29.7	-29.2	-28.5	-9.8	-8.5	
Other current account flows (negative = net inflow)	-4.2	-5.6	-9.4			-14.7	-14.7	-14.7	-14.7	-14.7	-14.8	-33.0	-29.4	
Net FDI (negative = inflow)	**0.3**	**0.3**	**0.2**	**0.0**	**0.7**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	0.2
Endogenous debt dynamics 2/	**-0.7**	**-0.8**	**1.7**			**0.6**	**0.5**	**0.3**	**0.2**	**0.2**	**0.2**	**0.0**	**-0.3**	
Contribution from nominal interest rate	0.7	0.7	0.7			0.6	0.6	0.5	0.5	0.4	0.4	0.2	0.0	
Contribution from real GDP growth	-0.5	0.0	1.2			0.0	-0.1	-0.3	-0.2	-0.2	-0.2	-0.2	-0.3	
Contribution from price and exchange rate changes	-1.0	-1.5	-0.2			...	...	...	...	...	...	...	...	
Residual 3/	**-17.1**	**-12.8**	**-11.9**			**1.6**	**-0.7**	**-0.6**	**-2.6**	**-0.3**	**-1.2**	**-1.6**	**-7.5**	
of which: exceptional financing (capital grants)	-20.1	-21.0	-13.4	**-13.0**	**7.2**	-12.7	-12.7	-13.1	-13.2	-13.3	-13.3	-7.0	-5.6	
PV of external debt 4/	...	...	21.5			20.9	21.0	21.0	20.2	20.9	21.5	24.7	32.3	
In percent of exports	...	...	76.7			72.9	75.4	75.3	72.3	74.8	77.2	91.3	125.7	
PV of PPG external debt	**...**	**...**	**21.5**			**20.9**	**21.0**	**21.0**	**20.2**	**20.9**	**21.5**	**24.7**	**32.3**	
In percent of exports	**...**	**...**	**76.7**			**72.9**	**75.4**	**75.3**	**72.3**	**74.8**	**77.2**	**91.3**	**125.7**	
In percent of government revenues	**...**	**...**	**80.3**			**55.9**	**67.9**	**68.2**	**65.5**	**67.8**	**69.8**	**50.4**	**71.3**	
Debt service-to-exports ratio (in percent)	**6.7**	**5.3**	**6.7**			**7.9**	**8.0**	**7.1**	**6.4**	**6.2**	**5.9**	**5.9**	**6.4**	
PPG debt service-to-exports ratio (in percent)	**6.7**	**5.3**	**6.7**			**7.9**	**8.0**	**7.1**	**6.4**	**6.2**	**5.9**	**5.9**	**6.4**	
PPG debt service-to-revenue ratio (in percent)	**7.8**	**6.8**	**7.0**			**6.0**	**7.2**	**6.4**	**5.8**	**5.6**	**5.4**	**3.3**	**3.7**	
Total gross financing need (Millions of U.S. dollars)	58.9	45.1	36.1			-1.9	8.2	8.0	10.0	11.9	14.4	20.2	46.5	
Non-interest current account deficit that stabilizes debt ratio	17.5	13.3	10.0			-2.4	-0.1	0.1	2.1	-0.1	0.8	1.4	7.5	
Key macroeconomic assumptions														
Real GDP growth (in percent)	1.8	0.1	-4.0	-0.4	2.5	0.1	0.3	1.0	0.9	0.9	0.8	0.6	0.6	0.6
GDP deflator in US dollar terms (change in percent)	3.4	5.3	0.6	3.0	1.7	0.0	0.0	0.0	1.8	1.3	1.9	1.7	1.7	1.7
Effective interest rate (percent) 5/	2.7	2.4	2.4	2.6	0.1	2.2	2.1	2.0	1.8	1.8	1.5	0.6	0.0	0.4
Growth of exports of G&S (US dollar terms, in percent)	8.3	27.0	-7.7	7.6	14.1	2.4	-3.0	1.5	2.7	2.3	2.4	1.7	1.8	1.7
Growth of imports of G&S (US dollar terms, in percent)	5.8	4.3	-1.9	3.7	4.8	0.0	-4.9	1.0	2.7	2.2	2.7	2.0	2.1	2.1
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	28.2	28.2	28.2	28.2	41.3	41.3	40.6	41.1	40.9
Government revenues (excluding grants, in percent of GDP)	20.8	22.9	26.8			37.4	30.9	30.9	30.9	30.9	30.9	49.0	45.3	42.8
Aid flows (in Millions of US dollars) 7/	226.6	230.9	196.9			181.1	181.6	180.4	180.3	189.1	197.7	156.0	248.8	
of which: Grants	136.8	140.6	111.7			98.1	97.9	95.3	96.6	97.8	98.8	17.4	15.8	
of which: Concessional loans	89.8	90.3	85.2			83.0	83.7	85.1	83.7	91.3	98.9	138.7	232.9	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			31.4	31.5	30.4	29.8	30.7	30.2	6.2	4.5	11.6
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			97.9	95.9	95.8	97.8	93.6	93.6	71.3	72.4	77.2
Memorandum items:														
Nominal GDP (Millions of US dollars)	309.1	325.9	314.6			314.8	315.7	318.7	327.4	334.7	343.6	385.6	484.4	
Nominal dollar GDP growth	5.3	5.4	-3.5			0.1	0.3	1.0	2.7	2.2	2.7	2.3	2.3	2.3
PV of PPG external debt (in Millions of US dollars)			67.7			65.9	66.2	67.1	66.2	70.0	74.0	95.3	156.3	
(PVt-PVt-1)/GDPt-1 (in percent)						-0.6	0.1	0.3	-0.3	1.2	1.2	1.6	0.9	1.4
Gross workers' remittances (Millions of US dollars)	14.1	14.3	14.4			14.4	14.5	14.5	14.6	14.6	14.7	15.1	16.0	
PV of PPG external debt (in percent of GDP + remittances)	...	...	20.6			20.0	20.1	20.1	19.3	20.0	20.7	23.8	31.2	
PV of PPG external debt (in percent of exports + remittances)	...	...	65.9			62.9	64.8	64.7	62.4	64.7	67.0	79.7	111.3	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	5.7			6.8	6.9	6.1	5.6	5.4	5.2	5.2	5.7	

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)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

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

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

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

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

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

8/ 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).

Table 2. Micronesia: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014–34
(In percent)

	Projections							
	2014	2015	2016	2017	2018	2019	**2024**	2034
PV of debt-to GDP ratio								
Baseline	21	21	21	20	21	22	**25**	32
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	21	29	37	44	52	60	**94**	127
A2. New public sector loans on less favorable terms in 2014-2034 2	21	21	22	21	23	25	**33**	52
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	21	22	23	22	22	23	**27**	35
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	21	22	24	23	24	24	**27**	34
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	21	21	21	20	20	21	**24**	31
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	21	21	21	20	21	21	**25**	32
B5. Combination of B1-B4 using one-half standard deviation shocks	21	19	17	16	17	17	**21**	30
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	21	21	21	20	21	22	**25**	32
PV of debt-to-exports ratio								
Baseline	73	75	75	72	75	77	**91**	126
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	73	104	132	158	187	217	**346**	497
A2. New public sector loans on less favorable terms in 2014-2034 2	73	77	78	76	82	88	**122**	202
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	73	75	75	72	75	77	**91**	126
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	73	81	96	92	95	98	**114**	149
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	73	75	75	72	75	77	**91**	126
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	73	76	75	72	74	77	**91**	125
B5. Combination of B1-B4 using one-half standard deviation shocks	73	66	59	56	58	60	**74**	113
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	73	75	75	72	75	77	**91**	126
PV of debt-to-revenue ratio								
Baseline	56	68	68	65	68	70	**50**	71
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	56	93	119	143	170	196	**191**	282
A2. New public sector loans on less favorable terms in 2014-2034 2	56	69	71	69	75	80	**67**	115
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	56	70	73	70	73	75	**54**	76
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	56	70	77	74	77	79	**56**	75
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	56	67	67	64	66	68	**49**	70
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	56	68	68	65	67	69	**50**	71
B5. Combination of B1-B4 using one-half standard deviation shocks	56	61	55	52	54	56	**42**	66
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	56	68	68	65	68	70	**50**	71

Table 2. Micronesia: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014–34 (concluded)

(In percent)

	Projections							
	2014	2015	2016	2017	2018	2019	**2024**	2034
Debt service-to-exports ratio								
Baseline	8	8	7	6	6	6	**6**	6
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	8	8	8	8	9	10	**18**	36
A2. New public sector loans on less favorable terms in 2014-2034 2	8	8	8	7	7	7	**10**	16
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	8	8	8	7	7	7	**8**	9
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	8	9	9	8	8	8	**10**	11
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	8	8	8	7	7	7	**8**	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	8	8	8	7	7	7	**8**	9
B5. Combination of B1-B4 using one-half standard deviation shocks	8	8	7	6	6	6	**6**	8
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	8	8	8	7	7	7	**8**	9
Debt service-to-revenue ratio								
Baseline	6	7	6	6	6	5	**3**	4
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	6	7	7	8	8	9	**10**	20
A2. New public sector loans on less favorable terms in 2014-2034 2	6	8	7	6	6	6	**5**	9
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	6	8	7	7	7	7	**5**	6
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	6	8	7	7	6	6	**5**	6
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	6	7	7	6	6	6	**4**	5
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	6	8	7	6	6	6	**4**	5
B5. Combination of B1-B4 using one-half standard deviation shocks	6	8	7	6	6	6	**4**	5
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	6	8	7	6	6	6	**4**	5
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	35	35	35	35	35	35	**35**	35

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 3. Micronesia: Public Sector Debt Sustainability Framework, Baseline Scenario, 2011–34

(In percent of GDP, unless otherwise indicated)

	Actual		Estimate		Projections								
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2014-19 Average	2024	2034	2020-34 Average
Public sector debt 1/	30.0	28.5	27.8	27.1	27.3	27.4	26.3	28.0	29.5		36.6	48.2	
of which: foreign-currency denominated	30.0	28.5	27.8	27.1	27.3	27.4	26.3	28.0	29.5		36.6	48.2	
Change in public sector debt	0.6	-1.5	-0.7	-0.7	0.2	0.2	-1.1	1.7	1.5		2.0	-0.2	
Identified debt-creating flows	-0.9	-2.3	-1.8	-12.5	-2.9	-2.9	-3.8	-3.8	-3.5		0.2	-0.9	
Primary deficit	-0.2	-1.5	-3.5	-13.1	-3.4	-3.2	-3.5	-3.7	-3.2	-5.0	0.8	0.2	-0.2
Revenue and grants	65.0	66.0	62.3	68.6	61.9	60.8	60.4	60.1	59.6		53.5	48.5	
of which: grants	44.3	43.1	35.5	31.2	31.0	29.9	29.5	29.2	28.8		4.5	3.3	
Primary (noninterest) expenditure	64.9	64.6	58.8	55.5	58.4	57.6	56.8	56.4	56.4		54.3	48.7	
Automatic debt dynamics	-0.7	-0.9	1.7	0.6	0.5	0.3	-0.2	-0.1	-0.3		-0.6	-1.1	
Contribution from interest rate/growth differential	-0.4	0.1	1.5	0.1	0.0	-0.2	-0.3	-0.3	-0.4		-0.7	-1.2	
of which: contribution from average real interest rate	0.2	0.2	0.3	0.1	0.1	0.0	-0.1	-0.1	-0.2		-0.5	-1.0	
of which: contribution from real GDP growth	-0.5	0.0	1.2	0.0	-0.1	-0.3	-0.3	-0.2	-0.2		-0.2	-0.3	
Contribution from real exchange rate depreciation	-0.4	-1.0	0.3	0.5	0.5	0.5	0.1	0.2	0.1		...	...	
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		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	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		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	1.5	0.8	1.1	11.8	3.1	3.1	2.6	5.5	5.1		1.8	0.7	
Other Sustainability Indicators													
PV of public sector debt	...	...	22.3	21.7	21.7	21.8	20.9	21.6	22.2		25.3	32.4	
of which: foreign-currency denominated	...	...	21.5	20.9	21.0	21.0	20.2	20.9	21.5		24.7	32.3	
of which: external	...	...	21.5	20.9	21.0	21.0	20.2	20.9	21.5		24.7	32.3	
PV of contingent liabilities (not included in public sector debt)	...	...	...	...	...	...	...	...	...		...	...	
Gross financing need 2/	1.5	1.0	-0.7	-10.1	-0.4	-0.5	-1.0	-1.3	-0.9		3.0	2.3	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	35.7	31.6	35.1	35.8	34.7	36.0	37.3		47.3	66.8	
PV of public sector debt-to-revenue ratio (in percent)	...	...	83.0	57.9	70.3	70.6	67.8	70.0	72.0		51.6	71.6	
of which: external 3/	...	...	80.3	55.9	67.9	68.2	65.5	67.8	69.8		50.4	71.3	
Debt service-to-revenue and grants ratio (in percent) 4/	2.5	2.4	3.1	3.4	3.6	3.3	3.0	2.9	2.8		3.1	3.4	
Debt service-to-revenue ratio (in percent) 4/	7.8	7.1	7.2	6.1	7.3	6.6	6.0	5.7	5.5		3.3	3.7	
Primary deficit that stabilizes the debt-to-GDP ratio	-0.7	0.0	-2.8	-12.4	-3.6	-3.4	-2.4	-5.4	-4.7		-1.2	0.3	
Key macroeconomic and fiscal assumptions													
Real GDP growth (in percent)	1.8	0.1	-4.0	0.1	0.3	1.0	0.9	0.9	0.8	0.7	0.6	0.6	0.6
Average nominal interest rate on forex debt (in percent)	2.7	2.4	2.4	2.2	2.1	2.0	1.8	1.8	1.5	1.9	0.6	0.0	0.4
Average real interest rate on domestic debt (in percent)	...	0.7	5.1	5.3	5.2	5.3	3.4	3.9	3.3	4.4	3.5	3.5	3.5
Real exchange rate depreciation (in percent, + indicates depreciation)	-1.3	-3.4	0.9	1.7	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	3.4	5.3	0.6	0.0	0.0	0.0	1.8	1.3	1.9	0.8	1.7	1.7	1.7
Growth of real primary spending (deflated by GDP deflator, in percent)	-1.4	-0.4	-12.5	-5.7	5.7	-0.6	-0.3	0.1	0.8	0.0	-0.9	-0.5	-0.4
Grant element of new external borrowing (in percent)	...	...	...	28.2	28.2	28.2	28.2	41.3	41.3	32.6	40.6	41.1	...

Sources: Country authorities; and staff estimates and projections.

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

2/ 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.

3/ Revenues excluding grants.

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

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 4. Micronesia: Sensitivity Analysis for Key Indicators of Public Debt 2014–34

		Projections						
	2014	2015	2016	2017	2018	2019	2024	2034
PV of Debt-to-GDP Ratio								
Baseline	22	22	22	21	22	22	25	32
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	22	25	29	32	37	42	62	87
A2. Primary balance is unchanged from 2014	22	16	9	2	-4	-10	-46	-134
A3. Permanently lower GDP growth 1/	22	22	22	22	23	25	34	73
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	22	23	26	26	28	30	43	74
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	22	29	36	35	36	37	41	48
B3. Combination of B1-B2 using one half standard deviation shocks	22	27	33	33	35	37	46	69
B4. One-time 30 percent real depreciation in 2015	22	31	31	30	30	30	30	33
B5. 10 percent of GDP increase in other debt-creating flows in 2015	22	28	28	28	28	29	33	40
PV of Debt-to-Revenue Ratio 2/								
Baseline	32	35	36	35	36	37	47	67
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	32	41	47	53	61	68	115	177
A2. Primary balance is unchanged from 2014	32	25	15	3	-6	-16	-85	-277
A3. Permanently lower GDP growth 1/	32	35	37	36	38	41	63	148
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	32	37	41	42	46	49	79	152
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	32	46	58	58	60	61	76	98
B3. Combination of B1-B2 using one half standard deviation shocks	32	44	54	54	57	61	86	141
B4. One-time 30 percent real depreciation in 2015	32	50	50	49	49	50	56	69
B5. 10 percent of GDP increase in other debt-creating flows in 2015	32	45	47	46	47	49	61	82
Debt Service-to-Revenue Ratio 2/								
Baseline	3	4	3	3	3	3	3	3
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	3	4	4	3	4	4	6	11
A2. Primary balance is unchanged from 2014	3	4	3	2	2	2	-1	-15
A3. Permanently lower GDP growth 1/	3	4	3	3	3	3	4	7
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	3	4	3	3	3	3	4	8
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	3	4	4	4	4	3	5	6
B3. Combination of B1-B2 using one half standard deviation shocks	3	4	4	4	4	3	5	8
B4. One-time 30 percent real depreciation in 2015	3	4	5	4	4	4	5	6
B5. 10 percent of GDP increase in other debt-creating flows in 2015	3	4	4	3	3	3	4	5

Sources: Country authorities; and staff estimates and projections.
1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.
2/ Revenues are defined inclusive of grants.

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IMF Executive Board Concludes 2015 Article IV Consultation with the Federated States of Micronesia

On May 11, the Executive Board of the International Monetary Fund (IMF) concluded the 2015 Article IV consultation[1] with the Federated States of Micronesia (FSM).

Micronesia's economy is stagnating, as externally-funded infrastructure projects are moving slowly while difficulties in the business climate, in particular those related to land tenure issues, continue to hold back private sector development. Staff estimates real GDP growth of around 0.1 percent for the fiscal year 2014 (ending September), while inflation has dropped to 0.7 percent on the back of falling oil prices. The current account strengthened in to 2½ percent of GDP in 2014, due mostly to a one-off increase in tax revenues and an increase in fishing license fees. Growth in 2015 is projected to remain subdued at 0.3 percent, while consumer prices are projected to further decline to -1.0 percent thanks to the continued pass through of low oil prices.

The Micronesian economy is projected to grow at 0.6 percent in the medium term, while risks on the outlook are tilted to the downside. The expiration in 2023 of grants provided under the Compact of Free Association with the United States is a significant challenge for Micronesia, requiring the country to implement wide-ranging reforms to enhance fiscal sustainability and private sector growth. Damages caused by the recent Typhoon Maysak have revealed again Micronesia's vulnerability to tropical cyclones, while disaster assistance arrangements with the United States help the nation to recover from those damages.

Some reforms have been started recently, in particular, fiscal consolidation efforts by the state governments under the Long-Term Fiscal Frameworks (LTFF) and the establishment of the Unified Revenue Authority (URA). A new legislation on credit unions is being prepared to extend the supervisory authority of the Banking Board. The recently produced "2023

[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.

Action Plan" shows further policy actions that are required, including the implementation of the tax reform package and regulatory reforms. Most of these policy actions will require legislative measures – hence the critical importance in achieving a wide consensus in a nation with a loosely federated structure.

Executive Board Assessment[2]

Executive Directors noted that medium-term growth prospects in the Federated States of Micronesia (FSM) remain weak given sluggish private sector activity, while fiscal challenges loom ahead, in particular, with the expiration of Compact grants in 2023. They also expressed concern about the impact of the damage caused by Typhoon Maysak in April, notwithstanding the provision of emergency assistance by the international community. Directors stressed the importance of critical fiscal and structural reforms to help lift the economy's growth prospects and achieve fiscal sustainability beyond the expiration of the Compact grants.

Directors called for the formulation of a realistic long-term fiscal framework based on a wide consensus across the national and four state governments, with a view to achieving budgetary self-reliance in the post-2023 period. While commending recent progress—including the establishment of the Unified Revenue Authority, the transfer of the 2014 fiscal surplus to the FSM trust fund, and the start of the Long-Term Fiscal Framework by the state governments—Directors encouraged the authorities to redouble their efforts in strengthening fiscal consolidation. They advised swift implementation of the long-debated tax reform package, in order to raise the revenue-to-GDP ratio closer to regional averages. Directors also noted the scope for improved prioritization of public spending, including through wage moderation and expedited implementation of an updated infrastructure development plan.

Directors emphasized that improving the investment climate is key to achieving private-sector-led growth in the FSM. They encouraged the authorities to undertake growth-enhancing policy actions, particularly by addressing land tenure issues through land surveys and registration. Efforts to strengthen investor protection and contract enforcement, and expedited investment application approvals would also help to attract foreign direct investment. In this regard, attention should be paid to safeguarding FSM's cultural heritage and pristine environment. Directors also supported greater bank credit expansion, including to SMEs, in order to help boost economic activity and promote diversified growth. They

[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.

noted that business skills of SMEs should be strengthened to support formulation of more bankable business projects.

Directors agreed that expanding regulatory oversight of credit unions would help to preserve financial stability. They supported the authorities’ efforts to prepare a new Credit Union Act that places credit unions under the supervision of the Banking Board, with technical assistance from the Pacific Financial Technical Assistance Centre(PFTAC).

Directors encouraged the authorities to redouble efforts to strengthen the capacity to produce timely economic statistics, with technical assistance from the Fund and other donors.

Micronesia: Selected Economic Indicators, FY2010–15 /1

Nominal GDP (FY2013):	US$315 million
Population (FY2013):	103,679
GDP per capita (FY2013):	US$3,034
IMF Quota:	SDR 5.1 million

	FY2010	FY2011	FY2012	FY2013	FY2014 Est.	FY2015 Proj.
Real sector (annual percent change)						
Real GDP	3.2	1.8	0.1	-4.0	0.1	0.3
Consumer prices	3.7	4.3	6.3	2.1	0.7	-1.0
Employment	3.9	1.7	-2.6	-2.0	0.0	0.1
Public (incl. public enterprises)	1.1	-0.4	-0.8	-0.7	0.0	0.0
Private	7.1	3.8	-4.8	-3.9	0.1	0.2
Nominal wages	2.7	0.4	3.8	1.6	1.8	1.9
public average wage/private average wage	2.2	2.1	2.0	2.0	2.0	2.0
Consolidated government finance (in percent of GDP)						
Revenue and grants	68.2	65.0	66.0	62.3	68.6	61.9
Revenue	21.6	20.8	22.9	26.8	37.4	30.9
Grants 2/	46.6	44.3	43.1	35.5	31.2	31.0
Expenditure	67.8	65.6	65.3	59.6	56.1	59.0
Current	46.9	45.6	44.2	45.9	46.0	45.5
Capital	20.8	20.0	21.1	13.7	10.1	13.6
Overall balance	0.5	-0.6	0.8	2.8	12.5	2.8
Overall balance (exc. Grants)	-46.1	-44.8	-42.4	-32.8	-18.7	-28.2
Commercial banks (in percentage of GDP; end of period)						
Loans	19.0	17.9	17.4	17.2	18.0	…
Deposits	52.5	53.8	62.7	67.8	75.4	…
Interest rates (in percent, average for FY)						
Consumer loans	14.9	14.4	14.2	15.7	15.7	…
Commercial loans	6.6	6.6	6.4	6.4	6.4	…
Balance of payments (in millions of U.S. dollars)						
Trade balance	-128.4	-134.0	-125.7	-131.1	-129.2	-119.1
Net services and income	-29.8	-32.5	-25.8	-11.7	5.5	5.6
Private and official transfers	113.8	111.2	110.3	111.1	131.7	111.4
Current account	-44.4	-55.3	-41.2	-31.6	8.0	-2.1
(in percent of GDP)	-15.1	-17.9	-12.6	-10.1	2.5	-0.7
Current account excluding official transfers	-153.4	-158.9	-142.5	-129.6	-89.6	-99.4
(in percent of GDP)	-52.2	-51.4	-43.7	-41.2	-28.5	-31.5
External debt (in millions of U.S. dollars; end of period) 3/						
Stock	86.4	89.8	90.3	85.2	83.0	83.7
(in percent of GDP)	29.4	29.1	27.7	27.1	26.4	26.5
Debt service	4.4	5.0	5.1	5.9	7.1	7.0
(in percent of exports of goods and services)	6.3	6.7	5.3	6.7	7.9	8.0
Exchange rate regime	U.S. dollar is the official currency					
Real effective exchange rate 4/	109.9	109.5	112.4	115.1	115.8	n.a.

Sources: FSM authorities and IMF staff estimates.

1/ Fiscal year ending September 30.

2/ Excludes grants to the Compact Trust Fund.

3/ Government and public enterprise debt only.

4/ Calendar year. 2003=100.

Statement by KwangHae Choi, Alternate Executive Director
and Hyunjoon Lim, Government-Provided Advisor to the Executive Director
May 11, 2015

Background

On behalf of the Micronesian authorities, we appreciate staff's well-organized and informative assessment of the developments in the economy and the constructive dialogue with the authorities.

The Federated States of Micronesia is a small Pacific island country which consists of four autonomous states guaranteed by its constitution. Such autonomy and the geographical dispersion among each state make it challenging to achieve social consensus on important issues.

The most serious challenges facing Micronesia include concerns related to grants from the United States which recently account for 25~30 percent of GDP. Grants are expected to expire in FY2023. Therefore, the FSM's sustainable growth in the long term will hinge on moving forward the fiscal reforms in preparation for the expiration of grants, and fostering a larger role for the private sector as a new engine of growth.

To address these challenges, the authorities recently initiated "Action Plan 2023" which aims at addressing the fiscal and economic challenges leading up to and post FY2023. The Action Plan targets achieving the FSM's annual real growth rate of 2 percent, creating an environment for private sector-driven growth, and strengthening fiscal consolidation over the remaining years at the Compact.

In this regard, while the authorities broadly agree with staff on the outlook, ambitious reforms and favorable development of global economy would play a pivotal role in helping to revive the economic activity.

In addition, pursuing sustainable growth, the authorities highly appreciate the staff's assessment and recommendation. In particular, staff's recommendations related to achievement of the sustainable growth are largely in line with the Action Plan 2023, which are to promote the country's economic development, budgetary self-reliance, and economic self-sufficiency.

Economic Outlook

The authorities broadly agree with staff's assessment of the outlook. However, the authorities believe that there is a range of upside risks that could materialize, particularly with implementation of reforms. Specifically, the authorities believe that the FSM's economy will be able to regain the momentum to 2 percent per annum on average over the remaining periods of the Compact in case the country radically realigns its productive capacity by undertaking key factors contained in the Action Plan and being helped by favorable factors as follows:

- Fishing and tourism are expected to benefit from favorable external factors such as lower oil prices and the gradual recovery of global economy.

- The authorities continue to have dialogue with the stakeholders to address the unused balance of allocated Compact grants for infrastructure projects. The authorities seek to accelerate the spending on the infrastructure arrears of $126 million over the next four years, and thereby help to reinvigorate the economy.

- Last but not least, the authorities believe that an additional upside risk could arise from the positive effects of the structural reforms on external and domestic confidence.

Pursuing Sustainable Growth

Fiscal Policy

Staff pointed out that from 2024 onwards, the FSM will face serious fiscal deficits without any interventions or reforms. A key challenge in fiscal reforms for the country is that the fiscal policy is implemented individually by the central and state governments, with separate expenditure and revenue policies. The authorities agree on the need to put in place both revenue and expenditure reforms that reflect the country's long term objectives.

On the revenue front, the authorities highly appreciate staff's emphasis on the central importance of improved tax administration and tax reforms.

- The authorities plan to lift a currently low tax-to-GDP ratio of 12 percent up to as high as 16 percent through a series of tax reforms, including through introduction of a value added tax and net profits tax.

- Going forward, the authorities seek to extend the URA to the remaining two states, enhance the current operations of the state and national tax offices, and broaden personnel training in anticipation of the broader tax reform.

This will be supported by sustained utilization of technical assistance from the Pacific Forum Secretariat (PFTAC) and other development partners, incorporating wherever possible the lessons from the experiences of comparable Pacific island countries that have already undertaken such reforms. Complimenting these efforts and standing critical to the success of the reforms, will be a more targeted public awareness program regarding the reforms.

On the expenditure front, a key policy objective is the need for national and state governments to limit their expenditure growth to 2 percent per annum over the medium-to- long term and thereby see total expenditure of government continue to decline as a percent of GDP by allowing expenditure to keep track of inflation levels.

- In particular, the authorities view the recent launch of state-level effort towards consolidation under the Long-Term Fiscal Frameworks (LTFF) as important progress, and moreover highlight their strong resolves to extend the LTFF to the national government level.

- Concerning the large wage bill, the authorities note that salaries have been frozen since 1997 through a decision of Congress. The government recently undertook a public administration reform project, under which it reviewed not only the salary freeze but also number of staff, payment structures, and staff grading etc and is in the process of implementing the findings.

The authorities seek to strike right balance between revenue enhancing measures and revenue sharing. In considering any revenue sharing with the states, the national government will seek to ensure that the states take appropriate and corresponding measures, including enabling tax reform legislation, improving the investment environment, and implementing expenditure reforms.

Private Sector Development

The authorities fully agree with staff that improving the investment climate is key to achieving private sector-led growth. They also acknowledge that compact grants, no matter how efficiently administered, will not lead to better economic performances by 2023 without substantially rebalancing sector grant usage to focus on private sector growth, that leads to achieving budgetary self- reliance and economic self-sustainability. Despite the authorities' steadfast resolve to generate a business-friendly climate, it will be challenging to achieve social consensus on the structural problems, including land tenure reform in the near term.

Specific issues for the FSM include dealing with insolvency, contract enforcement, investor protection, access to credit, property rights, and business start-up challenges as well as land leases and foreign investment. It is hoped that diverse measures for Regulatory reforms Covered by the Action Plan 2023 will provide a cornerstone for enhancing protection for foreign investors and reducing investment-related uncertainty. The Action Plan, in practice, contains diverse measures and initiatives to expedite the construction of infrastructure which will help to enhance the competitiveness of tourism and fishery sectors.

Regarding the ownership and leasing of land, the authorities also see merit in reviewing restrictions imposed by Foreign Investment Acts at both levels of government to harmonize and provide greater clarity on land tenure practices across the states, while respecting local investors' legitimate interests. As is the case in other Pacific island countries, the land issue is so delicate and intricately connected to people's perception of inheritance and community that it needs to be tackled sensitively to produce solution that are sustainable in the long term.

Financial Sector

The authorities welcome staff's appraisal that the commercial banking sector is sound with adequate capital and ample liquidity. Nevertheless, the authorities continue to extend their regulatory efforts to credit unions. The authorities also note that continued reliance on the PFTAC for technical assistance is critical to prepare for a Credit Union Act which will expand the Board's supervisory mandate of the Banking Board over credit unions. The newly created Insurance Board will also benefit from technical assistance from the Fund and other agencies, to enhance its supervisory capacity and strengthen foreign corporation auditing.

External Stability

We share staff's view that risks to external stability are relatively contained given that its current account deficits have largely been financed by concessional foreign grants for infrastructure projects. Although this nature helps the FSM's public debt to remain stable and low as a percent of GDP, the authorities remain mindful of the external risks posed by foreign denominated loans. Given this, the authorities are committed to closely monitoring the pressures from foreign loans and the scheduled reduction of Compact grants, on external stability, and will continue their efforts to reduce heavy external dependence for the energy and foods.