Approved By
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Discussions took place in Pohnpei from November 9–19, 2012. The staff team comprised with A. Yoshida (head), I. Saito, T. Dao (all APD), and Y. Yang (Regional Resident Representative). B. Karae (OED), L. Pan (World Bank), and H. Rijn (AsDB) participated in the discussions.

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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 new Compact of Free Association Agreement with the United States ("Compact") effective since FY2004[2] continues to provide funding for infrastructure expenditure and administrative expenses, but transfers to the FSM are steadily declining and ceasing in FY2023. Thereafter, the FSM is expected to complement its domestic revenues with income from its Compact Trust Fund (CTF) and other savings.

2. **The amended Compact has tightened rules on reporting, auditing, and the use of grants, which were initially difficult for the national and state governments to meet.** Although infrastructure projects started to be implemented more smoothly in FY2009 as government agencies adapted themselves to the new rules, about $44 million (15 percent of GDP) in infrastructure grants remains unused, even excluding another $28 million (10 percent of GDP) that was returned to the pool of funds after once approved either due to cancellation or less than estimated costs (Box 1). The U.S. dollar is the official legal tender.

3. **The Article IV discussions focused on policies to ensure long-term sustainability through strengthening fiscal management and promoting the private sector growth.** The scheduled expiry of Compact grants in FY2023 poses a major challenge to continuation of public services at the current level. On the other hand, remoteness from major markets and the small scale of the economy makes it difficult to attract foreign investors and retain skilled workers. Outward migration continues to the United States where FSM citizens can work without a visa. In the absence of monetary policy and given the large fiscal adjustment needed over the medium term, the authorities have limited policy space to respond to external shocks. The government therefore needs to proceed with fiscal and structural reforms to secure fiscal sustainability, boost potential growth of the economy, and create sufficient policy space to dampen the effects of unforeseen developments.

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

4. **Since the last Article IV consultation, the economy continued on a steady growth path.** Following a recession in FY2006–08 due to delays in Compact grants utilization as well as high fuel and food prices, the FSM economy grew by 2–2½ percent for FY2010 and FY2011. The expansion was driven by new construction activities, such as the airport renewal projects funded by the U.S. Federal Aviation Authority (FAA), and by growth of the fishery sector helped by good fishing conditions and high prices. The economy remains dependent on the large public sector (40 percent of GDP, including public enterprises), although there are signs of a further growth pick up in the fisheries and agriculture sectors. Inflation moderated from its FY2009 peak, and fluctuations are

[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, FY2012 covers October 2011 to September 2012).

largely driven by commodity prices (Box 2). After reaching 7.8 percent in FY2009, inflation has declined to 4.6 percent in FY2011. However, the last quarter of 2011 recorded a 6.5 percent increase (year-on-year) reflecting the rise in international food and fuel prices, which compose about 46 percent of the consumption basket. Increasing availability of consumer loans may have also contributed to a pick-up in inflation in recent years (see paragraph 34).

Selected Economic Indicators

	FY2009	FY2010	FY2011	Est. 1/ FY2012	Proj. FY2013
			(Year-on-year Changes)		
Real GDP	1.0	2.5	2.1	1.4	0.8
Consumer price index	7.8	6.3	4.6	5.6	4.2
			(In percent of GDP)		
Consolidated fiscal balance	1.6	0.5	0.6	1.2	0.8
Current account balance	-18.5	-16.6	-18.9	-15.0	-14.3

Sources: FSM authorities and Fund staff estimates.
1/ Data for FY2012 are preliminary.

5. **The overall fiscal balance of the consolidated government recorded modest surpluses for three straight years through FY2011, with an uneven distribution of outcomes across states.** In FY2011, the overall consolidated fiscal balance was $1.9 million (0.6 percent of GDP) in surplus, helped by economic growth and stabilizing public wages. While Chuuk and Yap turned in a surplus in FY2011 with better revenue administration, Kosrae and Pohnpei each recorded deficits equivalent to about 1 percent of state GDP.

6. **Public debt remains at a relatively low level, but underfunding in the CTF assets and declining balance of the social security fund pose long-term challenges.** Gross public debt is relatively low at $87.1 million (below 30 percent of GDP) in FY2011, mostly owed to the Asian Development Bank (AsDB) on concessional terms. The size of public financial assets held in the CTF is substantial at $257 million (83 percent of GDP) as of end-FY2012. However, asset accumulation in the CTF is insufficient for the long-term budget self-reliance (see Appendix II). In addition, net assets of the social security fund declined from $42.4 million in 2010 to $40.4 million in 2011 with benefit payments still exceeding contribution revenue, continuing to raise concerns over the viability of the system (see paragraph 21).

7. **Despite some deterioration of the current account balance (from -12 percent of GDP for FY2006–8 to -18 percent for FY2009–11 on average), external balance is sustained by a stable flow of official transfers.** The majority of the overall current account deficit (18 percent of GDP for FY2009–11) is financed through capital transfers from official sources (12 percent of GDP). Given their contractual nature, they can be considered a stable source of funding. Similarly, imbalances within the current account balance (a trade and services deficit of 61 percent of GDP) are largely offset by a stable surplus in the income and transfer balances from Compact current grants and remittances (43 percent of GDP). Given the dedicated official funding sources, the level of gross international reserves (about 3½ months of imports) is not as much a critical indicator for the

external sustainability as in other countries. The current account deficit widened in FY2011, with an increase in exports (mainly fish) more than offset by that in imports driven by construction materials and fuels. Visitor arrivals declined significantly in FY2011 to 20 percent below the FY2009 peak, while higher inflation than in trading partners has kept the real effective exchange rate at an appreciated level.

8. **Financial conditions have remained tight.** There are large spreads between deposit rates (around 1 percent) and loan rates (about 14 percent for consumer loans, about 7 percent for commercial loans), partly reflecting high risks involved in lending in the FSM, given limited availability of land as collateral. Commercial loan growth has been stagnant in recent years, while consumer loans saw some pick up. The ratio of consumer loans to household income is relatively high (about 24 percent in 2011).

9. **Economic growth will likely slow in the near term, as the private sector falls short of offsetting the declining public sector demand from Compact grants reduction.** Growth in FY2012 is estimated at 1.4 percent as recent construction projects financed through FAA grants are winding down. A modest consolidated fiscal surplus of 1¼ percent of GDP is expected in FY2012, mainly due to a sharp increase in fishing access fee revenue by $7.6 million (2½ percent of GDP). While the fishery sector is expected to continue its healthy expansion, lackluster wholesale and retail activities will remain a drag on the private sector growth.

10. **Beyond the near-term, growth is weighed down by the scheduled reduction in Compact grants.** In addition, the 2010 census shows that the population has been shrinking, and significant outward migration continues despite the reasonably good economic performance in recent years. Staff expects growth to stay low at about ½ percent over the medium term, with limited private sector growth failing to offset the effects of a decline in Compact sector grants ($0.8 million per annum before adjusting for inflation).

11. **Risks to the outlook are on the downside (see Appendix I, Figures and Tables).** While there are certain upside risks from the U.S. military base upgrading projects in Guam (more demand for the FSM workers, goods and services) and possible acceleration in release of delayed infrastructure grants, larger risks are that further deterioration in the external environment and volatile commodity prices hold back growth, leading to further delays in fiscal adjustment, and thus elevating concerns over fiscal sustainability. Long-term risks include failure to fully prepare for the expiry of the Compact grants, continued outward migration of working age population, and climate change and the associated shore erosion of limited farmland. In order to better prepare for growth shock, strengthening the fiscal policy space should be explored (see paragraph 17). In the event exogenous shocks materialized, fiscal adjustment toward self-sufficiency could be temporarily eased or suspended as long as the medium-term target is maintained. To mitigate the impact of commodity price shock, possible long term measures to be considered include promoting domestic food supply through commercial farming (see Box 2).

Authorities' Views

12. **The authorities generally agreed with staff projections for the FSM economy.** They shared the view that medium–term growth prospects are diminished as a result of declining

Compact grants, and the private sector does not have enough strength to compensate for it. They also agreed that risks to the outlook are on the downside, citing among others the vulnerability of the economy to commodity price shocks.

13. On fishing activities, the authorities acknowledged that, while fishing fees provide a valuable source of additional revenue for the public finance, it does not generate sufficient employment and income for the private sector in the FSM.

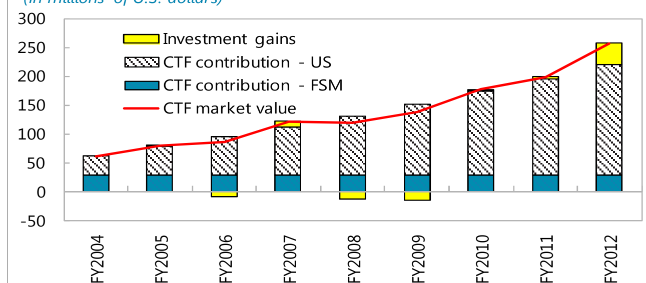
POLICIES TO ACHIEVE SUSTAINABLE GROWTH

A. Fiscal Policy

14. The projected amount of government assets is unlikely to generate sufficient income to replace expiring Compact grants in FY2023 (Appendix II). Notwithstanding the benign investment performance in FY2012, projected investment returns from the CTF in FY2024 will fall short of the Compact grants to be replaced by as much as $16 million in FY2011 prices (about 5 percent of GDP). To achieve the long-term fiscal sustainability, the FSM needs a steady and decisive fiscal adjustment.

Compact Trust Fund

(In millions of U.S. dollars)



Sources: FSM authorities.

15. A new high-level initiative on achieving long-term sustainability provides an opportunity to thoroughly review the direction of policies. President Mori announced in March 2012 his intention to establish the "2023 Planning Committee" (the Committee) to undertake an assessment of the financial situation of the FSM in FY2024 onwards and develop a realistic action plan for addressing the looming budgetary shortfall, though it is unclear when Congress will approve the appropriation of budget for the establishment of the committee. In the draft FY2013 budget, the President proposed to contribute $1 million to the CTF, but Congress did not approve such allocation.

16. There is considerable risk that the CTF would not reach the necessary level for self-sufficiency. Both the national and states government should agree to realistic plans of reform and start implementing them as soon as possible. In this light, approval of the budget for establishment of the 2023 Planning Committee is urgently needed.

17. The following four points should serve as the guiding principles for the Committee to meet its objectives of developing a credible long-term fiscal strategy.

- *Develop a realistic macroeconomic framework.* Budget documents should cover the general government (include contingent liabilities from public enterprises or social security fund), and long-term fiscal projections should use conservative assumptions on growth and asset returns while providing an appropriate expenditure trajectory. The IMF stands ready to share its long-term fiscal projection framework to assist the government in preparation of their own projections.

- *Devise a balanced fiscal adjustment path*. The adjustment path should strike an appropriate balance between the need to preserve assets for future generation, current developments needs (for instance for infrastructure), and short-term growth implications of fiscal reforms.

  Based on a 6 percent rate of return assumed in an earlier GAO study, achieving budgetary self-sufficiency requires financial assets in the CTF of $1.1 billion in FY2023 (in FY2011 prices). This level could be achieved by increasing fiscal surplus to about 6.4 percent of GDP by FY2016, and then maintaining the surplus at that level until FY2023. Alternatively, to soften the growth impact the government could accumulate fiscal surpluses more gradually over a longer period; but this would require a higher overall fiscal surplus target and leave a shorter time to re-adjust the fiscal trajectory in the event of setbacks (see Appendix II); the longer adjustment would also pose a higher risk of reform fatigue. Regardless of the chosen path, the considerable growth impact of fiscal consolidation would need to be partly offset by accelerating structural reforms (see section C below).

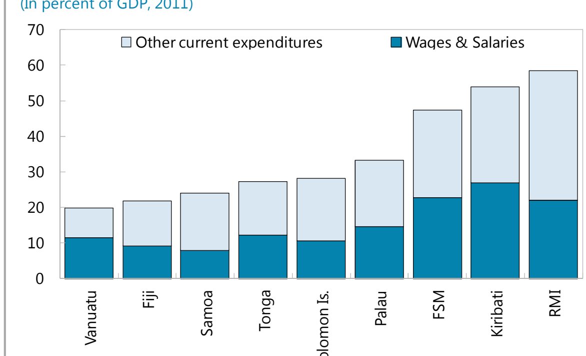
- *Build in policy buffers*. Given the long implementation period, the absence of monetary policy, and the susceptibility of the economy and the poor to external shocks, the FSM needs to build fiscal policy space for the resilience of its medium-term plan. Possible policy actions include allocating part of expenditures to fund an emergency transfer program. In designing these arrangements, however, care should be taken that they do not undermine the long-term fiscal consolidation efforts, possibly by requiring that the amount should be recovered by other savings within a limited length of years once the temporary shocks subsided.

- *Secure buy-in of the public and state governments*. The long-term fiscal consolidation cannot be carried out and sustained without broad public support. In addition, given the significant size of state governments in the FSM, their contributions to the fiscal adjustment are essential. It is thus imperative for the national government to engage these stakeholders into the discussion of needed fiscal reforms. From this viewpoint, the continuous enhancement of audits and the reflection of their results in fiscal management are also important.

Approval of a long-term fiscal reform plan should be the key deliverable of the Committee.

18. The government should immediately prepare fiscal expenditure reforms, especially to contain the public wage bill. Significant savings could be made by improving the operational efficiency of current and capital expenditure through better planning and coordination between national and state governments. Beyond such gains, there is room for reducing current expenditure as public wage rates for governments are on average 2.1 times higher than for the private sector. Those for public enterprises have even higher ratio of 2.8 times. While qualifications required for private and public sector may not be

Government Current Expenditures
(In percent of GDP, 2011)



Sources: Country authorities and Fund staff estimates.

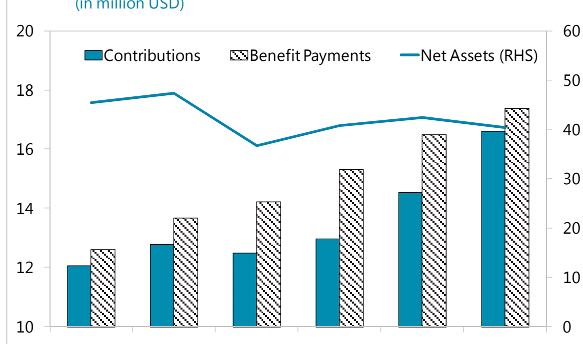
fully comparable and drastic cuts in public wages may risk accelerating outward migration, regional comparison of public wages (see text chart) suggests that there is room for reducing them as share of GDP without having too negative effect on the economy. Governance control by the government over compensation of public enterprises should be strengthened to ensure their wage level is justifiable from the viewpoint of job requirement.

19. In parallel, the planned comprehensive tax reform should be swiftly implemented. Enhancing revenue is imperative to put public finances on a more sustainable path. A set of bills to create the Unified Revenue Authority (URA) and to introduce a net profits tax (effective October 2013) and a value added tax (effective October 2014) in lieu of gross revenue and state sales taxes were approved by the national government as well as two out of the four state governments, but will not take effect until they are approved by all states. This reform will remove the bias against industries with relatively high fixed costs and distortions from different tax rates across goods and services, making the FSM tax system more efficient. Given the urgency of the tax reform, the national government should step up its efforts to engage state governments and the general public for swift consideration of the tax reform bill in the remaining states. Further efforts to strengthen the tax administration through staff training and upgrading of the IT system will also be necessary.

20. To complement and safeguard the benefits of expenditure and tax reforms, it is essential to improve public sector financial management. Ongoing efforts to strengthen financial management with support from the Pacific Financial Technical Assistance Center (PFTAC) should be accelerated in this respect: budget documents should reflect activities of the general government financed by domestic revenues and foreign grants as well as those of state governments. The mission also encourages the authorities to devise a fiscal rule requiring fiscal surpluses to be transferred to the CTF. Under the current system, fiscal surpluses in one year can be appropriated to finance next year's expenditure. Given the nature of the FSM as federated states, the long-term fiscal consolidation also requires strengthening the fiscal discipline at state level to contain expenditures, including through tighter fiscal rules on their use of the expenditure carry-over between annual budgets.

21. The social security system of the FSM remains in a challenging financial situation. It is financed by employer/employee contributions at a rate of 7 percent each paid to the system and funds benefit payments for the old-age, surviving spouses of deceased workers, and disabled. Despite some efforts in recent years to strengthen collection, total benefit payments ($17.4 million) were still in excess of total contributions ($16.6 million) in 2011. Although the contributions rate was raised from 6 to 7 percent in 2010 and will be further increased to 7.5 percent in 2013, it is unlikely to halt the erosion of assets permanently. Further reforms of the benefit structure and tax collection are needed to reverse fund deficits and reduce delinquent accounts so as to bring the

Social Security Finances
(in million USD)



Sources: Audit Reports
Note: Unfunded accrued liability is 245 million USD as of Jan. 1, 2011.

system into long-term sustainability. Given that it will take time to carry out comprehensive reforms, contributions from the general budget will likely be needed to protect the value of the social security fund.

22. Public enterprises pose another important fiscal risk. They have significant economic presence accounting for 8.6 percent of GDP. Though budget transfers to public enterprises are currently limited, utilities and other public service providers pose considerable contingent liabilities for public finances in the event of a deterioration of their financial positions. It is therefore critical to strengthen the oversight and accountability of public enterprises, in particular in electricity and telecommunication, which are critical services for private sector development.

Authorities' Views

23. The authorities did not specify a preferred pace of fiscal adjustment, partly because it did not want to preempt discussions in the 2023 Planning Committee. The government is currently considering expenditure cuts of 6 percent every three years, totaling around 20 percent, to accommodate the scheduled reduction in Compact grants. However, the authorities were willing to also review the staff's fiscal adjustment plan at the Committee including a more comprehensive reforms, not least because it appears difficult to protect critical public services in areas, such as health and education, under the current expenditure cut plan.

24. The authorities agreed on the need to contain the growth of wage expenditure. However, they noted that public and private sector wages are not necessarily comparable given different levels of competence and skill that are required. Staff reiterated that the aggregate public sector wages in the FSM are notably high as share of GDP among the regional peers.

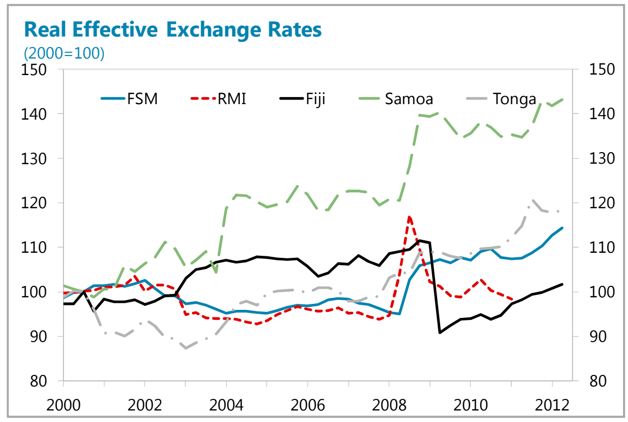
25. Regarding policy buffer against external shocks, the authorities pointed out that they have a separate trust fund from the CTF whose assets are accumulated against the risk of natural disasters. They admitted, however, that use of those assets was limited to the purpose of disaster relief and available other funds were not sufficient to mitigate other costs, such as commodity price shocks.

26. The authorities agreed on the need for social security reform. With an increase in the contribution rate (from 7 percent to 7.5 percent) scheduled in January 2013, however, there are no immediate plans for improving the social security fund balance. For the time being, they will explore options for comprehensive reforms while continuing support from the general budget.

27. On public enterprises, the authorities pointed to the fact that operational subsidies from the government to public enterprises have been significantly reduced over the past several years. While there remain some capital subsidies, they argued, those are primarily used to support provision of essential services by public enterprises.

B. External Stability and Exchange Rate

28. The FSM's real exchange rate has been appreciated since the global downturn. The real effective exchange rate appreciated by 9 percent in FY2009 due to high inflation driven by food and fuel prices, and has since remained appreciated though not out of line from regional peers (text chart). The goods trade balance worsened over the same period, with an increase in exports (mainly fish) more than offset by that in imports. The trend of real exchange rate, however, is expected to reverse as inflationary pressures subdue over the medium term.



29. Despite the real appreciation, the risks to external stability are currently limited. The large current account deficit is financed through foreign assistance. Compact-related financial flows are the main determinant of external balances and will continue to provide a stable source of funding over the next decade, while external debt is expected to decline in terms of GDP. It should be kept in mind, however, that fiscal and structural reforms are essential for securing external stability after the expiry of Compact grants. The use of the U.S. dollar as the official currency is appropriate given the small size of the economy and its close financial and trade linkages with the United States.

Authorities' Views

30. The authorities broadly shared staff's assessment on the external stability and the real exchange rate. They highlighted, however, the tendency of the price level in the FSM to keep elevated even after international food and fuel prices have stabilized. They also highlighted the limited policy options available to respond to such price shocks while agreeing that use of the U.S. dollar as the domestic currency remains appropriate for the FSM given its limited administrative capacity for independent monetary and exchange rate policies.

C. Private Sector

31. Sustainable growth will require a vibrant private sector. The structure of the FSM economy has changed little over the last decade—the share of the public sector stands at 38 percent, the private sector at 22 percent, and the household at 31 percent. The key bottlenecks for private sector development include difficulties in obtaining secure long-term land leases, reliance on a single carrier operating high-priced flights, poor infrastructure, and lack of skilled labor. Moreover, some public enterprises crowd out precious financial and human resources from other sectors of the country, and constrain productivity growth of the entire economy through inefficient or costly services. While some key infrastructure projects are underway, the government could further support private sector growth by accelerating infrastructure investments and providing a more business-friendly environment.

32. **Reforms to attract inward FDI could have an immediate impact on activity as part of an overall development strategy.** Given the FSM's competitive advantage in some niche tourism markets, a more focused approach on improving inward FDI in these areas could generate immediate benefits. In particular, addressing issues regarding obtaining longer-term land leases and burdensome procedures of approval for foreign investment would help facilitate tourism FDI. Other measures to improve business environment include: committing long-term government support for the College of the FSM in training future workers; keeping public wages in check to reduce the large public-private sector wage gap; and advancing the public enterprises reform to encourage new entrants for more competition in the provision of infrastructure services including through increasing private sector participation in public enterprises, where feasible. The FSM's first Development Partners Forum, held in early November to discuss economic and development challenges for the FSM, provided an excellent opportunity for representatives from national and local governments, private sector, civil society and international partners to sit together and explore possible paths to the future growth. It is essential to keep the momentum going and ensure the forum is followed by concrete action plans with strong engagement by stakeholders.

Authorities' Views

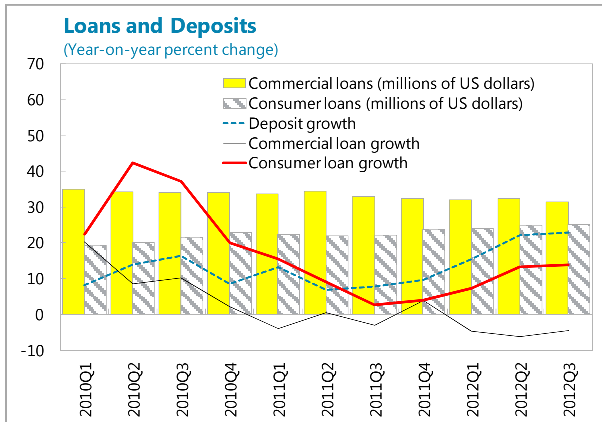
33. **The authorities shared the staff's view that the FSM business environment remains very challenging.** They cited land issue as the most difficult impediment to investment from outside, as it is so intricately connected to people's perception of inheritance and community. Also, some foreign investors do not appear to appreciate the size and culture of local economy and tend to plan unrealistically large projects, only to trigger strong oppositions and concerns from traditional communities and civil societies. Nonetheless, the authorities see potential in areas, such as fisheries, agriculture (niche tropical products) and eco-tourism, and are striving to improve transportation access to and from other Pacific countries as well as more populous countries in Asia. They stressed the importance of advancing these efforts in tandem with upgrading the core infrastructure.

D. Financial Sector

34. **The banking sector is well capitalized and with sufficient liquidity, but renders little support to the private sector with a low loan-to-deposit ratio (33 percent at end-FY2011).** While deposits are steadily increasing over the past three years, majority of them are invested by banks in safe financial assets overseas rather than being lent to the private sector, apparently due to lack of bankable projects. The introduction of the Secured Transactions Act in 2006 has facilitated taking movable property as collateral and did help banks to extend loans to those customers they would not have been able to lend to before, but it has not so far led to boosting commercial lending. Further legislative measures to facilitate taking immovable property as collateral are necessary to increase commercial lending. Increasing availability of consumer loans may have contributed to a pick-up in inflation in recent years, and while NPLs remain relatively low at just over 3½ percent, careful monitoring of credit quality is warranted.

35. **The FSM Development Bank continues to be engaged in consumer lending.** While the main focus of the bank stipulated in the law is to provide loans for high priority projects, it continues to provide consumer loans in direct competition with private banks. The Development Bank should

return to its mandate of fostering new businesses to complement private banks. Moreover, it lacks sufficient risk assessment capacity and provisioning against consumer loans. Appropriate supervision of the Development Bank, together with credit unions, in line with international best practices, is key to financial stability. The mission urged that capacity of the regulatory authorities should be enhanced to include the supervision of lending activities by the Development Bank and credit unions. In the area of insurance, strengthening the regulatory and supervisory capacity is a priority in view of the increasing activities of captive insurance companies.



Source: FSM authorities.

Authorities' Views

36. The authorities confirmed that staff's assessment of financial sector stability is consistent with their own views. In order to strengthen its supervision of the broader financial sector, the FSM banking commission is preparing a draft bill on regulation and supervision of credit unions. While they generally support placing the FSM Development Bank under appropriate supervision, they cautioned that it would call for significant political decision to realize such policy change.

E. Other Issues

37. Improving the reliability, coverage, and timeliness of economic statistics would better guide policies. Staff notes ongoing efforts by the Office of Statistics, Budget and Economic Management, Overseas Development Assistance, and Compact Management (SBOC) to improve data collection and management, including efforts to release quarterly CPI data and upgrade its website. The authorities are encouraged to further enrich statistics and use them for policy-making. In particular, it is crucial to collect and consolidate fiscal data across national and state governments in a timely manner.

STAFF APPRAISAL

38. Medium-term growth prospects in the FSM remain weak as sluggish private sector growth is insufficient to offset the scheduled decline in Compact grants. While ongoing construction projects and a further expansion of the fisheries sector will render some support to growth in the near term, risks to the outlook are on the downside. Medium-term prospects are weighed down by the reduction of Compact grants and weak private sector.

39. Risks to external stability are currently limited. The external balance is sustained by a stable flow of official transfers. It should be noted, however, that failure to address challenge of Compact grants expiry in FY2023 would cause difficulty in financing external deficit as well. The use of the U.S. dollar as the official currency remains appropriate given the small size of the economy and its close financial and trade linkages with the United States.

40. There is considerable risk that the CTF would not reach the necessary level for self-sufficiency. Both the national and states government should agree to realistic plans of reform and start implementing them as soon as possible. In this light, approval of the budget for establishment of the 2023 Planning Committee is urgently needed.

41. The government needs to prepare and adopt a credible fiscal strategy to deal with the looming revenue gap in FY2023. The guiding principles should be: (i) a realistic macroeconomic framework; (ii) a balanced fiscal adjustment path; (iii) policy buffers to guard against possible shocks; and, (iv) broad buy-in by the public and state governments.

42. To secure fiscal sustainability substantial fiscal reforms are needed. Passage of the planned comprehensive tax reform should be accelerated with increasing efforts of engaging state governments and the general public to garner their support. In addition to savings from improved operational efficiency of overall government expenditure, public sector wage growth should be curtailed.

43. Public sector financial management should be strengthened to complement and safeguard the benefits of fiscal reforms. Staff encourages the authorities to devise a fiscal rule requiring fiscal surpluses to be transferred to the CTF.

44. Underfunding of the social security fund poses another sustainability concern. While recognizing the recent efforts to reduce the imbalance through increasing the social security tax rates, the authorities are urged to prepare further comprehensive measures including on the system design to protect the value of the social security fund.

45. Advancing structural reforms to facilitate investment by both domestic and foreign investors is critical in order to minimize the possible growth impact from expected fiscal reforms. In addition to further liberalizing land use and lease, streamlining procedures related to investment permits both at the national and state level will help. Reforming of public enterprises should also contribute to higher productivity through better use of financial and human resources. These structural reforms should be pursued through setting a clear nation-wide development plan in line with the Development Strategy adopted in the first Development Partners Forum.

46. The financial system is stable, but should lend more support to private sector development. Though the banking sector remains well capitalized and sufficiently liquid, its credit quality warrants careful monitoring as consumer loans increase. The FSM Development Bank should be brought under appropriate supervision and redirected to help financing the viable start-ups rather than directly competing with private banks over consumer loans.

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

Box 1. Micronesia: Fiscal Arrangements and Operational Challenges in Compact Grants Utilization[1]

1. Overview of the FSM fiscal structure.

Most of service delivery functions (for example, health and education) are assigned to the State Governments, and they are financed through a combination of fiscal transfers from the National Government and the States' share in domestically generated revenue. Unit costing data that would allow for an assessment of the link between functional assignments and financing arrangements are not available.

The key sources of these fiscal transfers to the state governments are the Compact Sector Grants, the Compact Infrastructure Grant, the Compact Supplemental Education Grant, and grants made available through the Federal Program, all of which are made available by the United States. At the aggregate level, these grants make up for over 60 percent of total allocations; the balance is made up mainly by the FSM General Fund (comprising domestic tax and non-tax revenue). The majority of the Compact sector grants (85 percent) and the Compact Infrastructure Grant (75 percent) is earmarked for operational and investment support for the education and health sectors.

Over 90 percent of the Compact Funds are allocated to the State Governments, while the National Government receives 67 percent of the Domestic Funds and roughly half of the U.S. Federal Grants and other external assistance. The table below provides an overview of submitted budget allocations for FY2013, broken down by type of transfer or revenue sharing arrangement.

2. Challenges in Compact grants utilization.

There are several possible causes for delay in Compact grants utilization:

a. Mismatches in budget calendar
Information on the Compact grants available for the next fiscal year is typically conveyed to state governments 4–5 months into the current fiscal year. State legislatures typically approve the state budgets in September (end of FY), leaving little time for coordination with national and other state governments.

b. Weak monitoring and management of projects
Infrastructure projects are centrally managed at Project Management Unit of the national government, but it is often a challenge to keep most updated information about prospects, estimated costs, and progress of individual projects in all four states.

c. Lack of timely data available on fiscal activities of national and state governments
Data on fiscal activities of national and state governments in the ongoing year are not available in a timely manner, making it hard to grasp the current status of consolidated government activities. Although the financial statements of the national government are submitted for audit within 6 months from the end of fiscal year, coordination and reallocation between national and state governments during the fiscal year is very difficult.

d. Coordination problems on the allocation of infrastructure grants across state governments
As the cost of infrastructure projects in individual states, such as the building of roads or power stations are large relative to the size of the state, reaching agreement on the allocation of funds is politically difficult given the limited economic spillovers to other states due to the large geographic distance between the states.

The opportunity costs associated with delay and under-utilization of Compact grants are substantial, and overcoming these impediments could lead to significant economic and efficiency gains.

[1] Prepared with inputs by Hans van Rijn of Asian Development Bank.

Box 1. Micronesia: Fiscal Arrangements and Operational Challenges in Compact Grants Utilization (cont'd)

Intergovernmental Fiscal Transfers and the Allocation of Domestic Revenues (US$, FY2013)

	National	Chuuk	Kosrae	Pohnpei	Yap	Line Totals
Population		**48,654**	**6,616**	**36,196**	**11,377**	**102,843**
I. REGULAR SECTOR ("Operations")						
A. Education Sector	4,353,841	9,603,527	2,447,446	7,374,354	3,880,125	27,659,293
B. Health Sector	895,705	8,608,714	2,111,506	5,768,196	3,308,441	20,692,562
C. Public Sector Capacity Building	0	1,300,506	502,060	421,057	506,512	2,730,135
D. Environment Sector	0	685,341	215,903	447,987	364,550	1,713,781
E. Private Sector Development	0	851,135	782,463	157,000	795,663	2,586,260
F. Enhanced Reporting & Accountability	222,450	619,095	177,582	288,645	173,465	1,481,236
Subtotal Operations	5,471,996	21,668,318	6,236,959	14,457,239	9,028,756	56,863,268
II. COMPACT INFRASTRUCTURE GRANT	2,443,795	9,286,422	2,663,737	6,185,246	3,858,752	24,437,952
III. SUPPLEMENTAL EDUCATION GRANT	1,175,163	4,465,620	1,280,928	2,974,339	1,855,583	11,751,634
Subtotal I+II+III	9,090,954	35,420,360	10,181,624	23,616,824	14,743,091	93,052,854
Share by Government (I+II+III)	9.8	38.1	10.9	25.4	15.8	100.0
IV. US FEDERAL PROGRAM (Federal Grants)	4,524,810	682,854	926,259	1,954,974	1,661,080	9,749,976
Share by Government	46.4	7.0	9.5	20.1	17.0	100.0
V. GENERAL FUND (Domestic Revenue)	43,191,184	6,735,229	1,974,544	7,332,640	5,490,187	64,723,784
Share by Government	66.7	10.4	3.1	11.3	8.5	100.0
VI. OTHER EXTERNAL ASSISTANCE	310,760	0	183,000	77,604	0	571,364
Share by Government	54.4	0.0	32.0	13.6	0.0	100.0
Totals by National and State Government	57,117,708	42,838,443	13,265,426	32,982,042	21,894,358	
Share in aggregate budget (by Government)	34.0	25.5	7.9	19.6	13.0	
GRAND TOTAL	168,097,978					
Share of US grants (I-IV)	61.2					
Share of General Fund (V)	38.5					
Share of Other External Assistance (VI)	0.3					

Source: Data provided by the FSM authorities.

Box 2. Micronesia: The Challenge of Commodity Price Volatility on Inflation

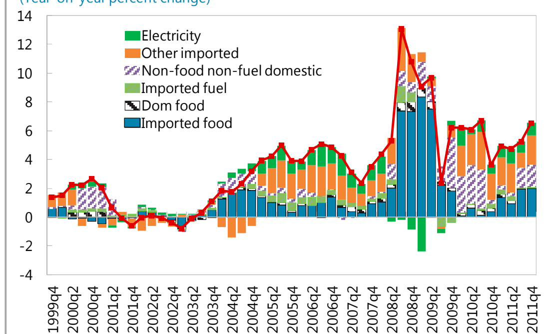
The Federated States of Micronesia (FSM), as many other Pacific Islands countries, relies heavily on imports to support domestic consumption. The country imported goods equivalent to 60 percent of GDP in 2011, with combined share of food and fuels just slightly below half of total imports. The share of imported goods and services in FSM's CPI baskets is high at 76.3 percent, with 30.5 percent of imported food. Fuel prices account only for 3.4 percent of total basket. However, when considering electricity and transportation, for which fuel oil price adjustment is a major component in retail pricing, the impact of world oil price changes on domestic inflation is more significant.

Changes in global food and oil prices are passed through at different speeds and patterns. Based on a VAR analysis of world oil and food prices on FSM's price index, we find that changes on global commodity prices, with some lags, have direct short-term impacts on domestic inflation. Oil prices shocks are only partially passed-through with a lag of one quarter. Due to the retail pricing scheme of FSM Petroleum Corporation, a state-owned company and the only fuel importer and distributor in the country, changes in retail prices are made every four months. Domestic food prices respond to world price shocks with a lag of about two quarters, but have a stronger persistence.

During the first wave of world commodity price increases during 2005–08, domestic inflation remained relatively muted between 4–5 percent, compared to 3–4 percent in the United States, thanks to limited impact of fuel prices on inflation and switching to lower-quality imports. However, inflation rose sharply to above 10 percent starting late 2008 after a shock in world prices of rice, the main staple food in the country, before subsiding at the end of 2009. Domestic prices started to edge up again in early 2010 as world commodity prices resumed upward trend and domestic demand improved.

Contribution to Inflation

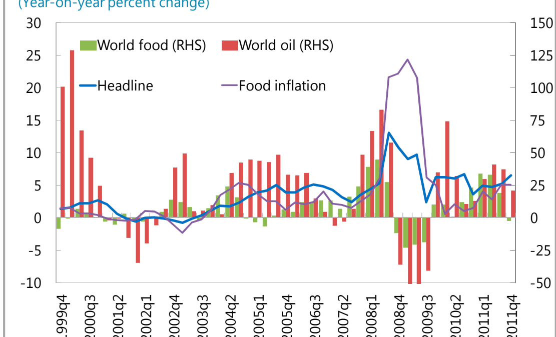
(Year-on-year percent change)



Sources: FSM authorities and IMF staff calculations.

Inflation and World Prices

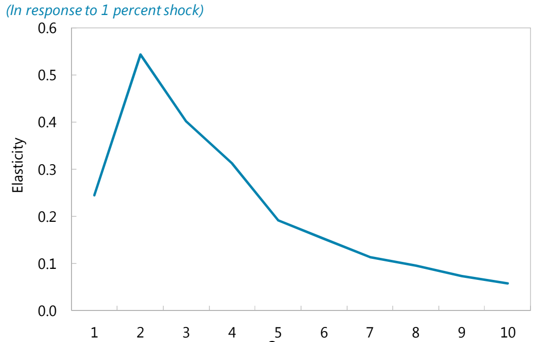
(Year-on-year percent change)



Sources: FSM authorities and IMF staff calculations.

Response of FSM's CPI to Changes in World Oil Prices

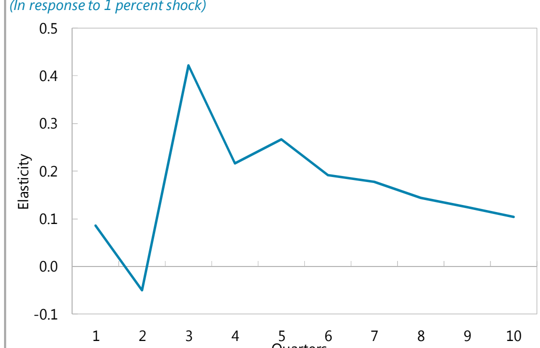
(In response to 1 percent shock)



Source: IMF staff calculations.

Response of FSM's CPI to Changes in World Food Prices

(In response to 1 percent shock)



Source: IMF staff calculations.

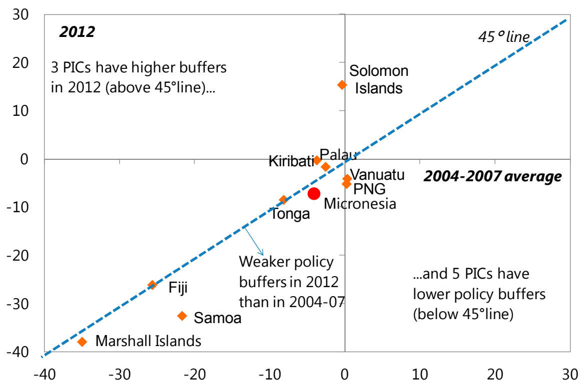
Looking forward, as the world commodity prices are expected to remain elevated and volatile, direct pass-through would potentially worsen the external positions and real incomes of the poor.[1] In order to better prepare against large commodity prices shocks, long-term measures to mitigate the price volatility impacts should be considered, including promoting domestic food supply through commercial farming, redesigning utility price scheme for slower fuel price pass-though while avoiding undue burden on public finance, and allowing more competition in importing businesses.

[1] According to a recent study by Sheridan, Tumbarello and Wu (IMF Working Paper WP/12/154 – June 2012), real oil price shocks also have a large impact on Micronesia GDP in the short term, as 10-percent increase in oil prices lowering GDP growth by 0.08 percent.

Figure 1. Micronesia: From Crisis to Recovery—Rebuilding Policy Buffers

Micronesia's overall buffer to withstand shocks has remained weak....

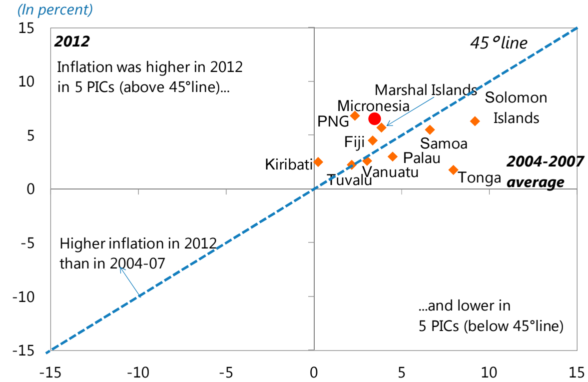
Overall Buffer Index, 2004-07 and 2012 1/



... and inflation is higher than during the pre-crisis period....

Inflation

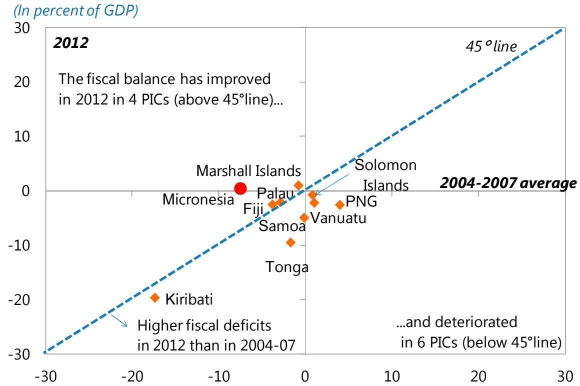
(In percent)



The fiscal balance in 2012 improved thanks to high fishing fees revenue...

Fiscal Balance

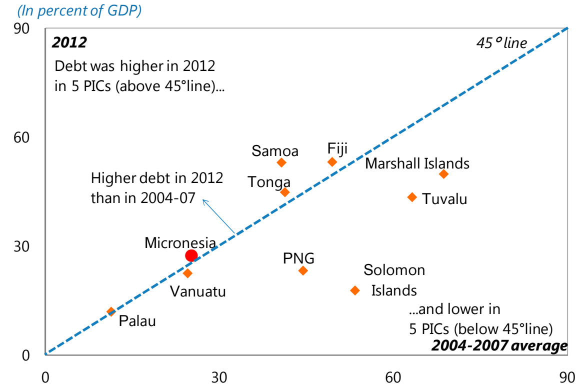
(In percent of GDP)



... and debt remains at a low level, though slightly above the 2004-07 average...

Gross Debt

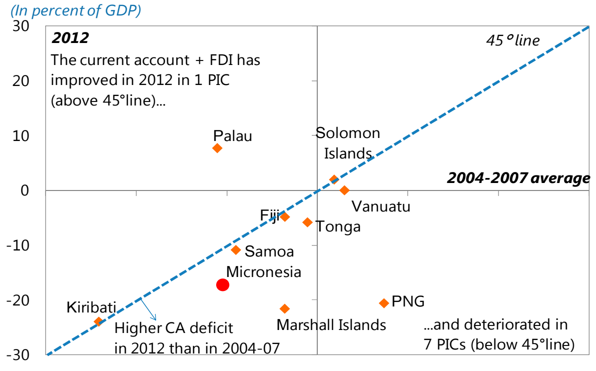
(In percent of GDP)



The current account position, net of FDI, deteriorated in recent years...

Current Account and FDI

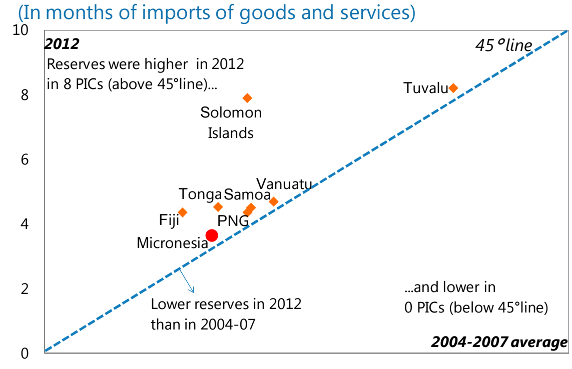
(In percent of GDP)



... though it is sustained by a stable flow of official transfers, and reserves have increased.

Reserves

(In months of imports of goods and services)



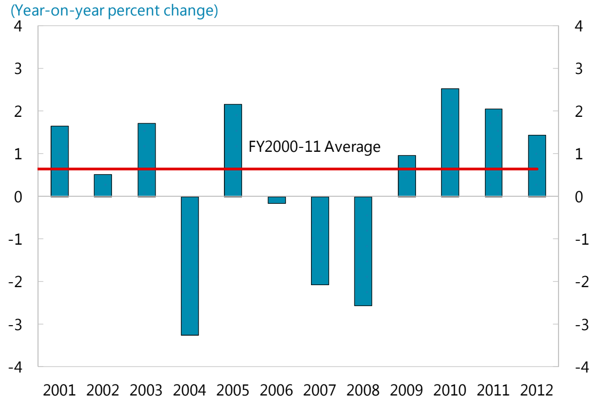
Source: Country authorities and Fund staff calculations.

1/ The overall buffer index is the sum of five individual buffers normalized by their respective standard deviations during 2004–07.

Figure 2. Micronesia: Economic Developments and Outlook

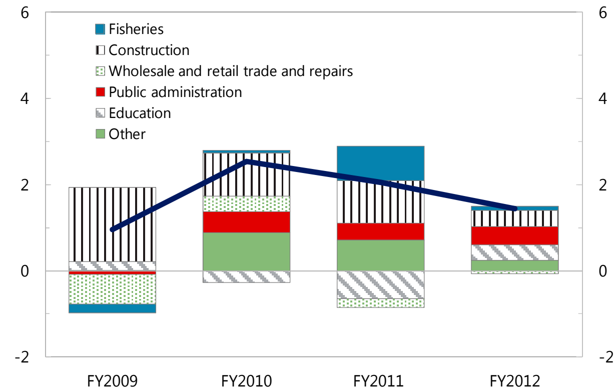
Over a longer horizon, growth has been sluggish, with some improvements in recent years.

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



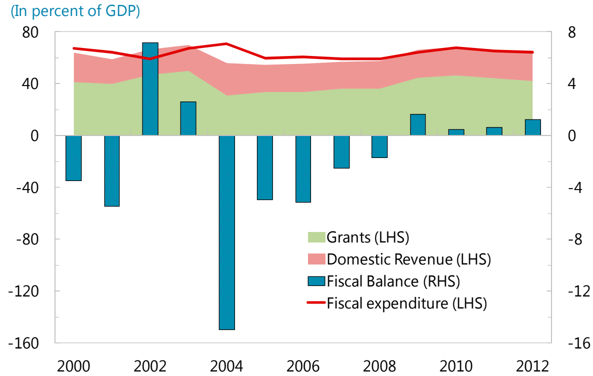
Growth has mainly been driven by the fishery sector, as well as public construction, which is not a sustainable source of growth.

Contribution to Growth
(As share to real GDP)



Fiscal balance has remained in surplus, though not sufficiently large.

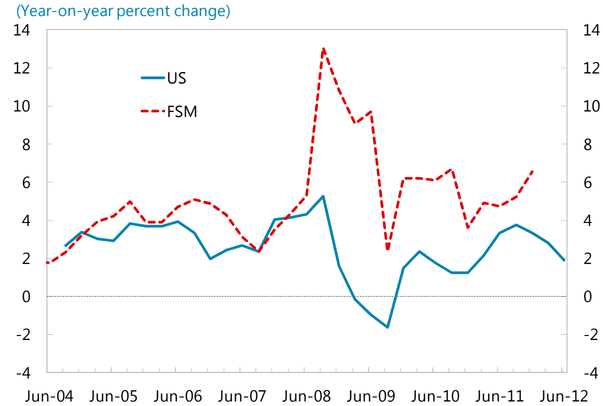
Fiscal Balance 1/
(In percent of GDP)



1/ Total revenue is the sum of grants and domestic revenue (stacked in chart).

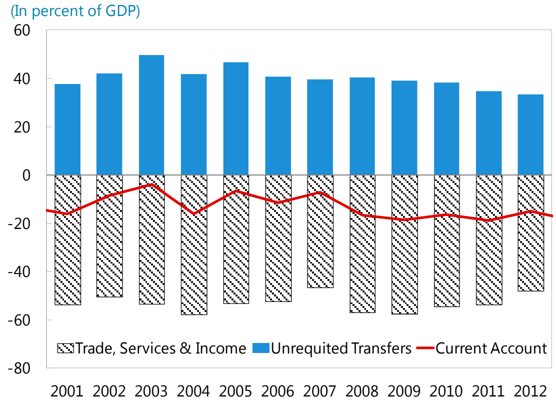
Inflation is volatile and higher than in the U.S., driven by food and commodity prices.

CPI Inflation
(Year-on-year percent change)



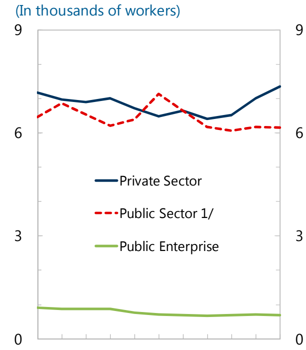
The current account deficit remains sizable, but largely offset by official capital inflows.

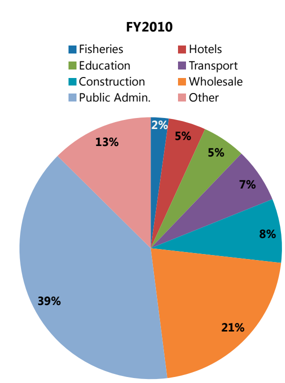
Balance of Payments
(In percent of GDP)



While private sector employment increased over the years, recent growth has been concentrated in a few industries, mainly fisheries and construction.

Employment
(In thousands of workers)





1/ National, state and local governments.

Table 1. Micronesia: Basic Data, FY2008–13 1/

Nominal GDP (FY2012):	US$327 million
Population (FY2012):	102,704
GDP per capita (FY2012):	US$3,185
IMF Quota:	SDR5.1 million

	FY2008	FY2009	FY2010	FY2011	FY2012 Est.	FY2013 Proj.
Real sector (average annual percent change unless otherwise noted)						
Real GDP	-2.6	1.0	2.5	2.1	1.4	0.8
Consumer prices	6.6	7.8	6.3	4.6	5.6	4.2
Employment	-4.8	-0.3	4.1	2.3	0.2	0.1
Public (incl. public enterprises)	-6.3	-2.1	1.3	-0.2	0.1	0.1
Private	-3.5	1.7	7.4	5.0	0.3	0.2
Nominal wages	3.7	4.2	2.5	0.1	2.7	2.7
Public-private wage ratio	2.1	2.2	2.2	2.1	2.1	2.1
Consolidated government finance (in percent of GDP)						
Revenue and grants	57.3	65.9	68.2	65.9	65.2	62.6
Revenue	21.2	21.4	21.8	21.8	23.3	22.0
Grants	36.1	44.5	46.3	44.1	42.0	40.6
Expenditure	59.0	64.2	67.7	65.3	64.0	61.8
Current	50.2	47.4	48.1	46.9	46.8	45.3
Capital	8.8	16.9	19.6	18.4	17.2	16.6
Overall balance	-1.7	1.6	0.5	0.6	1.2	0.8
Compact Trust Fund (millions of U.S. dollars)	119.1	138.3	177.2	198.5	257.4	297.5
Commercial banks (in millions of U.S. dollars; end of period)						
Foreign assets	101.4	121.5	127.7	143.6	156.2	169.8
Loans	49.2	46.7	55.7	55.2	60.0	65.3
Total deposits	118.9	132.5	154.1	166.2	175.2	181.8
Interest rates (in percent, average for FY)						
Consumer loans	14.4	15.4	15.1	14.4	15.0	14.8
Commercial loans	8.5	7.4	6.6	6.6	8.1	7.7
Balance of payments (in millions of U.S. dollars)						
Trade balance	-121.7	-128.4	-130.7	-134.2	-133.1	-130.4
Net services and income	-27.6	-31.3	-30.1	-32.4	-24.5	-25.6
Private and official transfers	105.5	108.4	112.1	108.0	108.7	107.3
Current account including official transfers	-43.8	-51.3	-48.7	-58.6	-49.0	-48.7
(in percent of GDP)	-16.7	-18.5	-16.6	-18.9	-15.0	-14.3
Current account excluding official transfers	-142.6	-155.9	-157.2	-162.2	-153.9	-152.0
(in percent of GDP)	-54.6	-56.2	-53.4	-52.3	-47.0	-44.8
Overall balance	-3.0	-1.6	-0.3	0.9	6.5	0.9
(in percent of GDP)	-1.2	-0.6	-0.1	0.3	2.0	0.3
Gross reserves (in months of imports)	2.5	2.7	2.8	3.6	3.6	3.6
External debt (in millions of U.S. dollars; end of period) 2/						
Stock	74.1	84.6	84.3	87.1	87.1	87.1
(in percent of GDP)	28.4	30.5	28.7	28.1	26.6	25.7
Debt service	3.2	3.9	4.3	5.0	5.1	5.0
(in percent of exports of goods and services)	5.4	6.6	6.6	6.9	6.6	6.1
Exchange rate regime	U.S. dollar is the official currency					
Real effective exchange rate 3/	97.5	106.7	108.6	107.6	108.1	108.5

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

1/ Fiscal year ending September 30. Estimates for FY2012 and projections for FY2013 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, FY2008–13 1/

	FY2008	FY2009	FY2010	FY2011	FY2012 Est.	FY2013 Proj
	(In millions of U.S. dollars)					
Revenue	149.8	182.8	200.5	204.5	213.4	212.4
Tax revenue	29.3	31.7	35.3	37.2	37.3	38.0
Wage and salary tax	7.3	7.1	7.6	7.6	8.3	8.9
Gross revenue tax	6.4	7.8	8.9	9.1	9.6	9.8
Import taxes	8.4	9.2	10.1	9.8	8.1	8.0
Other taxes	0.0	0.0	0.0	0.0	0.3	0.0
Grants (from abroad)	94.3	123.5	136.2	136.8	137.3	137.8
Current	79.0	84.4	85.6	84.0	85.3	85.6
Capital	15.4	39.1	50.7	52.8	52.1	52.1
Non-tax revenue	26.1	27.6	28.9	30.5	38.8	36.6
Fishing access revenue	17.0	20.0	17.7	18.8	26.4	24.7
Dividend and interest income	0.5	0.7	0.7	3.6	3.6	3.6
Other nontax revenues	8.6	6.8	10.5	8.0	8.8	8.3
Expenditure	154.2	178.2	199.1	202.5	209.4	209.7
Expense	131.1	131.4	143.0	145.6	153.2	153.6
Goods and services	127.5	128.9	139.1	143.5	151.2	151.4
Wages and salaries	60.2	63.1	66.4	65.9	68.4	69.0
Travel	8.2	8.3	10.0	9.7	9.7	9.7
Other	59.1	57.5	62.7	67.9	73.1	72.7
Interest payments	0.0	0.1	0.1	0.2	0.2	0.2
Subsidies	2.9	2.3	2.5	1.9	1.9	1.9
Net transfers	0.7	0.0	-0.3	0.0	0.0	0.1
Capital transfers	0.0	0.0	1.6	0.1	0.0	0.0
Net acquisition of nonfinancial assets	23.1	46.8	56.1	56.9	56.2	56.2
Acquisition of fixed capital	14.7	38.0	40.0	38.2	37.7	37.7
Multi-purpose development projects	8.4	8.8	16.0	18.7	18.5	18.5
Gross operating balance	18.6	51.4	57.4	58.9	60.2	58.8
Net lending/borrowing	-4.5	4.6	1.4	1.9	4.1	2.6
	(In percent of GDP)					
Revenue	57.3	65.9	68.2	65.9	65.2	62.6
Tax revenue	11.2	11.4	12.0	12.0	11.4	11.2
Grants (from abroad)	36.1	44.5	46.3	44.1	42.0	40.6
Non-tax revenue	10.0	9.9	9.8	9.8	11.9	10.8
Expenditure	59.0	64.2	67.7	65.3	64.0	61.8
Expense	50.2	47.4	48.6	46.9	46.8	45.3
Net acquisition of nonfinancial assets	8.8	16.9	19.1	18.4	17.2	16.6
Gross operating balance	7.1	18.5	19.5	19.0	18.4	17.3
Net lending/borrowing	-1.7	1.6	0.5	0.6	1.2	0.8
Memorandum items:						
GDP in nominal prices	261.3	277.5	294.1	310.3	327.2	339.3

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, FY2006–12

	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012
Commercial banks							
Deposits (Year-on-year percent change)	2.1	5.1	-0.5	11.4	16.3	7.8	22.9
Demand (in millions of U.S.$)	27.6	32.8	27.8	31.5	34.0	37.6	55.6
Savings (in millions of U.S.$)	51.7	47.2	54.1	70.2	88.5	98.0	120.8
Time (including CDs) (in millions of U.S.$)	34.4	39.4	36.4	30.1	30.8	28.6	27.3
Other (in millions of U.S.$)	0.1	0.1	0.6	0.7	0.8	2.1	0.7
Loans (Year-on-year percent change)	16.9	17.7	39.3	-5.1	19.3	-0.9	2.9
(in percent of GDP)	11.9	13.8	18.8	16.8	18.9	17.8	17.4
	(In percent of total assets)						
Foreign assets	76.3	76.2	68.9	74.1	75.1	75.5	77.7
Return on assets 1/	1.6	1.6	1.2	0.7	0.6	0.6	...
Equity capital 1/	10.8	11.1	11.0	10.4	9.4	9.1	8.0
	(In percent of total loans)						
Loss allowance	4.9	4.0	5.8	6.2	3.4	3.9	3.3
Non-performing loans	0.9	3.3	6.0	3.2	2.5	2.5	...
FSM Development Bank							
	(Year-on-year percent change)						
Loans	8.5	6.2	5.2	-5.5	8.0	-10.7	-5.0
(in percent of GDP)	9.3	9.8	10.1	9.0	9.3	8.7	8.2
	(In percent of total assets)						
Foreign assets	7.1	7.9	7.6	7.8	7.0	7.2	9.9
Return on assets	2.4	4.7	-4.6	6.6	1.2	...	...
	(In percent of total loans)						
Loss allowance	21.0	18.7	22.3	24.0	25.5	17.6	20.6
External indicators							
Exports (goods & services, y/y percent change)	9.2	23.2	5.8	-1.8	11.9	10.8	6.8
Imports (goods & services, y/y percent change)	3.4	0.1	14.2	8.0	0.4	5.9	1.6
Current account balance (percent of GDP)							
Including official transfers	-11.6	-7.3	-16.7	-18.5	-16.6	-18.9	-15.0
Excluding official transfers	-50.9	-44.9	-54.6	-56.2	-53.4	-52.3	-47.0
Overall balance (percent of GDP)	0.3	1.0	-1.2	-0.6	-0.1	0.3	2.0
Gross official reserves 2/							
In millions of U.S. dollars	47.2	49.5	45.3	53.1	56.5	76.8	77.2
In months of imports of goods and services	2.9	3.1	2.5	2.7	2.8	3.6	3.6
In percent of GDP	18.7	19.4	17.3	19.1	19.2	24.8	23.6
Total external debt 3/							
In millions of U.S. dollars	63.4	65.9	74.1	84.6	84.3	87.1	87.1
In percent of exports of goods and services	139.2	117.4	124.9	145.1	129.3	120.5	112.9
In percent of GDP	25.1	25.7	28.4	30.5	28.7	28.1	26.6
Debt service							
In millions of U.S. dollars	2.5	2.7	3.2	3.9	4.3	5.0	5.1
In percent of exports of goods and services	5.5	4.8	5.4	6.6	6.6	6.9	6.6
In percent of GDP	1.0	1.1	1.2	1.4	1.5	1.6	1.6

1/ On calendar year basis and data in FY 2012 are as of August 2012. The equity capital ratio refers to domestic bank.
2/ Data for 2012 as of end-August.
3/ About 2/3 of the total is concessional debt to the Asian Development Bank.

Table 4. Micronesia: Balance of Payments, FY2008–13

	FY2008	FY2009	FY2010	FY2011	FY2012 Est.	FY2013 Proj.
			(In millions of U.S. dollars)			
Overall balance	**-3.0**	**-1.6**	**-0.3**	**0.9**	**6.5**	**0.9**
Current Account Balance	**-43.8**	**-51.3**	**-48.7**	**-58.6**	**-49.0**	**-48.7**
Trade balance	-121.7	-128.4	-130.7	-134.2	-133.1	-130.4
Exports, f.o.b.	27.4	25.0	29.3	40.4	43.2	47.0
Imports, f.o.b.	-149.1	-153.4	-160.0	-174.6	-176.4	-177.4
Petroleum products	-34.3	-40.6	-39.2	-45.7	-46.4	-46.7
Services account	-39.8	-51.9	-43.6	-47.4	-47.6	-47.6
Receipts	32.0	33.3	36.0	31.9	33.9	35.5
Travel	26.5	27.1	29.3	26.1	27.9	29.3
Communications (net)	1.8	1.8	1.7	1.6	1.7	1.7
Other	3.7	4.4	5.0	4.2	4.3	4.5
Payments	-71.8	-85.2	-79.6	-79.2	-81.5	-83.0
Freight and insurance	-23.6	-25.5	-25.6	-28.4	-30.0	-31.1
Transportation	-15.4	-15.7	-15.6	-15.4	-15.6	-15.7
Travel	-7.1	-7.5	-8.0	-8.3	-8.8	-9.1
Other	-25.7	-36.5	-30.4	-27.1	-27.1	-27.1
Income, net	12.2	20.6	13.6	14.9	23.0	22.0
Receipts	27.7	30.7	26.4	28.1	35.9	34.7
Fishing rights fees	17.0	20.4	17.6	19.1	26.4	24.7
Interest dividend income	10.7	10.3	8.8	8.9	9.5	10.0
Payments	-15.5	-10.2	-12.8	-13.1	-12.8	-12.7
Foreign workers earnings	-1.6	-2.2	-2.6	-2.7	-2.7	-2.7
Interest payments	-1.8	-2.1	-2.4	-2.4	-2.1	-2.0
Dividends	-12.1	-5.9	-7.7	-8.0	-8.0	-8.0
Unrequited transfers	105.5	108.4	112.1	108.0	108.7	107.3
Private	6.7	3.8	3.6	4.4	3.8	4.0
Inflows	17.4	18.2	18.9	20.1	19.5	19.8
Outflows	-10.7	-14.4	-15.3	-15.7	-15.7	-15.8
Official	98.8	104.6	108.5	103.6	104.9	103.3
Compact funds	57.9	65.8	65.9	66.7	68.0	68.3
Other	40.9	38.8	42.6	36.9	36.9	34.9
Capital and financial account	**40.7**	**49.7**	**48.4**	**59.5**	**55.5**	**49.6**
Capital Account Balance	48.9	75.8	85.7	84.4	75.4	76.6
Capital Transfers, Official	4.9	7.5	16.3	19.2	24.2	24.4
Trust Fund Grants	19.0	20.9	21.5	22.4	23.3	24.5
Other	25.1	47.4	47.9	42.7	27.9	27.7
Financial Account Balance	-8.2	-26.1	-37.4	-24.9	-19.8	-27.0
Direct Investment (net)	-5.3	0.6	0.8	0.8	0.8	0.9
Portfolio investment	-20.0	-19.8	-25.9	-16.5	-11.3	-18.5
of which: Contributions to the Trust Fund	-19.0	-20.9	-21.5	-22.4	-23.3	-24.5
Other investment (net)	17.1	-6.9	-12.2	-9.1	-9.4	-9.4
Memorandum items			(In percent of GDP)			
Current account balance	-16.7	-18.5	-16.6	-18.9	-15.0	-14.3
Trade balance	-46.6	-46.3	-44.5	-43.3	-40.7	-38.4
Exports	10.5	9.0	10.0	13.0	13.2	13.9
Imports	-57.0	-55.3	-54.4	-56.3	-53.9	-52.3
Service	-15.2	-18.7	-14.8	-15.3	-14.5	-14.0
Income	4.7	7.4	4.6	4.8	7.0	6.5
Transfers	40.4	39.1	38.1	34.8	33.2	31.6
Private	2.6	1.4	1.2	1.4	1.2	1.2
Official	37.8	37.7	36.9	33.4	32.1	30.4
Current account, ex. transfers	-57.1	-57.6	-54.7	-53.7	-48.2	-46.0
Overall balance	-1.2	-0.6	-0.1	0.3	2.0	0.3

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

Table 5. Micronesia: Medium-term Scenario (Current Policies), FY2009–17 1/

	FY2009	FY2010	FY2011	FY2012 Est.	FY2013 Proj.	FY2014 Proj.	FY2015 Proj.	FY2016 Proj.	FY2017 Proj.
Real sector									
Real GDP (percent change)	1.0	2.5	2.1	1.4	0.8	0.7	0.6	0.6	0.6
Consumer prices (percent change)	7.8	6.3	4.6	5.6	4.2	3.5	2.7	2.0	2.0
General government finance (in percent of GDP)									
Revenue and grants	65.9	68.2	65.9	65.2	62.6	60.5	59.3	58.3	57.5
Total domestic revenue	21.4	21.8	21.8	23.3	22.0	21.1	20.8	20.5	20.2
Grants	44.5	46.3	44.1	42.0	40.6	39.4	38.5	37.8	37.2
Expenditure	64.2	67.7	65.3	64.0	61.8	59.9	58.6	57.7	56.9
Current	47.4	48.1	46.9	46.8	45.3	43.9	43.0	42.4	41.9
Capital	16.9	19.6	18.4	17.2	16.6	16.0	15.6	15.3	15.0
Overall balance	1.6	0.5	0.6	1.2	0.8	0.6	0.6	0.6	0.6
Compact Trust Fund									
(in millions of US$; end of period)	138.3	177.2	198.5	257.4	297.5	341.0	388.5	440.0	496.1
Balance of payments (in millions of U.S. dollars)									
Trade balance	-128.4	-130.7	-134.2	-133.1	-130.4	-128.8	-126.1	-124.2	-125.8
Net services	-51.9	-43.6	-47.4	-47.6	-47.6	-47.7	-47.9	-48.0	-48.1
Net income	20.6	13.6	14.9	23.0	22.0	21.2	22.1	22.9	23.7
Private and official transfers	108.4	112.1	108.0	108.7	107.3	106.3	104.1	102.4	100.9
Current account	-51.3	-48.7	-58.6	-49.0	-48.7	-49.0	-47.8	-46.9	-49.2
(In percent of GDP)	-18.5	-16.6	-18.9	-15.0	-14.3	-14.0	-13.3	-12.8	-13.2
Current account excluding official transfers	-155.9	-157.2	-162.2	-153.9	-152.0	-151.5	-148.0	-145.5	-146.4
(In percent of GDP)	-56.2	-53.4	-52.3	-47.0	-44.8	-43.3	-41.3	-39.8	-39.2
External debt (in millions of US$; end of period) 2/									
Stock	84.6	84.3	87.1	87.1	87.1	86.9	86.8	86.7	86.3
(in percent of GDP)	30.5	28.7	28.1	26.6	25.7	24.9	24.2	23.7	23.1
Debt service	3.9	4.3	5.0	5.1	5.0	5.1	5.0	5.0	5.1
(in percent of exports of goods and services)	6.6	6.6	6.9	6.6	6.1	6.0	5.6	5.2	5.2

Sources: the FSM authorities and Fund staff estimates.

1/ Estimates for FY2012 and projections from FY2013–17 are preliminary and based on data received from the authorities.

2/ Government and public enterprise debts only.

Table 6. Micronesia: Social Indicators 1/

	Micronesia	Comparator Region/ Income Group	
		East Asia and Pacific	Lower-middle Income
Population 1/			
Total population (millions)	0.11	1,974	2,533
Growth rate (percent annual)	0.4	0.7	1.6
Urban population (percent of population) 2/	n.a.	45.1	38.8
Total fertility rate (births per woman) 2/	3.5	1.8	2.9
GNI per capita (in U.S. dollars) 1/	2,900	4,235	1,760
Current public expenditure 2/			
Health (in percent of GDP)	12.5	2.2	1.7
Education (in percent of GDP)	6.7	3.8	4.0
Gross primary enrollment 2/			
(in percent of school age population)	110	110	104
Male	109	110	106
Female	111	111	102
Immunization rate (percent 12-23 months) 2/			
Measles	86	94	78
Diphtheria/Pertussis/Tetanus (DPT)	91	94	77
Life expectancy at birth (years) 2/			
Total	69	72	65
Male	68	70	64
Female	69	74	67
Mortality 2/			
Infant (per thousand live births)	35	21	51
Under 5 (per thousand live births)	43	26	70

Sources: World Development Indicators 2011 and Millenium Development Goals, World Bank.

1/ Data as of 2011.

2/ Data as of 2010 or latest available.

APPENDIX I. MICRONESIA—RISK ASSESSMENT MATRIX[1/]

Sources of Risks	Likelihood	Potential Impact
Strong Intensification of the Euro area crisis	**Medium** Further slowdown in the Euro area and its negative spillover to the rest of the world would lower the demand for exports from the FSM.	**Medium** Global slowdown would reduce fish exports (9 percent of GDP) and fishing license fees (6 percent of GDP). Tourism (8 percent of GDP) and household remittances (6 percent of GDP) would be also adversely affected. On the other hand, the adverse impact would be somewhat mitigated by the FSM's proximity to the growing Asia and Pacific economies and its limited direct exposure to the Euro area.
Global food price shock	**Low** High global food prices would create inflationary pressure in the FSM.	**High** The impact of a hike in global food prices could be significant, especially for the vulnerable population, as the weight of food in the FSM CPI basket is as high as 37 percent.
Global oil price shock	**Low** Continued turmoil in the Middle East could disrupt world oil supplies and increase global fuel prices.	**Medium** Although the weight of fuel in the CPI basket (9 percent) is lower than that of food, higher fuel prices would hold back the economic growth and worsen the current account balance.
Fiscal sustainability risks	**High** Declining reform momentum and political will would lead to delay in delivering the necessary fiscal reforms.	**High** Lack of progress in tax and expenditure reforms would undermine the public confidence in the fiscal sustainability and lead to acceleration of outward migration. It could result in the disruption of provision of public services in the long run.
Financial sector risks	**Low** Slowdown of the economy could increase credit risks and NPLs at banks.	**Medium** Economic slowdown could result in increased credit risks and NPLs at banks as many households are heavily indebted with short-term consumer loans.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (i.e., which is the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding this baseline. The RAM reflects staff's views on the source of risks and overall level of concerns as of the time of preparation of this document.

APPENDIX II. MICRONESIA—LONG-TERM FISCAL SUSTAINABILITY

This appendix assesses the FSM's long-term fiscal sustainability, updating the estimates in the 2010 Article IV consultation. The analysis considers implications of the expected expiry of annual Compact grants on the fiscal sustainability of the FSM and possible policy options to address the challenge. Fiscal sustainability is considered achieved if the government's financial asset level at end-FY2023 would generate an investment income large enough to replace expiring Compact grants without significantly disrupting public services and eroding the value of the Compact Trust Fund (CTF).[1]

The CTF has exhibited a volatile investment performance over FY2008–12. For FY2008–09, net return on assets was negative by a cumulative 17 percent, substantially eroding the market value of the CTF. Over the period of FY2010–12, the average annual rate of return improved to about 7½ percent in line with improved financial market conditions, bringing the value of the CTF to $257 million as of end-FY2012. As of end-FY2012, financial assets of the CTF are invested into U.S. equity (30 percent), non-U.S. equity (30 percent), fixed income investment (22 percent), real estate (7 percent), hedge fund (4 percent), and private equity (8 percent).

Prospects for achieving long-term fiscal sustainability are assessed by presenting several adjustment scenarios against the baseline. The baseline scenario features limited fiscal adjustment and structural reforms, while alternative scenarios consider comprehensive reforms, including implementation of tax and expenditure reforms as well as structural reforms. Throughout all scenarios, net investment returns on the CTF assets are assumed to be 6 percent, in line with an earlier GAO study.

1. Baseline Scenario

The baseline scenario assumes that small medium-term fiscal surplus (around ½ percent of GDP), similar to those in recent years, will continue over the medium term, as expenditure adjusts to the declining Compact grants. Medium-term real growth is expected to be low at about ½ percent, reflecting sluggish investment, continued outmigration, and low productivity growth.

Under the baseline, the CTF 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 $840 million (in FY2011 dollars), of which $770 million would be in the CTF and about $70 million in other funds.[2][3] During the drawdown phase beginning FY2024, investment income would be about $50 million per year compared to $66 million of expiring Compact grants in FY2024,

[1] The Compact Trust Fund for the 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 Compacts and their subsidiary agreements contain no commitments, either express or implied, regarding the level of the revenue that will be generated by the trust fund, nor is there any commitment regarding the degree to which the revenue will contribute to the long-term budgetary self-reliance of the FSM.

[2] All the amounts in this appendix are based on FY2011 prices, unless otherwise stated.

[3] Government reserves in various funds are assumed to be invested and contribute to closing the revenue gap.

leaving a shortfall of about 5 percent of FY2011 GDP.[4] With no firm commitment of grants beyond FY2023 and lack of vibrant private sector activity, the government would be forced to either sharply tighten the budget or rapidly deplete its accumulated savings.

Higher investment returns could narrow the shortfall, but simply relying on high returns over a long horizon is not recommended. To generate sufficient investment income to offset the expiring Compact grants, the net investment returns would need to remain at 7.2 percent per year until FY2023. While the CTF has recorded high investment returns in several years, given the high volatility in its performance, it is not advisable to expect as the baseline continuation of such high investment returns over a long period.

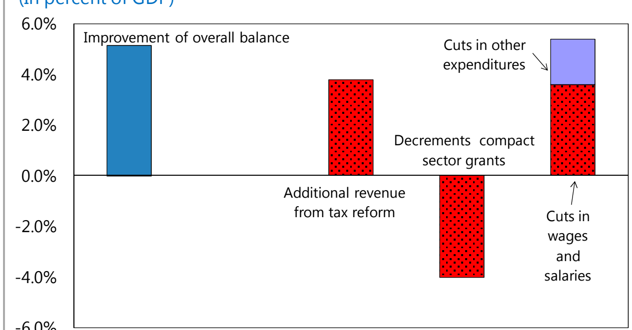
2. Policy Adjustment Scenarios

Fiscal sustainability can be achieved through significant fiscal adjustments and structural reforms to promote private-sector growth. In policy adjustment scenarios, the government would accumulate savings by fortifying the recent fiscal surplus through comprehensive tax reform and cuts in wasteful current expenditures. According to the PFTAC preliminary estimates, the planned tax reform could improve tax revenue by about 4 percent of GDP. In parallel, it is assumed as in the previous report that structural reforms (e.g., improved education, and other development needs) and accelerated utilization of infrastructure grants will boost potential growth to about 2½ percent in the medium term despite fiscal consolidation.

i) Swift adjustment scenario

Model simulations indicate that long-term fiscal sustainability would be achieved by gradually increasing fiscal surpluses by about 1¼ percent of GDP per annum for four years to reach 6.4 percent of GDP in FY2016, and maintaining that level until FY2023. The budget would need to run a surplus sufficient to keep the real value of the fund after FY2023.

Accumulated Changes in Expenditure and Revenues under the Swift Adjustment Scenario 1/
(In percent of GDP)

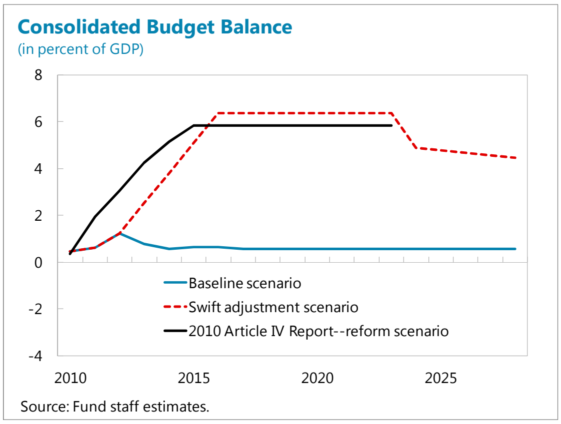


1/ Cumulative change between FY 2012–16.
Source: IMF staff estimates.

Under this swift adjustment 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. The required fiscal adjustment is higher than that in the 2010 Article IV Staff Report by about ½ percent of GDP, which reflects a shorter accumulation period until FY2023 (see text charts).

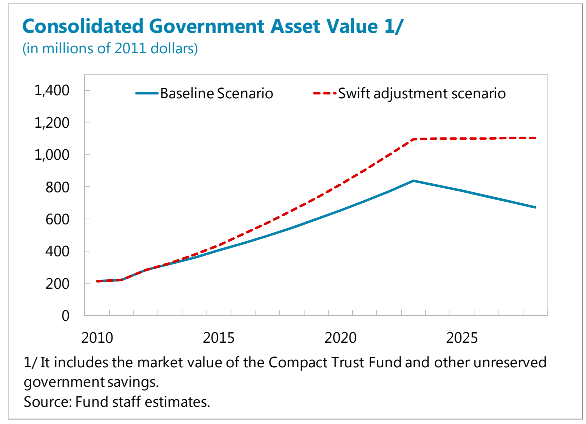
Given the federated system of the FSM, where fiscal surplus of each state belongs to itself, all states need to accumulate their own fiscal surpluses and contribute to closing the revenue gap.

[4] The shortfall would be even larger at about 10 percent of GDP if the Supplemental Education Grants (SEG) is discontinued after FY2023.



Consolidated Budget Balance
(in percent of GDP)

Source: Fund staff estimates.



Consolidated Government Asset Value 1/
(in millions of 2011 dollars)

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

ii) Gradual Adjustment Scenario

Alternatively, the government could accumulate fiscal surpluses more gradually over a longer period than the swift adjustment scenario. A higher overall level of fiscal surplus would however be required given the slower accumulation process of assets until FY2023. To illustrate this point the scenario assumes an adjustment over eight years rather than four years. Fiscal surpluses would need to be increased by 0.8 percent of GDP per annum until they reach 7.8 percent of GDP in FY2020, and then maintained at that level until FY2023. The expected amount of the CTF assets in FY2023 is the same as under the swift adjustment scenario.

Table 1. Required Fiscal Adjustments for Sustainability

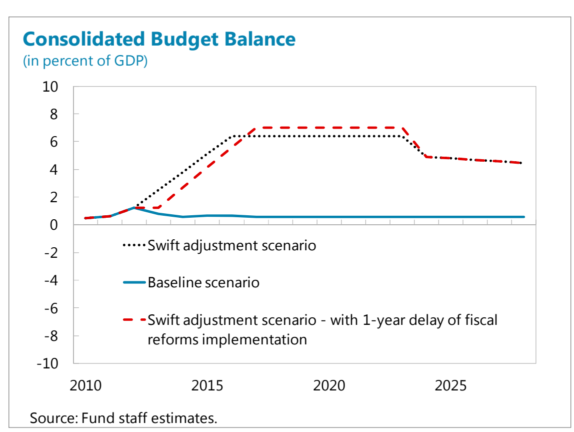
	Medium-term overall fiscal balance	Total required adjustment compared to FY2012 1/	Average annual fiscal adjustment 1/	
Scenarios	in percent of GDP	in percent of GDP	in percent of GDP	in USD millions (2011 prices)
1 Baseline scenario: no policy change	0.6	-	-	-
2 Swift adjustment scenario 1/	6.4	5.1	1.3	**4.0**
if fiscal reforms are delayed by one year	7.0	5.8	1.4	**4.5**
3 Gradual adjustment scenario 1/	7.8	6.6	0.8	**2.6**

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.

iii) Risk Analysis

Delays in implementing fiscal reforms would increase the required adjustments. If the implementation of fiscal reforms under the swift adjustment scenario is delayed by one year, the medium term fiscal surplus required to achieve the sustainability would be 7.0 percent of GDP, higher by 0.6 percentage points, thus requiring even more challenging adjustments (see text chart).



Consolidated Budget Balance
(in percent of GDP)

Source: Fund staff estimates.