EXECUTIVE SUMMARY

Economic environment. The economy has recovered following the stabilization of commodity and food prices. The recovery, however, is mainly supported by public infrastructure projects, and private sector activity remains weak. The fiscal situation has somewhat improved, but spending pressures are building up with elections approaching.

Outlook and risks. While the gradual release of delayed infrastructure grants is expected to stimulate the economy, structural impediments to private sector development and volatile commodity prices could hold back the recovery. Given the lack of private sector initiatives, the planned decrements in Compact grants and continued outward migration, medium-term growth will likely remain weak.

Fiscal sustainability. Achieving long-term budgetary self-reliance has become more challenging after the global crisis. Lower than anticipated returns on the government's trust fund imply a large projected revenue shortfall in FY2023, when the annual Compact grants are set to expire. Closing this revenue gap would require a medium-term fiscal surplus of about 5¾ percent of GDP.

Fiscal reforms. The tax reform bills have been submitted to the national congress; the technical issues regarding the constitutionality of the bills appear to have been resolved, and support for the tax reform at State level seems strong. Further strengthening of tax administration efforts, personnel training, and public education in parallel with the legislative process carry utmost importance.

Private sector development. Weak private sector development continues to hold back sustainable economic growth. With a number of infrastructure projects completed, reforms to attract foreign direct investment (FDI) could generate significant benefits. The policy priorities would be to relax the restrictive FDI legislation, increase the supply of skilled labor, and accelerate the implementation of pending infrastructure projects.

Financial sector. The banking sector remains liquid, but contributes little to economic growth. Activities by the public development bank and credit unions are currently not regulated and should be brought under the supervision of the Banking Board. Insurance supervision has recently been separated from banking supervision, but its supervisory capacity is inadequate and should be immediately stepped up, particularly in the area of captive insurance.

I. Introduction

1. **The Federated States of Micronesia (FSM) is a small Pacific Island country highly dependent on external aid, mainly from the United States.**[1] A renewed Compact of Free Association Agreement ("Compact") with the United States 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 (CTF) and other savings. The amended Compact has tightened 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 $150 million (over 50 percent of GDP) in grants has not been used, contributing to weak economic performance in recent years.

2. **The Article IV discussions focused on policies to secure a sustained recovery and achieve long-term economic and fiscal sustainability.** In addition to delays in Compact disbursements, the surge in global commodity prices and the global financial crisis have taken a heavy toll on the FSM economy. The economy has contracted since FY2006, and the value of the CTF has declined significantly. The political environment for reforms remain challenging with presidential elections scheduled for March 2011, which could delay the passage of key tax legislation. Against this background, the discussions focused on the fiscal and structural policies needed to secure a recovery and achieve long-term sustainability.

II. Economic Background and Outlook

3. **Since the last Article IV consultation, the economy has improved.** Following a long period of contraction, the economy grew for the first time in three years by 0.4 percent in FY2009, supported mainly by the airport renovation and other infrastructure projects, the reopening of a freezing plant in Kosrae, and the rise in subsistence agriculture. The shift to subsistence farming reflects the rise in commodity prices and the loss of employment in public sector in certain states. Inflation is estimated to have significantly slowed to 3.5 percent (y/y) in FY2010, after reaching 7.7 percent in FY2009, due to moderating food prices and decline in fuel and services prices.

Selected Economic Indicators

	Average FY2004-2008	FY2009	Est. 1/ FY2010	Proj. FY2011
	(year-on-year changes)			
Real GDP	-1.3	0.4	0.4	0.5
Consumer price index	4.1	7.7	3.5	2.0
	(in percent of GDP)			
Consolidated fiscal balance	-5.9	1.6	0.4	0.1
Current account balance	-12.2	-18.6	-18.4	-17.0

Sources: FSM authorities and Fund staff estimates.
1/ Data for FY2010 are preliminary.

[1] The FSM (with a population of about 102,000) 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, FY2010 covers October 2009 to September 2010).

4. **The consolidated fiscal balance has also improved, but with differences across states.** Chuuk and Kosrae have reduced public employment and salaries in line with the annual decline in Compact grants. Fishing fees temporarily increased along with the rise in fish catch, while tax revenues have expanded thanks to improved tax administration. As a result, the consolidated overall balance recorded its first surplus in six years of 1.6 percent of GDP in FY2009. However, performance varied across states, with Chuuk achieving a modest surplus and Yap and Pohnpei continuing to draw down their savings. In Chuuk, which is still struggling over a significant amount of debt (See Box 1), the authorities highlighted the difficulties in containing expenditures, given the already reduced working hours for non-Compact public employees, but nevertheless remained committed to keeping a balanced budget.

5. **The current account deficit widened and external debt rose in FY2009.** High fuel prices and grant-financed imports related to construction activities have worsened the current account. At the same time, external debt rose significantly in FY2009 mainly due to the $12 million borrowing by the FSM Telecom to finance fiber-optic installation, but the level of debt has remained relatively low at about 30 percent of GDP and is mostly on concessional terms.

6. **The recovery will likely remain weak, and the consolidated fiscal surplus is expected to decline in the near term.** Growth in FY2010 is estimated at 0.4 percent, supported mainly by infrastructure projects. The near-term outlook is overshadowed by sluggish private sector growth, which has been unable to offset the scheduled annual decline in Compact grants. Medium-term growth is estimated to increase slightly to 0.6 percent, supported by additional infrastructure projects in the pipeline. The fiscal surplus is expected to decline through FY2010–11 with the gains in tax revenues more than offset by the decline in fishing fees and increase in current expenditures related to the upcoming elections. The current account is expected to remain in deficit due to imports from ongoing infrastructure projects.

7. **Risks are on the downside.** While the release of delayed infrastructure funds is expected to stimulate the economy, structural impediments to private sector development and volatile commodity prices could hold back the recovery, leading to further delays in fiscal adjustment, and elevating sustainability concerns. Long-term risks include the possible loss of fish stock and reduction of farmland due to climate change and growing outward migration.

8. **The authorities acknowledged the challenges facing the FSM in offsetting Compact decrements.** In this context, they are currently in the process of developing state-specific solutions through a nationwide economic symposium to look into ways of promoting private sector and reducing import dependence by shifting to local production. To better manage risks stemming from volatile commodity prices, they are also considering developing an energy policy in line with best practices in other resource scarce countries.

Box 1. Micronesia: Public Finance in the State of Chuuk

Although Chuuk State has gone through significant fiscal adjustment since FY2007, it still faces major challenges in reducing its sizeable debt. Based on the report prepared for the Compact, the debt liabilities stood at about $28.9 million (about 37 percent of state GDP) as of FY2009, including loans to Asian Development Bank (AsDB) and accumulated arrears for land acquisition and vendor payments. To reduce arrears and expenditure related to the non-conforming uses of the capacity-building sector grant, the state undertook a decisive fiscal consolidation in FY2008–09 through a severe public workforce downsizing of about 300 people (about 13 percent of state public employment) and by reducing working hours for non-Compact related employees from 80 hours to 64 hours. As a result, fiscal balance has been restored since FY2008.

The authorities are expected to maintain fiscal discipline in FY2010 and FY2011. A small fiscal surplus is expected for FY2010, partly reflecting higher tax collections due to improved tax administration. While the authorities intend to remain current with the expenditures, they still fall short of making contributions to the infrastructure maintenance fund. For FY2011, the authorities envisage a balanced budget.

A debt relief task force has been established to explore ways of reducing the debt. The accumulated debt is sizeable and its reduction will be a major challenge. Proposed measures to reduce debt include selling of the state holdings of bank shares, earmarking a one percent increase in the sales tax for debt servicing, and canceling the cross-claims with the utility company, but they are not likely to be enough to reduce the debt significantly. The authorities are, therefore, looking into other options to rollover the debt, including through bond issuance or borrowing from commercial banks. However, staff strongly cautioned against refinancing existing debt with new debt, pointing to the possibility of significant increase in future debt burden unless adequate fiscal surpluses are secured.

Staff encouraged the authorities to continue building up fiscal surpluses to reduce accumulated debt rather than simply earmarking tax revenues. In this context, the authorities and staff agreed on the importance of verifying amounts owed in accordance with the existing laws and accumulating fiscal surpluses by resisting the pressures to increase wage bill and limiting the non-Compact funded expenditures. Staff cautioned in particular against plans to prematurely increase the working hours of non-Compact financed public employees.

Improving the governance and implementation of Compact grants can further enhance their effectiveness. The problems regarding land title issues, lack of qualified personnel, and weak project planning have caused significant delays in the implementation of infrastructure projects. While performance audits for Compact sectoral projects are conducted, the enforcement of the findings has been weak. For example, the public auditor's office identified problems regarding procurement practices, but there is no effective implementation process in action. The effectiveness of the grants can be enhanced by introducing mechanisms ensuring the enforcement of the improvements identified by the auditors, detailed project planning at an early stage, and contracting of qualified personnel at both manager and technical level. In this context, the efforts by legislature to resolve the land title issues and the ongoing effort of better contracting practices are an encouraging sign.

III. POLICIES TO ACHIEVE SUSTAINABLE GROWTH

A. Fiscal Policy

9. **Achieving long-term fiscal sustainability has become more challenging.** Staff projections indicate that the resources in CTF and other unreserved accounts will not be able to supplement expiring Compact-related grants in FY2023 without significantly disrupting public services (Appendix I). Owing to the sharp drop in global equity markets, CTF experienced a cumulative net investment loss of around 17 percent over FY2008—FY2009, before recovering partly in FY2010. Based on conservative investment returns, limited fiscal adjustments, and structural reforms, the income shortfall is projected to reach $16 million (about 6 percent of FY2010 GDP) when Compact sector grants expire in FY2023, higher than the estimates (5 percent of GDP) in the 2008 Article IV Consultation report. The authorities agreed that even if the returns on assets recover, the CTF will likely not generate enough revenue to maintain the same level of government operations in FY2024.

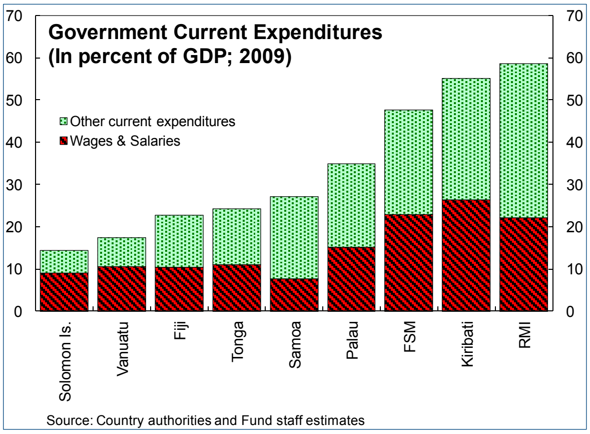
10. **Long-term sustainability could be achieved through increasing the fiscal surplus to around 5¾ percent of GDP by FY2015.** This would involve raising the fiscal surplus by about 1.1 percentage point per year (equivalent to $3.7 million in 2010 prices) for five years, and then maintaining the surplus at that level until FY2023. Under the FSM's federal system, each state would need to run surpluses to supplement the CTF returns. Staff encouraged the authorities to start the adjustment in FY2011, as further delay would increase the cost of adjustment (See appendix I). While the authorities recognized the need for the early adjustment, they noted the difficulties in starting next fiscal year due to spending pressures related to Presidential elections and challenges in coordinating fiscal policies across the states.

Table 2. Recommendations for Medium-term Budget Adjustments

	Fiscal balance			Fiscal surpluses (in FY2010 prices)	
	FY2009	FY2010 Est.		FY2015 Proj.	
	in USD millions	in USD millions	in percent of GDP	in USD millions	in percent of GDP
National government	5.4	2.0	0.7	2.7	0.9
Chuuk	2.5	0.4	0.1	4.3	1.4
Kosrae	0.4	0.1	0.0	1.0	0.3
Pohnpei	-1.3	-0.3	-0.1	6.7	2.2
Yap	-2.4	-1.2	-0.4	2.7	0.9
FSM (consolidated basis)	4.6	1.0	0.4	17.4	5.8
Memorandum item:					
Nominal GDP	276.5	287.4		303.3	

Sources: FSM authorities and staff estimates.

11. **In the near term, containing current expenditures will remain essential.** While there has been considerable progress in reducing public employment in Chuuk and Kosrae, wages and salaries of the national government increased significantly in FY2009. Other Compact economies face similar challenges in adjusting, but there is room for FSM to curtail current expenditures which remain high when compared to other Pacific Island economies. Also, public wages remain much higher than in the private sector and have grown rapidly compared to other Compact economies (See the table and Box 2). Authorities and staff agreed on the



Source: Country authorities and Fund staff estimates need to curtail expenditures, in particular public wages, but underscored the challenges ahead. In Pohnpei, the mission supported the planned expenditure cuts, but recommended a more targeted approach rather than across the board reductions.

Box 2. Micronesia: Challenges for Northern Pacific Islands Countries with Compact Grants

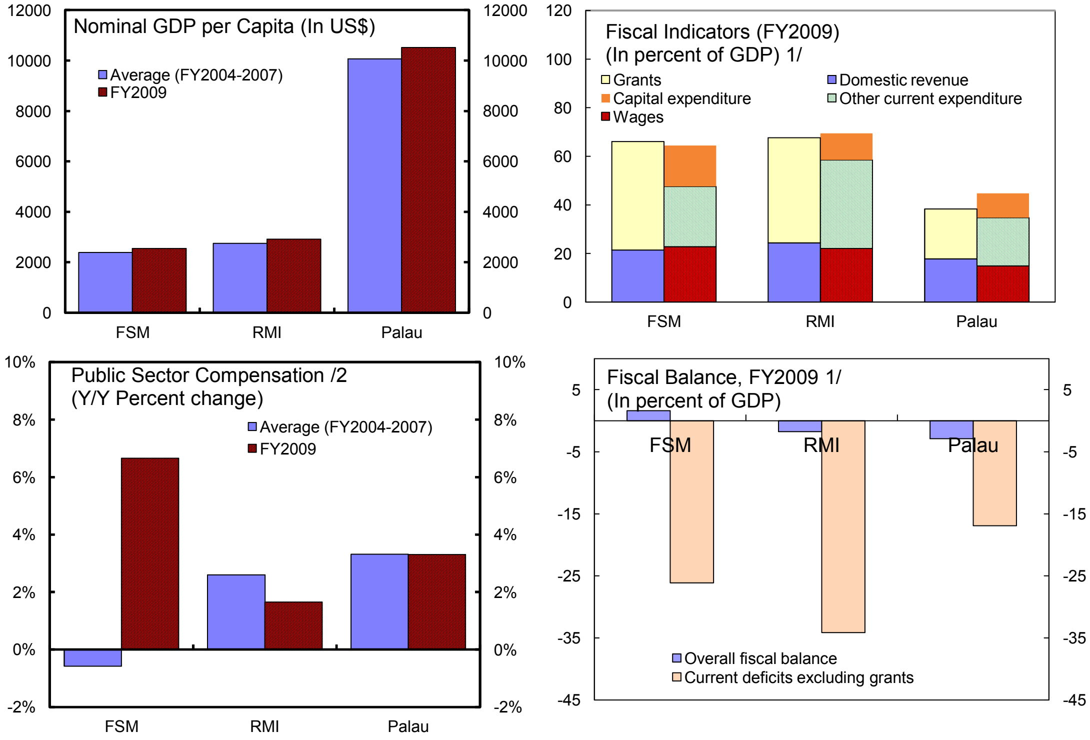
Many northern Pacific Island countries (PICs), including FSM, Marshall Islands (RMI), and Palau, are likely to face significant fiscal adjustment and reform challenges under the Compact. These countries are highly dependent on foreign grants, with a sizeable public sector. Despite a large share of foreign grants devoted to capacity building and private sector development, implementation has been slow and large gaps persist in attaining budgetary self-sufficiency. This box discusses the challenges for these three countries in overcoming their heavy reliance on Compact grants.

Most foreign grants in these three countries are through the financial provisions under the Compact agreement with the United States. For the FSM and RMI, sector grants from the amended Compact are set to expire in FY2023, while Palau's new agreement with the United States lasts for 15 years until FY2024. Grants under the agreement are about $250 million. In recent years, foreign grants accounted for about 50–60 percent of the overall revenue in these countries, with Compact-related grants making up a large portion.

Heavy dependence on grants translates into large fiscal imbalances and sizeable public sectors. While overall fiscal positions are roughly in balance across all three countries, their current deficits excluding grants are significant between 15 percent and 35 percent of GDP (Figure B2.1). With domestic revenues about at the same level as public wages across all three countries, these countries rely entirely on foreign grants to finance other current expenditures and capital spending. The overall public sector (including public enterprises) accounts for more than half of the economy, crowding out private sector activity. Public sector payrolls far exceeded those in the private sector in the FSM and RMI and wage gaps have remained since the amended Compact agreements took effect in FY2004. In the FSM, the public sector wages increased substantially in FY2009, particularly for the national government.

In light of their heavy reliance on grants, significant fiscal adjustment is needed in all three countries to ensure fiscal sustainability. The required size of adjustment in staff estimates varies across the three countries, reflecting factors such as different arrangements under the Compact, and ranges from about 5 percent of GDP for RMI, around 5¾ percent of GDP for FSM, to about 8 percent of GDP for Palau. However, in all three, the required medium-term adjustment is substantial, requiring a comprehensive approach combining expenditure cuts, revenue improvements, and structural reforms (Table B2.1). A delay in adjustment would result in more costly and difficult adjustments in the future.

Figure B2.1. Comparison Across Compact Countries



1/ Data for Palau for FY2009 are estiamtes.
2/ Wages and salaries for the public sector refer to weighted average of national and state governments in FSM and weighted average of central and local governments in RMI.
Sources: FSM, RMI and Palau authorities, and Fund staff estimates.

Table B2.1. Summary of Recommended Measures to Achieve Long-term Fiscal Sustainability

	FSM	RMI	Palau
Revenue measures	· National congress and state legislators need to expedite the approval of the tax reforms.	· Expedite tax reform process by drafting the legislature and public outreach. · Strengthening tax administration through audit for unreported income.	· Improve tax system by eliminating import duty exemptions and replacing the GRT with less distortionary tax.
Expenditure measures	· Contain civil service payrolls and public sector employment. · Adopt a multi-year fiscal plan to ensure fiscal prudence and guard against election-related spending.	· Reudce civil service payrolls · Limit financial support to state-owned enterprises (SOEs).	· Further reduce public sector wage expenditure · Curtail subsidies on water and sewage services
Other structural measures	· Undertake reforms to encourage FDI; harmonize FDI legislature across states.	· Undertake comprehensive reforms to SOEs (e.g., establish an SOE policy with ADB assistance).	· Strengthen budget processes by improving cash management; liberalize the FDI regime; improve land regulation.

Sources: Various IMF Article IV Consultation Reports.

12. **In this context, a multi-year fiscal plan would strengthen the fiscal discipline.** Over the medium term, net current expenditure cuts of about 2¾ percent of GDP would be needed in addition to revenue gains from the tax reform (Appendix I).[3] To achieve this, the FSM should adopt a medium-term fiscal consolidation plan with clear targets for public wages and other administrative spending. A multi-year plan would also guard against election-related spending and secure the gains from painful expenditure cuts over the past few years, while safeguarding critical spending on health care, education and infrastructure. For such a plan to be credible, effective public communication is essential.

Micronesia: Average Nominal Wages by Sector

	Government 1/	SOEs	Private sector	Government / private sector wage
	Wage level, USD (FY2009)			
Chuuk	7,957	8,406	3,445	2.3
Kosrae	8,944	10,709	3,739	2.4
Pohnpei	13,088	14,787	4,721	2.8
Yap	7,637	7,086	4,564	1.7
FSM: weighted average across states	9,744	12,475	4,309	2.3

Sources: FSM authorities and Fund staff estimates.
1/ Weighted average of wages across national and state governments.

13. **Building the right incentive mechanism into the public financial management is key.** In this context, similar to those on Compact-funded expenditures, public performance audits should be extended to cover general operations financed by local revenues. The authorities should ensure that subsequent enforcement of the audit findings, such as weak procurement practices, is followed through and incorporated into budget planning.

14. **Even with significant expenditure cuts, swift implementation of the planned tax reform is still needed.** Despite the wide recognition of the importance of a comprehensive tax reform, progress has stalled. A set of tax reform bills to create a Unified Revenue Authority (URA), and introduce net profits tax and value added tax (VAT), in place of the current gross revenue tax and sales tax, has been submitted to Congress. These reforms should generate additional revenue amounting about 3 percent of GDP. Although the technical problems regarding the constitutionality of the URA and the VAT appear to be resolved, prospects for completion of tax reform are still uncertain with political priorities shifting towards the upcoming election and continued coordination problems among the national and state governments. National and state legislatures are not likely to pass the bills before the March 2011 elections, with each legislature waiting for the other to move first. The Congressional leaders are planning to visit states in attempts to break the gridlock.

15. **Although tax administration has improved, there is still room to enhance current operations of the state and national tax offices and expand personnel training.** This, if done in parallel with the legislative process of tax reform bills, would help facilitate a smooth transition to the new system and avoid a fall in the tax collection. In addition, expanding communication and the consultation process to involve community groups, including small enterprises, would help generate more broad-based support for the legislative process. The

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[3] The expenditure adjustment is on net terms after accounting for scheduled decrements of Compact grants.

authorities agreed with the proposed approach and noted the need for technical assistance on personnel training during the process.

16. **The mission supported the steps to reduce unfunded liabilities of the social security system.** As highlighted by the authorities, unfunded liabilities of the social security are large at about $232 million (89 percent of GDP) as of January 2009. To address the problem, the authorities passed a new bill in 2010, increasing social security tax rates by 2 percentage points and reducing benefits by 50 percent for retirement before the age of 65. Staff supports the move and encourages the authorities to monitor closely the projected balance of social security funds for any deviation from the targeted path given that these measures provide only a partial relief going forward.

B. External Stability and Exchange Rate

17. **The FSM has experienced a real appreciation since the global downturn.** Following the surge of domestic food and fuel prices in FY2008, the real effective exchange rate has appreciated by 9 percent, posing a risk of loss of competitiveness with respect to other Pacific Islands countries. Looking forward, the FSM could regain competitiveness as the pressure to domestic prices subsides or reforms to improve productivity take hold. The authorities acknowledged such risks but noted that their main export items, particularly niche tourism, are not sensitive to the exchange rate or changes in global demand.

18. **Despite the appreciation, the risks to external stability are limited, and the use of the U.S. dollar as currency remains appropriate given the size and the links of the economy.** While tourist arrivals and overall exports fell more than those of regional peers, staff and authorities agreed that the Compact grants would continue to provide a stable source of funding over the next decade and the U.S. dollar remain the appropriate currency.

19. **However, increased debt repayment on foreign loans (about 1½ percent of GDP) and scheduled decrements of Compact grants could create some pressure and would require careful monitoring of the external position.** The authorities are considering a foreign denominated loan from the Export-Import Bank of China amounting $20–25 million (about 7–9 percent of GDP) to upgrade a Pohnpei fishing processing plant. While the details of the loan and its commercial viability are not yet decided, staff recommended a careful consideration of the terms of the loan, including its currency risk, debt repayment burden, and potential government obligation involved, in view of its possible impact on external debt sustainability.

C. Private Sector

20. **The private sector in the FSM is stagnant and contributes little to growth.** The authorities highlighted several obstacles for vibrant private sector development including difficulties in land tenure and registration, poor infrastructure, lack of skilled labor, a large public and private sector wage differential, limited access to credit by start-ups, and

regulatory hurdles for inward FDI.[4] They also emphasized difficulties stemming from high transportation costs and energy prices.

21. **The FSM has recently completed a number of key infrastructure projects, which could support the private sector.** The extension of Pohnpei airport, to be completed in mid-2011, has the potential for expanding tourism with direct flights from the region and more broadly Asia. It also has the potential for increasing niche exports, such as fish, sakow (local alcohol drink), and other agricultural products. The authorities noted that the relocation of a U.S. Marine base to Guam is also likely to expand opportunities for both tourism and agriculture. The expanded fiber-optic network, completed in 2010, is expected to improve overseas communication.

22. **Building on these infrastructure projects, reforms to attract inward FDI could generate significant gains.** Greater FDI is especially feasible in the areas of aquaculture, agriculture, and tourism. In order to seize this opportunity the FSM needs to overcome many challenges:

- *FDI Legislation*. The Foreign Investment Act in several states are restrictive, with regards to both ownership and renting of the land, and investment approval. The Acts should be reviewed to ensure an environment conducive to FDI, while respecting local investors' legitimate interests. Harmonizing FDI legislation across states could also reduce investment uncertainty and facilitate large-scale FDI. Greater clarity on land tenure and regulation, which varies by states, would also help. In this context, staff welcomes the proposal to relax the Pohnpei Foreign Investment Act along these lines.
- *Lack of skilled labor.* The limited availability of skilled labor holds back FDI. Improving education and vocational training while relaxing legal restrictions on hiring of expatriates may help ease this barrier. At the same time, joint ventures would create positive spillover effects through skill transfers.
- *Inadequate infrastructure.* Without reliable infrastructure in power, transportation, and communications, foreign investors face steep challenges in entering the FSM. With about US$150 million still not utilized, greater utilization of Compact infrastructure grants should be given priority. In this context, improving project management and procurement of resources would accelerate the existing projects in the pipeline.

23. **The authorities shared the staff's view that the FSM business environment remains very challenging.** On FDI, the Pohnpei legislators noted that the Foreign Investment Act of the state was very restrictive and were considering revision to make it more investment friendly. The Pohnpei government also acknowledged the slow progress in

[4] In the most recent *Doing Business* report by the World Bank, the FSM ranks 141st out of 183 countries in the world, the lowest among Pacific Island countries in terms of the ease of doing business. The FSM fares especially poorly in such areas as registering properties (183th) and protecting investors (173th).

mapping, surveying, and certification of land and the need to step up efforts in these areas, in view of their critical role in supporting private activities. Some private sector representatives, on the other hand, expressed reservations regarding foreign investment, pointing to potential negative impacts stemming from limited use of domestic factors of production and knowledge spillover.

D. Financial Sector

24. **The banking system remains liquid, but renders little support to the private sector.** Since the last Article IV, non-performing loans have declined to about 2¾ percent of total loans, and banks have maintained sufficient liquidity with a loan to deposit ratio of about 36 percent in FY2010. The risk-adjusted capital ratio stays high at over 30 percent. The increase in deposits in FY2010 reflects a few accounts related to the ongoing infrastructure projects. However, the majority of deposits are being held in safe financial assets rather than being lent to the private sector. Under the secured transaction act, there has only been a small increase in lending, mainly auto-loans.

25. **The Banking Board's supervision capacity has improved, but would benefit from further strengthening.** The Banking Board performs on-site supervision with technical assistance from PFTAC. However, staff turnover remains high and newly appointed staff need additional training. Staff supported continued efforts to strengthen on-sight monitoring of liquidity policies, compliance with AML laws and loan-loss provisions. Staff also highlighted the importance of operational independence and well-defined legal authority of the Banking Board for prudential regulatory purposes and supported the revision of the Banking Act in this direction.

26. **The staff also recommended that the FSM Development Bank and other non-deposit taking financial institutions be supervised by the Banking Board.** Over half of the loans in the Development Bank are under substandard and doubtful categories, with insufficient provisioning against possible losses. The Development Bank also plans to go beyond the current focus on commercial lending and compete directly with private banks in retail lending. The staff cautioned against under-provisioning for poor-performing loans and potential risk exposures on consumer lending, and reiterated the importance of bringing both credit unions and the Development Bank under appropriate regulation and supervision in line with the international best practices.

27. **There is an urgent need to increase the capacity for insurance supervision, especially in the area of captive insurance.[5]** There are currently three captive insurance companies licensed in the FSM, and three more are expected over the coming months. These companies are now supervised by the Insurance Board, which recently separated from the Banking Board. The Insurance Board, however, lacks adequate staffing, data processing

[5] Captive insurance company provide insurance or reinsurance for risks of the entity or entities to which it belongs. Captive insurance activities are seen by some as a possible revenue source from licensing fees and taxes.

capacity, and specialized skills to perform effective supervision. The authorities agreed with the need to step up their supervisory capacity and would seek technical assistance from the Fund and other agencies. They also noted the need to strengthen the national tax administrator's capacity to audit foreign corporations.

E. Other Issues

28. **The reliability, coverage, and timeliness of economic statistics need to be improved to guide policies.** Domestic capacity to produce economic data in all sectors remains limited, though some progress has been made in the area of balance of payment statistics. In particular, the authorities are encouraged to collect consolidated fiscal data across national and state governments in a timely manner to determine fiscal policy priorities. In addition, collecting remittance data should be given priority in light of continued outward migration.

IV. Staff Appraisal

29. **Growth prospects in the FSM remain weak given the sluggish private sector and the scheduled decline in Compact grants.** The FSM's recovery relies mainly on public infrastructure projects, with limited private sector support. While growth could be supported in the short term through the release of delayed infrastructure grants, long-term growth would only be achievable through sound fiscal and structural policies.

30. **The global crisis has increased the urgency of major fiscal and structural reforms.** The FSM has relied heavily on the amended Compact to advance its economic development and sustain a large public sector. The CTF suffered large losses during the global financial crisis, and is unlikely to generate sufficient income to supplement the expiry of Compact grants in FY2023. Further delays in needed reforms would lead to more costly adjustments in the future.

31. **The fiscal balance has improved, but the need for significant adjustment remains.** Securing fiscal sustainability will require swift implementation of the planned tax reform and tight expenditure control. Consolidation should begin in FY2011 with the passage of the proposed tax bills at both the national and state levels and further improvements in tax administration. On the expenditure side, the priority is to contain spending, especially in the run-up to the spring elections. A medium-term budgeting framework would also improve expenditure control.

32. **At the same time, reforms to facilitate foreign direct investment would enhance growth, create new employment, and generate higher revenue**. The priorities should be to further liberalize the foreign investment regime, improve project management and procurement of resources, increase the availability of skilled labor through external contracting as well as domestic training, and reduce the large public-private wage gap.

33. **Supervision over the financial system should be enhanced.** A refocusing of the FSM Development Bank to avoid direct competition with commercial banks would help

promote the development of the financial system. At the same time, supervision should be extended to cover credit unions and the FSM Development Bank, while insurance supervision should be strengthened, particularly in the growing area of captive insurance.

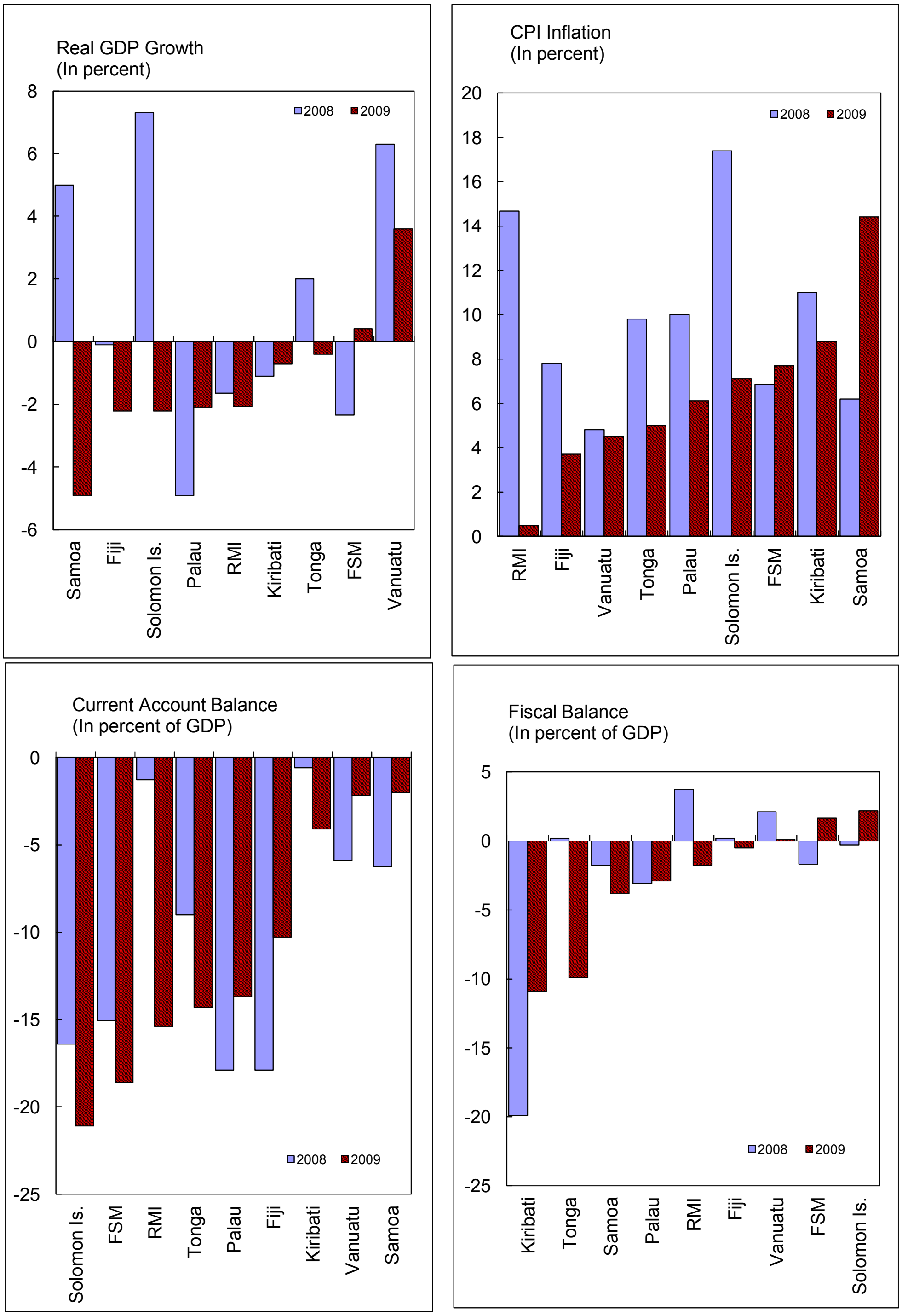
34. **The U.S. dollar remains the appropriate currency for the FSM**, given the size of the economy, its close ties to the United States, and limited administrative capacity for independent monetary and exchange rate policies.

35. **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.

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

Figure 1. Micronesia: Regional Comparison of Recent Developments

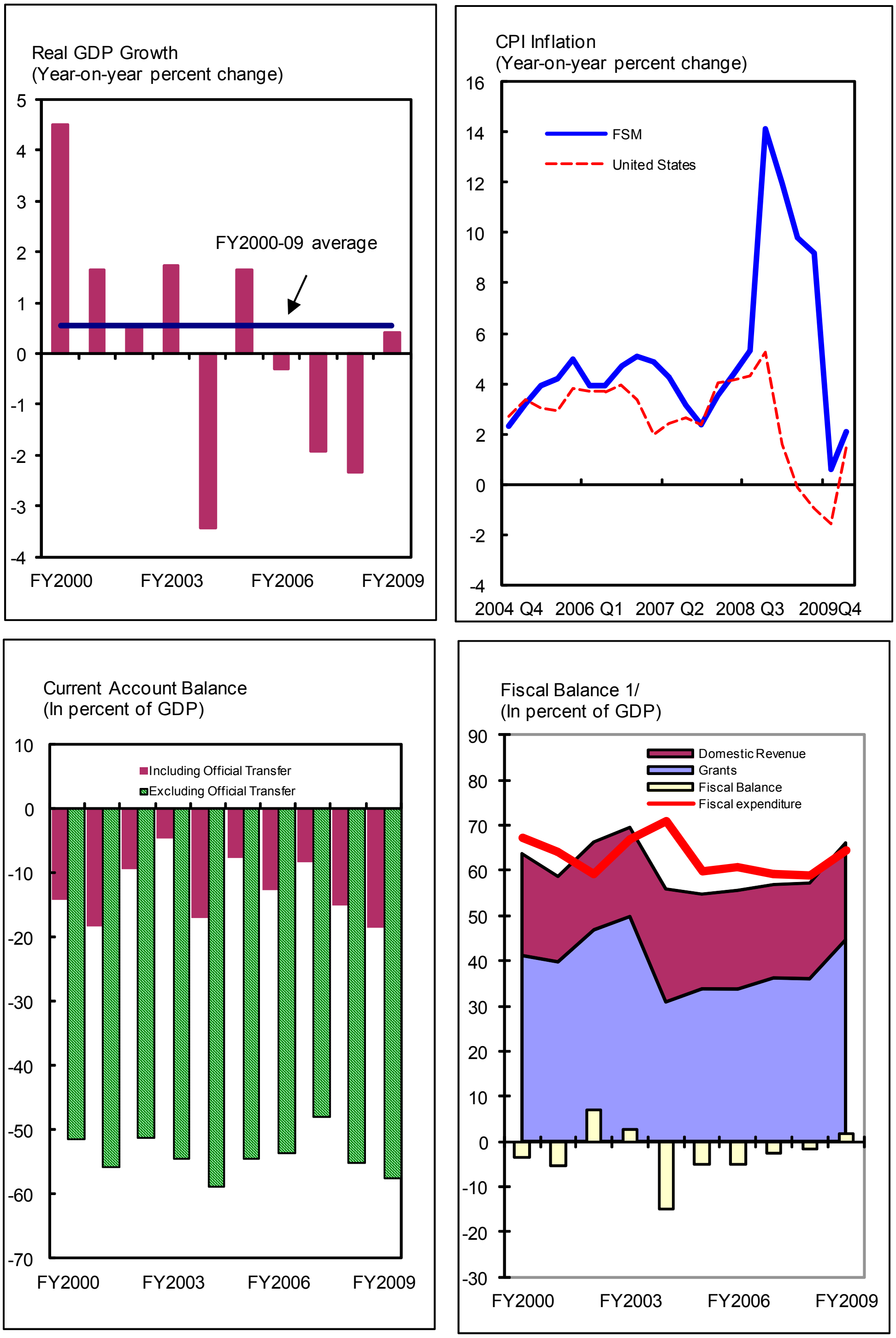
Compared to the PICs, the FSM is one of the few countries that recorded positive growth in FY2009, but inflation remained high. The high current account deficit reflects Compact related spending, and the improvement in fiscal balance is noticeable among the other Pacific Island economies.



Note: RMI and FSM stand for Republic of Marshall Islands and Federated States of Micronesia, respectively. The charts are sorted by 2009 data.
Source: Fund staff estimates and FSM authorities.

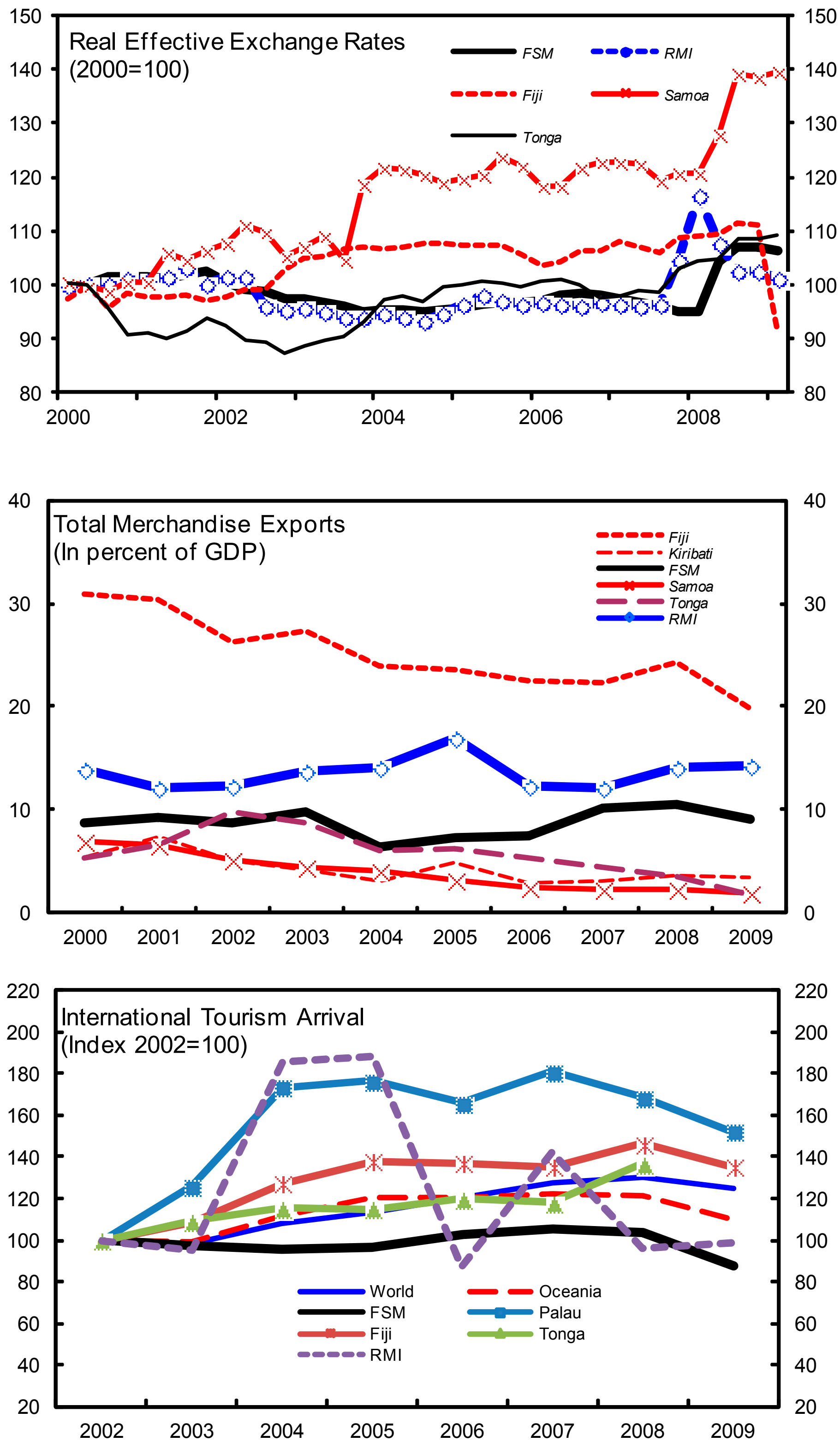
Figure 2. Micronesia: Macroeconomic Developments

Following the contraction in FY2008, the economy recovered in FY2009. CPI inflation remained high for FY2009, but moderated in the second half of the year. The current account deficit remains high, reflecting high commodity prices and construction related imports. The fiscal balance improved despite the pick up in expenditures.



Source: Fund staff estimates and FSM authorities.
1/ Total revenue is sum of grants and domestic revenue (stacked in chart).

Figure 3. Micronesia: Developments in the Exchange Rate, Export Growth, and Tourism (2000–09)



Source: International Financial Statistics, Fund staff estimates, and FSM authorities.

Table 1. Micronesia: Basic Data, FY2006–11 1/

Nominal GDP (FY2009):	US$277 million
Population (FY2009):	102,354
GDP per capita (FY2009):	US$2,702
IMF Quota:	SDR5.1 million

	FY2006	FY2007	FY2008	FY2009	FY2010 Est.	FY2011 Proj.
Real sector (average annual percent change unless otherwise noted)						
Real GDP	-0.3	-1.9	-2.3	0.4	0.4	0.5
Consumer prices	4.4	3.6	6.8	7.7	3.5	2.0
Employment	0.9	-1.5	-3.7	0.8	-0.1	0.2
Public (incl. public enterprises)	3.2	-5.7	-6.3	-1.3	0.3	0.1
Private	-1.9	3.5	-1.0	2.9	-0.5	0.3
Nominal wages	1.8	0.6	2.9	3.4	5.8	2.6
Public-private wage ratio	2.2	2.2	2.2	2.3	2.3	2.4
Consolidated government finance (in percent of GDP)						
Revenue and grants	55.6	56.9	57.2	66.1	60.1	62.1
Revenue	21.8	20.7	21.2	21.4	21.3	21.2
Grants	33.7	36.2	36.0	44.7	38.8	40.8
Expenditure	60.8	59.3	58.9	64.4	59.7	61.9
Current	57.3	51.7	50.1	47.5	46.6	48.3
Capital	3.5	7.6	8.8	16.9	13.1	13.6
Overall balance	-5.2	-2.4	-1.7	1.6	0.4	0.1
Compact Trust Fund (millions of U.S. dollars)	86.5	122.6	119.1	138.3	167.9	200.1
Commercial banks (in millions of U.S. dollars; end of period)						
Foreign assets	101.1	106.2	101.4	121.5	111.3	113.0
Loans	30.0	35.3	49.2	46.7	55.7	57.1
Total deposits	113.7	119.5	118.9	132.5	154.1	158.0
Interest rates (in percent, average for FY)						
Consumer loans	15.6	14.0	14.4	15.4	13.0	14.2
Commercial loans	8.4	9.1	8.5	7.4	5.7	6.6
Balance of payments (in millions of U.S. dollars)						
Trade balance	-110.8	-104.4	-119.4	-128.0	-126.5	-128.5
Net services and income	-24.5	-18.3	-25.1	-31.4	-20.3	-22.9
Private and official transfers	103.1	101.1	105.1	108.0	93.9	101.4
Current account including official transfers	-32.1	-21.6	-39.4	-51.4	-53.0	-50.0
(in percent of GDP)	-12.8	-8.4	-15.1	-18.6	-18.4	-17.0
Current account excluding official transfers	-131.7	-118.0	-137.9	-155.5	-143.1	-147.4
(in percent of GDP)	-52.4	-46.1	-52.7	-56.2	-49.8	-50.0
Overall balance	-1.9	-0.4	-5.6	-5.9	-1.3	0.1
(in percent of GDP)	-0.8	-0.1	-2.1	-2.1	-0.4	0.0
Gross reserves (in months of imports)	2.9	3.1	2.5	2.7	3.0	3.0
External debt (in millions of U.S. dollars; end of period) 2/						
Stock	63.4	65.9	68.0	80.5	79.2	78.7
(in percent of GDP)	25.2	25.8	26.0	29.1	27.6	26.7
Debt service	2.5	2.7	3.1	3.4	4.3	5.2
(in percent of exports of goods and services)	5.8	5.1	5.5	6.1	7.2	8.3
Exchange rate regime	U.S. dollar is the official currency					
Real effective exchange rate 3/	97.2	97.7	97.6	106.5	104.2	…

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

1/ Fiscal year ending September 30. Estimates for FY2010 and projections for FY2011 are preliminary and based on data received from the authorities.

2/ Government and public enterprise debt only.

3/ Year 2000=100.

Table 2. Micronesia: General Government Operations, FY2006–10 1/

	FY2006	FY2007	FY2008	FY2009	FY2010 Est.
	(In millions of U.S. dollars)				
Overall balance	-13.1	-6.2	-4.5	4.6	1.0
Total revenue and grants	139.7	145.4	149.8	182.8	172.7
Revenue	54.9	52.8	55.4	59.3	61.3
Tax revenue	29.7	27.8	29.3	31.7	34.2
Non-tax revenue	25.2	24.9	26.1	27.6	27.1
Fishing access revenue	13.2	15.0	17.0	20.0	18.3
Dividend and interest income	1.4	2.7	0.5	0.7	0.7
Other nontax revenues	10.6	7.2	8.6	6.8	8.1
Grants (from abroad)	84.8	92.6	94.3	123.5	111.4
Current	79.6	79.2	79.0	84.4	73.6
Capital	5.2	13.3	15.4	39.1	37.8
Total expenditure	152.8	151.6	154.2	178.2	171.7
Current	144.0	132.1	131.1	131.4	134.1
Goods and services	138.4	129.0	127.5	128.9	130.6
Wages and salaries	65.5	61.7	60.2	63.1	65.9
Travel	8.4	8.2	8.2	8.3	8.6
Other	64.5	59.0	59.1	57.5	56.1
Subsidies	1.2	2.4	2.9	2.3	3.3
Net transfers	4.4	0.7	0.7	0.0	0.0
Capital	8.8	19.5	23.1	46.8	37.6
Acquisition of fixed capital	5.0	9.1	14.7	38.0	23.0
Multi-purpose development projects	3.8	10.4	8.4	8.8	14.6
Capital Transfers	0.0	0.0	0.0	0.0	0.0
Memorandum items:	(In percent of GDP)				
Overall balance	-5.2	-2.4	-1.7	1.6	0.4
Revenue and Grants	55.6	56.9	57.2	66.1	60.1
Revenue	21.8	20.7	21.2	21.4	21.3
Tax revenue	11.8	10.9	11.2	11.5	11.9
Non-tax revenue	10.0	9.7	10.0	10.0	9.4
Grants	33.7	36.2	36.0	44.7	38.8
Total expenditure	60.8	59.3	58.9	64.4	59.7
Current	57.3	51.7	50.1	47.5	46.6
Capital	3.5	7.6	8.8	16.9	13.1

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, FY2006–10

	FY2006	FY2007	FY2008	FY2009	FY2010
Commercial banks					
Deposits (Year-on-year percent change)	2.1	5.1	-0.5	11.4	16.3
Demand (in millions of U.S.$)	27.6	32.8	27.8	31.5	34.0
Savings (in millions of U.S.$)	51.7	47.2	54.1	70.2	88.5
Time (including CDs) (in millions of U.S.$)	34.4	39.4	36.4	30.1	30.8
Other (in millions of U.S.$)	0.1	0.1	0.6	0.7	0.8
Loans (Year-on-year percent change)	16.9	17.7	39.3	-5.1	19.3
(in percent of GDP)	11.9	13.8	18.8	16.9	19.4
	(In percent of total assets)				
Foreign assets	76.3	76.2	69.1	74.1	62.4
Return on assets 1/	1.6	1.6	1.2	0.7	…
Equity capital 1/	10.8	11.1	10.6	10.4	9.4
	(In percent of total loans)				
Loss allowance	4.9	4.0	5.7	6.2	3.4
Non-performing loans	0.9	3.3	6.0	3.2	2.8
FSM Development Bank					
	(Year-on-year percent change)				
Loans	48.6	5.4	-2.0	6.2	-4.5
(in percent of GDP)	12.9	13.3	12.7	12.8	9.5
	(In percent of total assets)				
Foreign assets	5.8	6.4	6.5	6.2	6.0
Return on assets	2.4	4.7	-4.6	6.6	1.2
	(In percent of total loans)				
Loss allowance	15.3	13.7	17.3	16.9	20.3
External indicators					
Exports (goods & services, y/y percent change)	8.9	24.5	6.5	-1.4	6.1
Imports (goods & services, y/y percent change)	3.4	0.1	11.0	9.1	-2.9
Current account balance (percent of GDP)					
Including official transfers	-12.8	-8.4	-15.1	-18.6	-18.4
Excluding official transfers	-52.4	-46.1	-52.7	-56.2	-49.8
Overall balance (percent of GDP)	-0.8	-0.1	-2.1	-2.1	-0.4
Gross official reserves 2/					
In millions of U.S. dollars	47.2	49.5	45.3	53.1	56.6
In months of imports of goods and services	2.9	3.1	2.5	2.7	3.0
In percent of GDP	18.8	19.4	17.3	19.2	19.7
Total external debt 3/					
In millions of U.S. dollars	63.4	65.9	68.0	80.5	79.2
In percent of exports of goods and services	147.9	123.4	119.6	143.5	133.1
In percent of GDP	25.2	25.8	26.0	29.1	27.6
Debt service					
In millions of U.S. dollars	2.5	2.7	3.1	3.4	4.3
In percent of exports of goods and services	5.8	5.1	5.5	6.1	7.2
In percent of GDP	1.0	1.1	1.2	1.2	1.5

1/ On calendar year basis and data for 2010 as of end-September. The equity capital ratio refers to domestic bank.
2/ Data for 2010 as of end-July.
3/ About 2/3 of the total is concessional debt to the Asian Development Bank.

Table 4. Micronesia: Balance of Payments, FY2006–10

	FY2006	FY2007	FY2008	FY2009	FY2010 Est.
	(In millions of U.S. dollars)				
Overall balance	**-1.9**	**-0.4**	**-5.6**	**-5.9**	**-1.3**
Current Account Balance	**-32.1**	**-21.6**	**-39.4**	**-51.4**	**-53.0**
Trade balance	-110.8	-104.4	-119.4	-128.0	-126.5
Exports, f.o.b.	18.7	26.0	27.3	24.9	28.2
Imports, f.o.b.	-129.5	-130.4	-146.7	-152.9	-154.8
Petroleum products	-27.0	-28.7	-34.3	-42.2	-37.7
Services account	-39.8	-35.8	-38.7	-50.4	-41.6
Receipts	24.1	27.4	29.6	31.1	31.3
Travel	20.4	22.2	24.1	25.3	25.4
Communications (net)	1.8	1.7	1.8	1.8	1.8
Other	1.9	3.5	3.7	4.1	4.1
Payments	-63.9	-63.3	-68.2	-81.6	-72.9
Freight and insurance	-20.8	-21.8	-23.2	-25.4	-25.3
Transportation	-15.9	-15.0	-15.4	-15.7	-15.7
Travel	-7.1	-7.2	-7.3	-7.6	-7.9
Other	-20.2	-19.3	-22.4	-32.8	-24.0
Income, net	15.3	17.5	13.6	19.0	21.3
Receipts	27.2	29.8	29.0	29.0	27.0
Fishing rights fees	13.3	14.8	17.0	20.4	18.3
Interest dividend income	13.9	14.9	12.0	8.5	8.7
Payments	-11.9	-12.2	-15.4	-10.0	-5.7
Foreign workers earnings	-2.2	-1.5	-1.6	-2.2	-2.2
Interest payments	-1.6	-1.6	-1.7	-2.0	2.2
Dividends	-8.1	-9.2	-12.1	-5.7	-5.7
Unrequited transfers	103.1	101.1	105.1	108.0	93.9
Private	3.5	4.7	6.6	3.8	3.8
Inflows	14.3	15.4	17.4	18.2	18.2
Outflows	-10.8	-10.7	-10.8	-14.4	-14.5
Official	99.6	96.4	98.4	104.1	90.1
Compact funds	59.3	60.6	57.9	65.8	58.0
Other	40.3	35.8	40.5	38.3	32.0
Capital and financial account	**30.1**	**21.2**	**33.8**	**45.5**	**51.7**
Capital Account Balance	35.0	37.3	43.2	70.1	63.1
Capital Transfers, Official	3.0	7.0	4.9	7.5	11.8
Trust Fund Grants	16.4	17.7	19.0	20.9	21.0
Other	15.5	12.6	19.3	41.6	30.4
Financial Account Balance	-4.8	-16.1	-9.3	-24.6	-11.4
Direct Investment (net)	0.1	0.1	-5.3	0.6	0.6
Portfolio investment	-8.2	-17.3	-20.0	-20.9	-21.0
of which: Contributions to the Trust Fund	-16.4	-17.7	-19.0	-20.9	-21.0
Other investment (net)	3.2	1.0	16.0	-4.2	9.0
Memorandum items	(In percent of GDP)				
Current account balance	-12.8	-8.4	-15.1	-18.6	-18.4
Trade balance	-44.1	-40.8	-45.6	-46.3	-44.0
Exports	7.5	10.2	10.4	9.0	9.8
Imports	-51.5	-51.0	-56.0	-55.3	-53.9
Service	-15.8	-14.0	-14.8	-18.2	-14.5
Income	6.1	6.9	5.2	6.9	7.4
Transfers	41.0	39.6	40.1	39.0	32.7
Private	1.4	1.9	2.5	1.4	1.3
Official	39.6	37.7	37.6	37.6	31.3
Current account, ex. transfers	-53.8	-48.0	-55.2	-57.6	-51.1
Overall balance	-0.8	-0.1	-2.1	-2.1	-0.4

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

Table 5. Micronesia: Medium-term Scenario (Current Policies), FY2007–15 1/

	FY2007	FY2008	FY2009	FY2010 Est.	FY2011 Proj.	FY2012 Proj.	FY2013 Proj.	FY2014 Proj.	FY2015 Proj.
Real sector									
Real GDP (percent change)	-1.9	-2.3	0.4	0.4	0.5	0.6	0.6	0.6	0.6
Consumer prices (percent change)	3.6	6.8	7.7	3.5	2.0	2.0	2.0	1.9	1.9
General government finance (in percent of GDP)									
Revenue and grants	56.9	57.2	66.1	60.1	62.1	61.9	60.7	59.7	58.7
Total domestic revenue	20.7	21.2	21.4	21.3	21.2	21.1	21.0	20.9	20.8
Grants	36.2	36.0	44.7	38.8	40.8	40.7	39.7	38.8	37.9
Expenditure	59.3	58.9	64.4	59.7	61.9	61.5	60.4	59.3	58.3
Current	51.7	50.1	47.5	46.6	48.3	46.6	45.9	45.2	44.5
Capital	7.6	8.8	16.9	13.1	13.6	14.9	14.5	14.2	13.8
Overall balance	-2.4	-1.7	1.6	0.4	0.1	0.3	0.3	0.4	0.4
Compact Trust Fund (in millions of US$; end of period)	122.6	119.1	138.3	167.9	200.1	235.3	273.7	315.7	361.4
Balance of payments (in millions of U.S. dollars)									
Trade balance	-104.4	-119.4	-128.0	-126.5	-128.5	-130.6	-132.7	-134.9	-137.0
Net services	-35.8	-38.7	-50.4	-41.6	-44.3	-45.3	-45.9	-46.4	-46.9
Net income	17.5	13.6	19.0	21.3	21.5	22.3	23.2	24.2	25.2
Private and official transfers	101.1	105.1	108.0	93.9	101.4	97.1	97.5	98.0	98.9
Current account	-21.6	-39.4	-51.4	-53.0	-50.0	-56.4	-57.9	-59.1	-59.8
(In percent of GDP)	-8.4	-15.1	-18.6	-18.4	-17.0	-18.7	-18.7	-18.6	-18.3
Current account excluding official transfers	-118.0	-137.9	-155.5	-143.1	-147.4	-149.4	-151.0	-152.4	-153.8
(In percent of GDP)	-46.1	-52.7	-56.2	-49.8	-50.0	-49.4	-48.7	-47.9	-47.1
External debt (in millions of US$; end of period) 2/									
Stock	65.9	68.0	80.5	79.2	78.7	78.2	77.6	77.0	76.3
(in percent of GDP)	25.8	26.0	29.1	27.6	26.7	25.8	25.0	24.2	23.4
Debt service	2.7	3.1	3.4	4.3	5.2	5.1	5.0	5.1	5.0
(in percent of exports of goods and services)	5.1	5.5	6.1	7.2	8.3	7.8	7.4	7.1	6.7

Sources: the FSM authorities and Fund staff estimates.
1/ Estimates for FY2010 and projections from FY2011-15 are preliminary and based on data received from the authorities.
2/ Government and public enterprise debts only.

Table 6. Micronesia: Social Indicators

	Micronesia	Same Region/Income Group	
		East Asia and Pacific	Lower-middle Income
Population 1/			
Total population (millions)	0.11	1,930	3,703
Growth rate (percent annual)	0.3	0.7	1.1
Urban population (percent of population)	22.5	44.1	41.3
Total fertility rate (births per woman)	3.6	1.9	2.5
GNI per capita (in U.S. dollars) 1/	2,460	2,644	2,073
Current public expenditure 2/			
Health (in percent of GDP)	12.6	1.9	1.8
Education (in percent of GDP)	7.3	2.7	4.0
Gross primary enrollment 2/			
(in percent of school age population)	110	112	108
Male	110	112	110
Female	111	113	106
Immunization rate (percent 12-23 months) 1/			
Measles	92	91	81
Diphtheria/Pertussis/Tetanus (DPT)	79	92	79
Life expectancy at birth (years) 1/			
Total	69	72	68
Male	68	70	66
Female	69	74	70
Mortality 1/			
Infant (per thousand live births)	32	23	45
Under 5 (per thousand live births)	39	29	64

Sources: World Development Indicators 2008 and Millenium Development Goals, World Bank.
1/ Data as of 2008.
2/ Data as of 2007 or latest available.

APPENDIX I: MICRONESIA—LONG-TERM FISCAL SUSTAINABILITY

This appendix assesses the FSM's long-term fiscal sustainability, updating the estimates in the 2008 Article IV consultation. The analysis considers implications of the expected expiry of annual Compact grants on the fiscal sustainability of FSM. It rests on a broader perspective than what the amended Compact agreement envisages in the sense that it looks at the general self-reliance of the FSM government and incorporates also a case where the Compact Trust Fund (CTF) would need to offset a possible loss of non-sector grants such as the Supplementary Education Grants (SEG) under the amended Compact.[1] Fiscal sustainability is measured by the usable government's asset position as of FY2023 that would generate an investment income large enough to supplement the expiring Compact grants without significantly disrupting public services and eroding the Trust Fund value.

The global financial turmoil has put a heavy toll on the financial performance of the CTF. Net return on assets fell by a cumulative 17 percent over FY2008—09. As a result, the market value of the CTF fell substantially, before recovering to about $168 million as of end-FY2010.

The assessment of the long-term fiscal outlook considers two scenarios. The baseline scenario features limited fiscal adjustment and structural reforms, while an alternative scenario considers comprehensive fiscal reforms, including swift implementation of tax reforms by mid-2011, structural reforms, and better utilization of Compact infrastructure grants. The alternative scenario also considers the costs of a delay in the tax reform implementation.

1. Baseline scenario

The baseline scenario assumes that the recent pickup in the fiscal surplus will gradually decline and eventually reach a small surplus of about 0.4 percent of GDP, as expenditure adjusts to the Compact step-down. Medium-term real growth is expected to be low at 0.6 percent, reflecting sluggish investment, continued outmigration, and low productivity growth. Net investment returns on the CTF are expected to be at 6 percent on average thereafter, in line with an earlier GAO study.

Under the baseline, the Trust Fund would not generate sufficient investment income to replace the annual Compact grants expiring in FY2023. By end-FY2023, the stock of financial assets would be about $800 million (in FY2010 dollars), of which $723 million would be in the CTF and about $77 million in other funds.[2] During the drawdown phrase beginning FY2024, investment income would only be about $48 million per year. On the other hand, Compact sector grants in FY2024 are estimated to be $65 million, leaving a shortfall of about 6 percent of FY2010 GDP. The shortfall would be even larger at over

[1] The Compact Trust Fund in FSM was created to contribute to the long-term budgetary self-reliance of the FSM and to provide the FSM government with an ongoing source of revenue after FY2023. The amended Compact and their subsidiary agreements contain no commitments, either express or implied, regarding the level of the revenue that will be generated by the Trust Funds, 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] All numbers reported here are in millions of USD based on 2010 prices, unless otherwise stated.

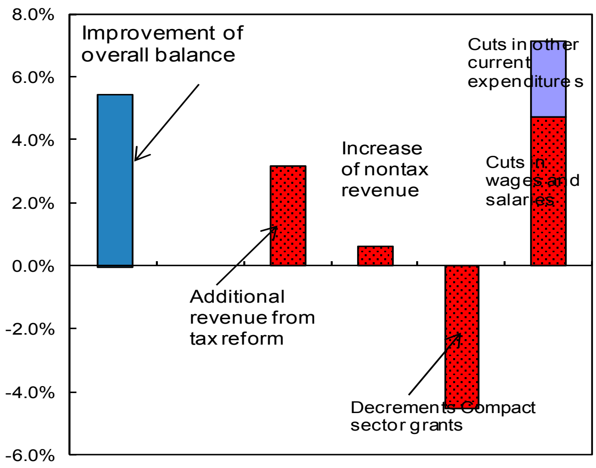
10 percent of GDP if the Supplemental Education Grants (SEG) is discontinued after FY2023. With no firm commitment of grants beyond FY2023 and lack of vibrant private sector activity, the government would be forced to either sharply cut expenditures or rapidly deplete its accumulated savings.

Higher investment returns could narrow the shortfall, but are unrealistic over a long horizon. To generate sufficient investment income to offset the expiring Compact grants, the net investment returns would need to be as high as 7.2 percent per year until FY2023, which would require a riskier and more aggressive investment strategy inappropriate for sound public finance management.

2. Alternative scenario

Fiscal sustainability can be achieved through significant fiscal adjustment and structural reforms to promote private-sector growth. In an alternative scenario, the government would fortify the recent fiscal surplus by accumulating the savings (e.g., through contribution to the Compact Trust Fund), and undertaking cuts in wasteful current expenditures. The authorities could also swiftly implement the tax reform as scheduled by mid-2011, thereby improving tax revenue by about 3 percent of GDP according to the PFTAC preliminary estimates (text chart). In parallel, structural reforms (e.g., improved education, and other development needs) and better utilization of infrastructure funds could boost potential growth to about 2½ percent in the medium term despite fiscal consolidation. Net investment returns are assumed to be identical to the baseline at 6 percent per annum. The estimates indicate that long-term fiscal sustainability would be achieved by gradually improving fiscal balance (front-loaded) by about 1.1 percent of GDP per annum for five years to reach 5.8 percent of GDP in FY2015, and maintaining that level until FY2023. The budget would return to the path under the baseline scenario after FY2023.

Contributions of Required Fiscal Adjustments Under Alternative Reform Scenario 1/
(in percent of GDP)



1/ Cumulative change between FY2011–15.
Sources: Fund staff estimates.

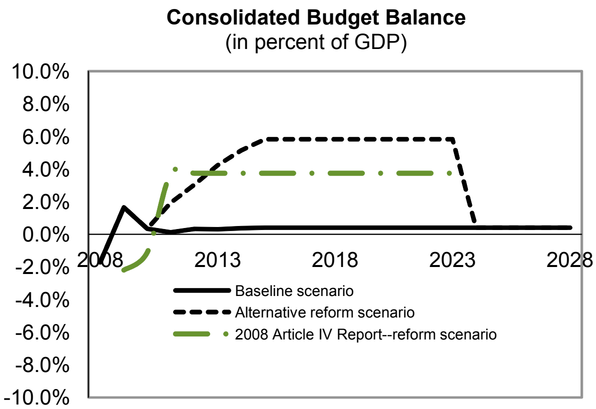
In the alternative scenario, the stock of government assets (including cumulative earnings from these fiscal surpluses) would reach about $1.1 billion by the end of the Compact period in FY2023, thus generating sufficient income to offset the expiring Compact grants. Additional savings would be required to reach a higher asset level to generate additional income if supplementing the SEG as well. The required fiscal adjustment is higher than that in the 2008 Article IV Staff Report by about 2 percentage points of GDP (see text charts). The difference reflects the significant decline of the CTF asset value during the financial crisis, which more than offset the modest public savings since then.

Table 1. Required Fiscal Adjustments for Sustainability

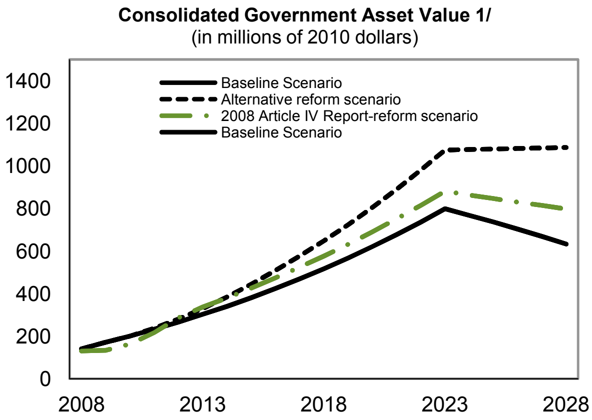
Scenarios	Medium-term overall fiscal balance	Total required adjustment 1/	Average annual fiscal adjustment 1/	
	in percent of GDP	in percent of GDP	in percent of GDP	in USD millions (2010 prices)
1 Baseline scenario: no policy change	0.4	-	-	-
2 Alternative reform scenario 1/				
a) Swift tax reforms implementation, accompanied by structural reforms and better utilization of infrastructure funds.	5.8	5.5	1.1	**3.7**
b) Delay in tax reforms by one year to mid-FY2012	6.3	6.2	1.5	**5.0**
Memorandum items:				
Cost of delay in tax reforms	0.5			**1.3**

1/ Required fiscal adjustments to supplement Compact sector grants (excluding SEG and audit grants) without significantly disrupt public services when those grants expire by FY2024.

Source: Fund staff estimates.



Source: Fund staff estimates.



1/ It includes the market value of the Compact Trust Fund and other unreserved government savings.
Source: Fund staff estimates.

Under the federal system in the FSM, each state would need to supplement the CTF returns with its own fiscal savings. Staff estimates suggest that all states would need to undertake fiscal reforms; however, the size of the required adjustment differs across states according to their initial deficits and stock of financial assets (text table). For example, the state government in Pohnpei would need to improve fiscal balance by about $7 million from its position in FY2010, possibly through public payroll reduction and tax reforms.