



FEDERATED STATES OF MICRONESIA

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION— DEBT SUSTAINABILITY ANALYSIS

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

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

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

Background

- 1. The FSM is a 607-island microstate in the Pacific, composed of four states with a total population of slightly above 100,000.** It is highly dependent on external aid provided mostly by the United States while adopting the U.S. dollar as legal tender. The loosely federated structure of the country makes policy decisions a complex task, as consensus across the national and the four state governments is required. This has hindered a number of critically important policy actions, including the long-debated tax reform package (introduction of a VAT in lieu of the state sales taxes and replacing the Gross Revenue Tax with a net income tax on corporations, among others, which will generate additional revenue of 4 percent of GDP) and growth-enhancing reforms, in particular, those related to address land tenure issues.
- 2. The FSM faces a long-term fiscal challenge as U.S. grants provided under the Compact of Free Association (Compact grants) will expire in FY2023, while the private sector is yet to become an engine of growth.** A portion of the Compact grants has been disbursed into the Compact Trust Fund (CTF), jointly managed by the US and the FSM, with the intention that returns from the trust fund would

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

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

4. The analysis is based on the standard DSA framework for Low-Income Countries. Debt sustainability is assessed in relation to policy-dependent debt burden thresholds. The FSM, with an average score of 2.7 between 2011 and 2013 for the Country Policy and Institutional Assessment (CPIA), is considered to have weak capacity. The DSA uses the indicative thresholds on the external public debt for countries in this category whose remittances are not large³: 30 percent for the PV of debt-to-GDP ratio; 100 percent for the PV of debt-to-exports ratio; 200 percent for the PV of debt-to-revenue ratio; 15 percent for the debt service-to-exports ratio; and 18 percent for the debt service-to-revenue ratio.

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

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

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

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

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

6. Other assumptions under the baseline scenario include: gradual reduction of the financial assistance as scheduled under the Compact of Free Association with the US before expiring in FY2023; continued robust fishing license fee revenues (15 percent of GDP throughout the projection period⁵), which helps strengthen the fiscal balances compared to the historical track record; increased allocation of budget for infrastructure projects from the national to state governments (3 percent of GDP) starting from FY2015, on account of continued stronger fishing license fees than before; transfer of half of the annual fiscal surplus to trust funds established to generate revenue after the expiration of financial assistance under the Compact in FY2023, reflecting on-going discussions in the country.⁶ Additionally, the baseline scenario assumes that the FSM authorities will continue to contract moderate amount of concessional loans to finance investment projects implemented by state enterprises in line with the newly adopted ODA Policy.

PPG External Debt Sustainability

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

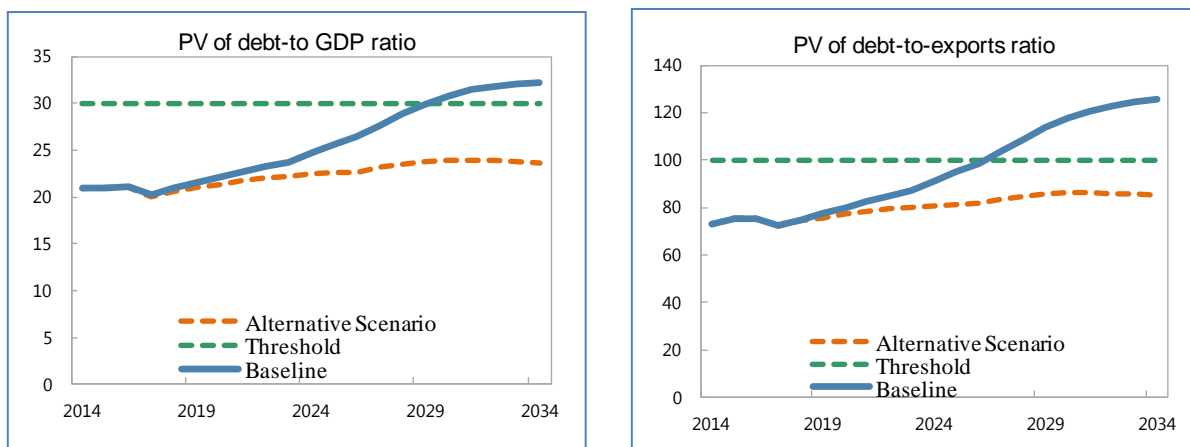
8. Stress tests confirm the vulnerability of the debt position relative to exports. In the most extreme shock scenario - with export value growth in FY2015–16 one standard deviation below the historical average - the PV of the external PPG debt-to-GDP will exceed the threshold of 30 percent in FY2023,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

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

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

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

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



Public Sector Debt Sustainability

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

Authorities' View

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

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

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

Conclusion

12. The standard DSA framework for LICs assesses the FSM to be at high risk of debt distress.

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

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

Box 1. Micronesia: Baseline Assumptions

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

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

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

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

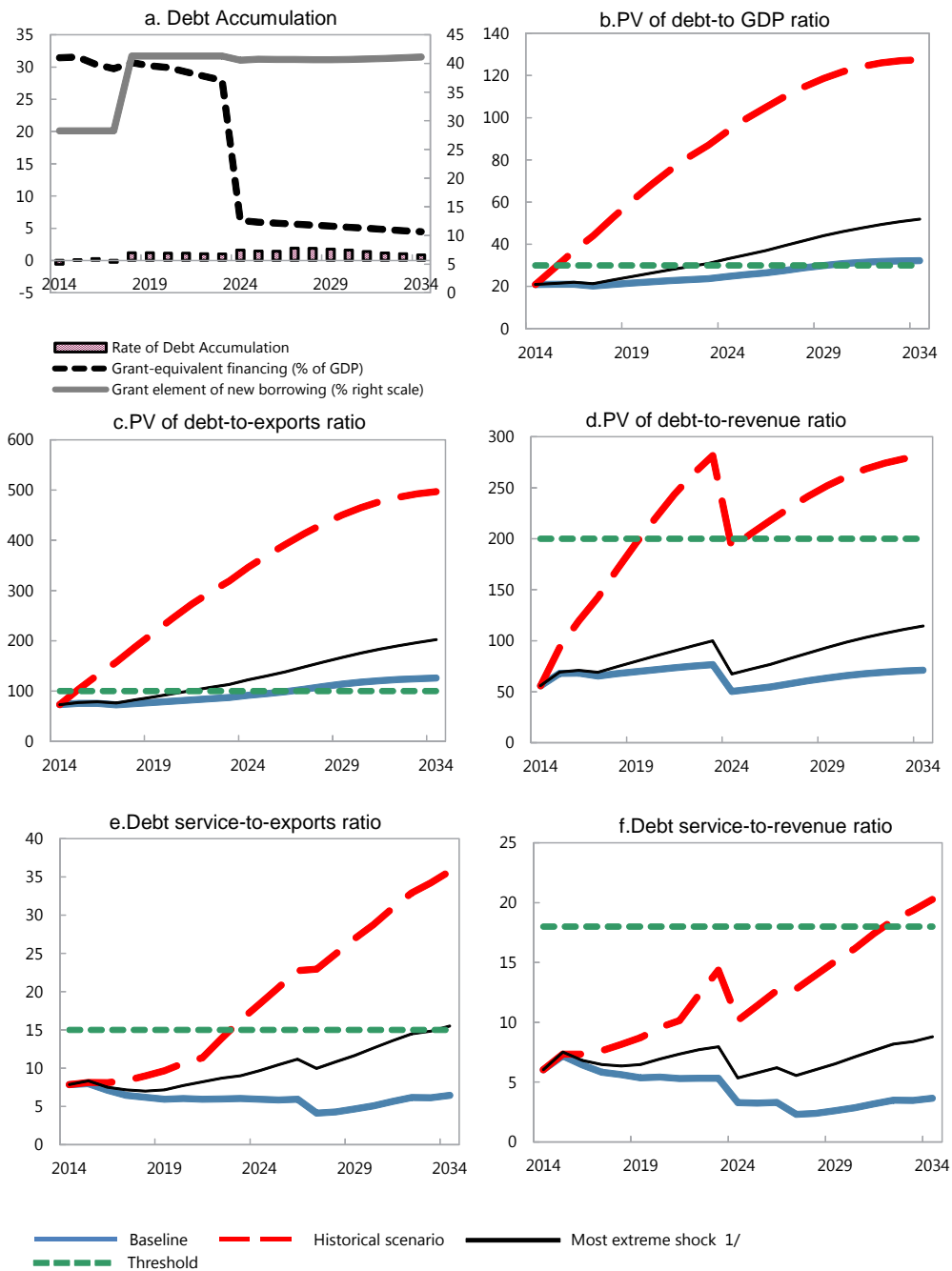
The Compact Trust Fund and the FSM Trust Fund are assumed to yield an average annual return of 6 percent.² Draw-downs from the trust funds will start from FY2024. While the baseline scenario assumes that only the annual investment returns are drawn down and that the nominal balance of the trust funds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

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

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

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

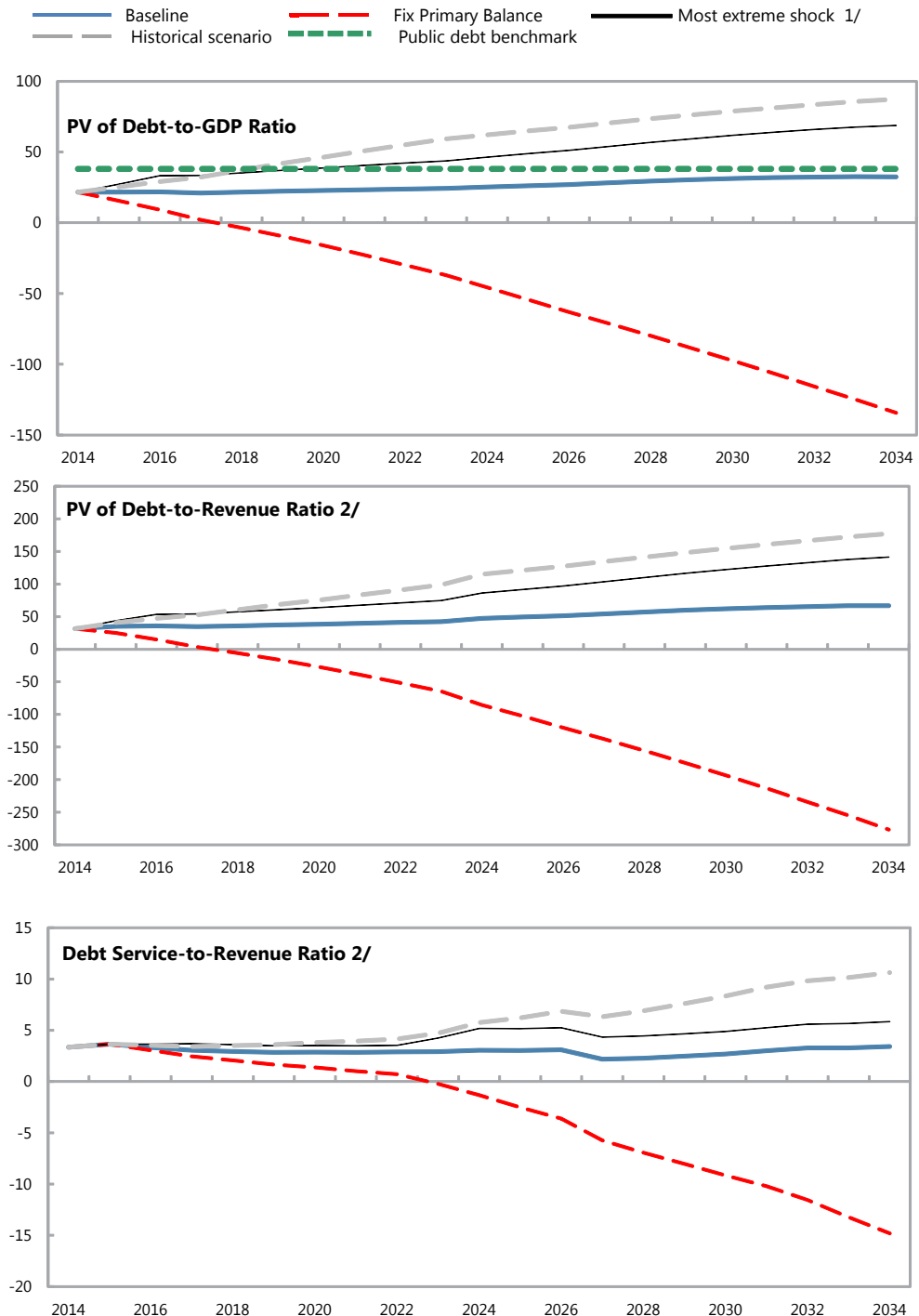
Figure 1. Micronesia: Indicators of Public and Publicly Guaranteed External Debt
Baseline Scenario, 2014–34 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2024. In figure b. it corresponds to a Terms shock; in c. to a Terms shock; in d. to a Terms shock; in e. to a Terms shock and in figure f. to a Terms shock
 2/ Tax reform package, generating additional revenue of 4 percent of GDP, is assumed to be gradually implemented at all levels of government between 2016 and 2018. To be implemented, the tax reform package needs to be endorsed by all the governments (national and state governments).

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



Sources: Country authorities; and staff estimates and projections.

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

2/ Revenues are defined inclusive of grants.

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

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

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as $[r - g - \rho(1+g)] / (1+g+\rho+gp)$ times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

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

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

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

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

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

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

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

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

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

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

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline, while grace and maturity periods are the same as in the baseline.

3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

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

(In percent of GDP, unless otherwise indicated)

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

Sources: Country authorities; and staff estimates and projections.

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

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

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

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

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

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

Sources: Country authorities; and staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.

2/ Revenues are defined inclusive of grants.



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Washington, D. C. 20431 USA

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

On May 11, the Executive Board of the International Monetary Fund (IMF) concluded the 2015 Article IV consultation¹ with the Federated States of Micronesia (FSM).

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

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

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

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

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

Executive Board Assessment²

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

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

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

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

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

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

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

Micronesia: Selected Economic Indicators, FY2010–15 /1

Nominal GDP (FY2013):	US\$315 million					
Population (FY2013):	103,679					
GDP per capita (FY2013):	US\$3,034					
IMF Quota:	SDR 5.1 million					
	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015
					Est.	Proj.
Real sector (annual percent change)						
Real GDP	3.2	1.8	0.1	-4.0	0.1	0.3
Consumer prices	3.7	4.3	6.3	2.1	0.7	-1.0
Employment	3.9	1.7	-2.6	-2.0	0.0	0.1
Public (incl. public enterprises)	1.1	-0.4	-0.8	-0.7	0.0	0.0
Private	7.1	3.8	-4.8	-3.9	0.1	0.2
Nominal wages	2.7	0.4	3.8	1.6	1.8	1.9
public average wage/private average wage	2.2	2.1	2.0	2.0	2.0	2.0
Consolidated government finance (in percent of GDP)						
Revenue and grants	68.2	65.0	66.0	62.3	68.6	61.9
Revenue	21.6	20.8	22.9	26.8	37.4	30.9
Grants 2/	46.6	44.3	43.1	35.5	31.2	31.0
Expenditure	67.8	65.6	65.3	59.6	56.1	59.0
Current	46.9	45.6	44.2	45.9	46.0	45.5
Capital	20.8	20.0	21.1	13.7	10.1	13.6
Overall balance	0.5	-0.6	0.8	2.8	12.5	2.8
Overall balance (exc. Grants)	-46.1	-44.8	-42.4	-32.8	-18.7	-28.2
Commercial banks (in percentage of GDP; end of period)						
Loans	19.0	17.9	17.4	17.2	18.0	...
Deposits	52.5	53.8	62.7	67.8	75.4	...
Interest rates (in percent, average for FY)						
Consumer loans	14.9	14.4	14.2	15.7	15.7	...
Commercial loans	6.6	6.6	6.4	6.4	6.4	...
Balance of payments (in millions of U.S. dollars)						
Trade balance	-128.4	-134.0	-125.7	-131.1	-129.2	-119.1
Net services and income	-29.8	-32.5	-25.8	-11.7	5.5	5.6
Private and official transfers	113.8	111.2	110.3	111.1	131.7	111.4
Current account	-44.4	-55.3	-41.2	-31.6	8.0	-2.1
(in percent of GDP)	-15.1	-17.9	-12.6	-10.1	2.5	-0.7
Current account excluding official transfers	-153.4	-158.9	-142.5	-129.6	-89.6	-99.4
(in percent of GDP)	-52.2	-51.4	-43.7	-41.2	-28.5	-31.5
External debt (in millions of U.S. dollars; end of period) 3/						
Stock	86.4	89.8	90.3	85.2	83.0	83.7
(in percent of GDP)	29.4	29.1	27.7	27.1	26.4	26.5
Debt service	4.4	5.0	5.1	5.9	7.1	7.0
(in percent of exports of goods and services)	6.3	6.7	5.3	6.7	7.9	8.0
Exchange rate regime						
	U.S. dollar is the official currency					
Real effective exchange rate 4/	109.9	109.5	112.4	115.1	115.8	n.a.

Sources: FSM authorities and IMF staff estimates.

1/ Fiscal year ending September 30.

2/ Excludes grants to the Compact Trust Fund.

3/ Government and public enterprise debt only.

4/ Calendar year. 2003=100.

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

Background

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

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

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

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

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

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

Economic Outlook

The authorities broadly agree with staff's assessment of the outlook. However, the authorities believe that there is a range of upside risks that could materialize, particularly with implementation of reforms. Specifically, the authorities believe that the FSM's economy will be

able to regain the momentum to 2 percent per annum on average over the remaining periods of the Compact in case the country radically realigns its productive capacity by undertaking key factors contained in the Action Plan and being helped by favorable factors as follows:

- Fishing and tourism are expected to benefit from favorable external factors such as lower oil prices and the gradual recovery of global economy.
- The authorities continue to have dialogue with the stakeholders to address the unused balance of allocated Compact grants for infrastructure projects. The authorities seek to accelerate the spending on the infrastructure arrears of \$126 million over the next four years, and thereby help to reinvigorate the economy.
- Last but not least, the authorities believe that an additional upside risk could arise from the positive effects of the structural reforms on external and domestic confidence.

Pursuing Sustainable Growth

Fiscal Policy

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

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

- The authorities plan to lift a currently low tax-to-GDP ratio of 12 percent up to as high as 16 percent through a series of tax reforms, including through introduction of a value added tax and net profits tax.
- Going forward, the authorities seek to extend the URA to the remaining two states, enhance the current operations of the state and national tax offices, and broaden personnel training in anticipation of the broader tax reform.

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

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

- In particular, the authorities view the recent launch of state-level effort towards consolidation under the Long-Term Fiscal Frameworks (LTFF) as important progress, and moreover highlight their strong resolves to extend the LTFF to the national government level.
- Concerning the large wage bill, the authorities note that salaries have been frozen since 1997 through a decision of Congress. The government recently undertook a public administration reform project, under which it reviewed not only the salary freeze but also number of staff, payment structures, and staff grading etc and is in the process of implementing the findings.

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

Private Sector Development

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

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

Regarding the ownership and leasing of land, the authorities also see merit in reviewing restrictions imposed by Foreign Investment Acts at both levels of government to harmonize and

provide greater clarity on land tenure practices across the states, while respecting local investors' legitimate interests. As is the case in other Pacific island countries, the land issue is so delicate and intricately connected to people's perception of inheritance and community that it needs to be tackled sensitively to produce solutions that are sustainable in the long term.

Financial Sector

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

External Stability

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