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

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

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 21, 2008, with the officials of the Federated States of Micronesia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 10, 2009. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 25, 2009, discussion of the staff report that concluded the Article IV consultation.

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

Statistical Appendix

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

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INTERNATIONAL MONETARY FUND

FEDERATED STATES OF MICRONESIA

Staff Report for the 2008 Article IV Consultation

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

Approved by Philip Gerson and Jerald Schiff

February 10, 2009

- **This report is based on discussions held in Pohnpei and Yap** during November 12–21, 2008. The team comprised Messrs. Kang (Head) and Sommer (both APD). Mr. Moveni (OED) joined the mission in Pohnpei, while Mr. Gill (AsDB) participated as an observer.
- **Counterparts:** The team met the Secretary of Finance, the Vice-Speaker of Congress, and other senior members of national and state governments, as well as parliamentarians and private sector representatives.
- **Outreach:** The mission's outreach included meetings with legislatures of Pohnpei and Yap, business leaders, and interviews with the local press.
- **Context of past surveillance:** During the 2006 Article IV consultation, the authorities and the Fund agreed on the broad policy priorities—fiscal adjustment through expenditure cuts and tax reforms to achieve self-sufficiency when the Compact ends in 2023 and structural reforms to support private sector development (for details, see http://www.imf.org/external/np/sec/pn/2007/pn0730.htm). While some progress was made on fiscal consolidation, the pace of reforms has been slow, partly due to capacity limitations and the loose federation of government, which has made it difficult to forge a consensus for reform and coordinate policies.
- **Exchange rate:** The U.S. dollar is the official currency. The government of the Federated States of Micronesia (FSM) has accepted the obligations of Article VIII, sections 2, 3, and 4 and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions except for security reasons.
- **Statistical issues:** Limited domestic capacity to produce economic data hampers surveillance and policy analysis. FSM continues to receive assistance from the Pacific Financial Technical Assistance Centre (PFTAC) to improve the quality of national accounts and balance of payment data.

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EXECUTIVE SUMMARY

Background

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

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

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

Key Policy Issues

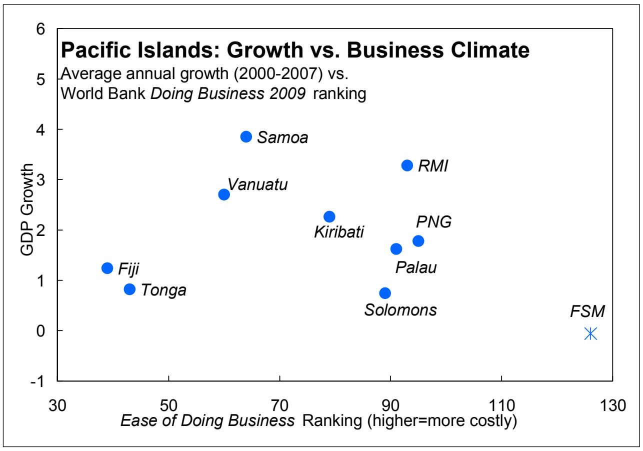
- **The authorities have limited tools to address risks from the global slowdown.** Monetary policy is not available as the U.S. dollar is the FSM's legal currency. Since fiscal policy is constrained by the need to adjust to the shrinking Compact grants, priority should be given to unlock undisbursed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

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

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

I. INTRODUCTION

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



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

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

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

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

II. Economic Background and Outlook

A. Recent Developments

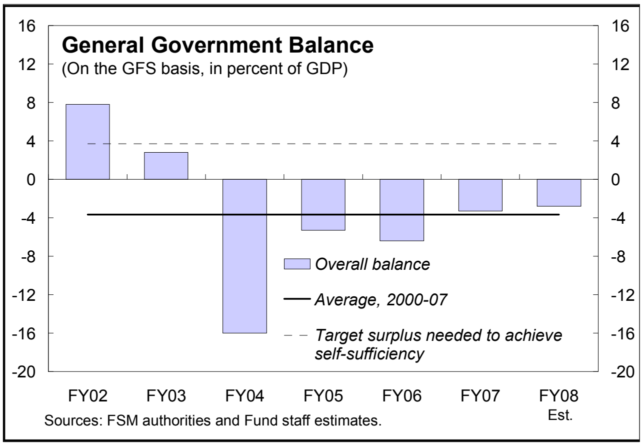
3. **Since the last Article IV consultation, the economic situation has deteriorated.** Compact-related spending cuts, particularly in Chuuk and Kosrae, have reduced public employment, while high commodity prices further reduced the real value of Compact grants and household incomes. In the absence of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

Selected Economic Indicators

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

Sources: FSM authorities and Fund staff estimates.

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



Sources: FSM authorities and Fund staff estimates.

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

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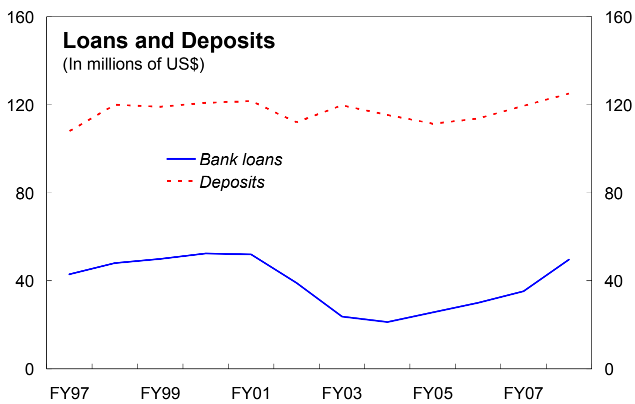
[4] The large current account deficit has been largely financed by capital transfers related to the Compact and unrecorded remittances.

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

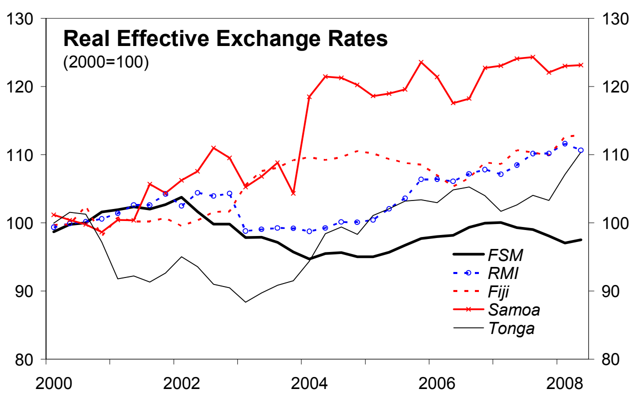
in Chuuk and Kosrae and grants from China, which helped offset stagnant tax revenue and an increase in fuel subsidies (mostly in Yap).[6]

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



Source: IMF, *Monetary and Banking Database* .

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



Sources: IFS, INS, and Fund staff estimates.

B. Outlook and Risks

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

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

BOX 1. MICRONESIA: POSSIBLE IMPLICATIONS OF THE GLOBAL SLOWDOWN AND FINANCIAL TURMOIL

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

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

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

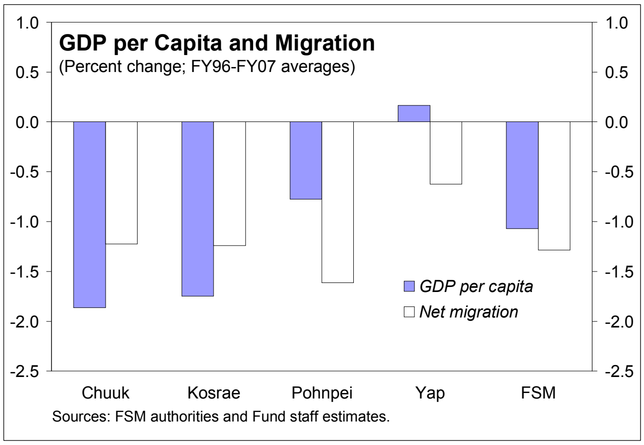
Lower remittances. Overseas worker remittances are estimated to have nearly tripled over the past five years, reaching around $9 million annually. Many workers are reported to be in lower-skilled jobs in the United States that may be at risk in a softening U.S. labor market. Besides reducing remittances,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

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

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

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

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



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

C. External Stability and Exchange Rate

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

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

III. Policies to Promote Sustainable Growth

A. Strategy for Fiscal Policy

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

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

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

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

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

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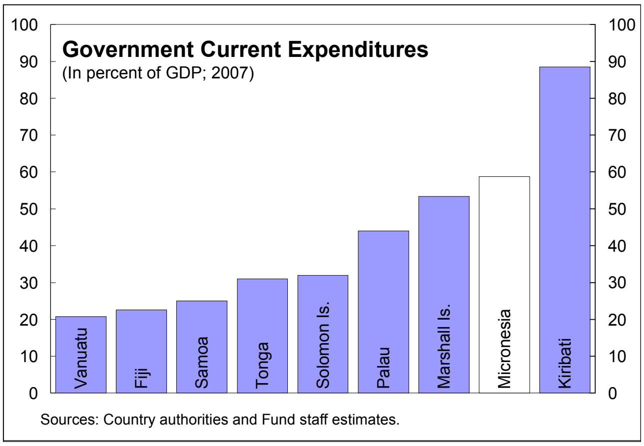
[7] The required budget surplus varies by state given the different starting level of savings, but even Yap—the state with relatively high savings—will need to improve its fiscal position.

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



Sources: Country authorities and Fund staff estimates.

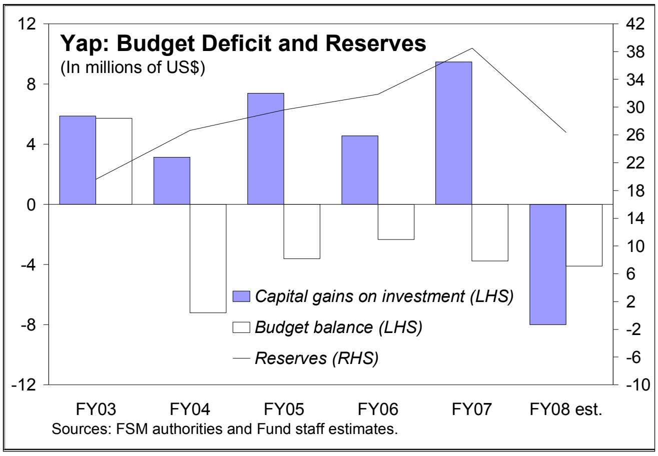
15. **Looking ahead, the scope for reducing current spending is significant.** Despite payroll reductions, current spending is—at 60 percent of GDP—still large by regional standards and public sector wages remain much higher than in private businesses. A further reduction in public employment together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

Wage Indicators by State (FY2007)

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

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

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



Sources: FSM authorities and Fund staff estimates.

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

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

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

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

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

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

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

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

Source: FSM authorities.

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

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

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

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

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

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

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

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

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

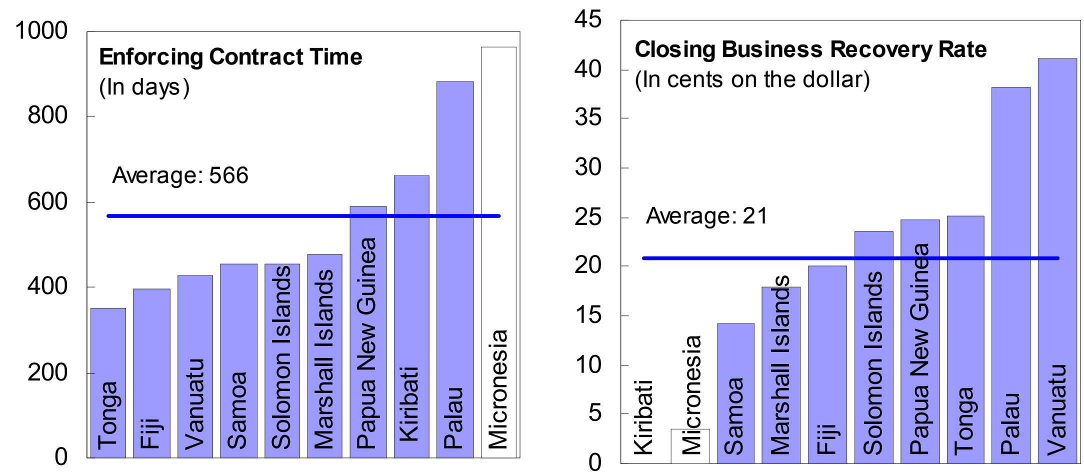
Investment Holdings of Selected FSM Entities
(As of end–September 2007, in millions of U.S. dollars)

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

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

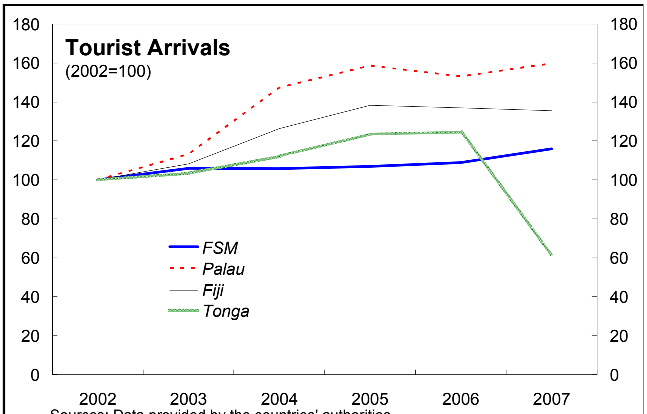
B. Real and Financial Sector Reforms

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



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

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



Sources: Data provided by the countries' authorities.

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

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

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

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

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

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

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

IV. OTHER ISSUES

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

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

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

V. Staff Appraisal

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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