INTERNATIONAL MONETARY FUND

IMF Country Report No. 24/66

FEDERATED STATES OF MICRONESIA

March 2024

2023 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR FEDERATED STATES OF MICRONESIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2023 Article IV consultation with Federated States of Micronesia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 23, 2024 consideration of the staff report that concluded the Article IV consultation with Federated States of Micronesia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 23, 2024, following discussions that ended on December 11, 2023, with the officials of Federated States of Micronesia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 7, 2024.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Statement by the Executive Director** for Federated States of Micronesia.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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International Monetary Fund
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PRESS RELEASE

PR24/66

IMF Executive Board Concludes 2023 Article IV Consultation with the Federated States of Micronesia

FOR IMMEDIATE RELEASE

Washington, DC – March 4, 2024: On February 23, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Federated States of Micronesia (FSM).

FSM experienced a short-lived recovery in 2021 from Covid, but economic activity has since stagnated because of additional shocks. Economic growth rebounded to 3 percent in FY2021, led by the fisheries sector and government support. However, economic growth is estimated to have averaged zero in FY2022-23. Inflation reached a decade high 6.2 percent driven by higher import prices for fuel and food, as well as supply bottlenecks. FSM is also facing significant labor shortages exacerbated by outward emigration. On the other hand, the external and fiscal positions of FSM remained robust. Substantial fiscal surpluses in recent years contributed to a decline in public debt to 12.4 percent of GDP, while the assets of the trust funds have risen to 323 percent of GDP.

FSM's near-term economic prospects will get a boost from higher public investment. Growth in FY2024 is projected at 1.1 percent before accelerating further to 1.7 percent underpinned by continued recovery in tourism, as well as higher public spending partly funded by the higher grants under the new Compact of Free Association (COFA) agreement with the United States (expected to be implemented starting in FY2025). However, without significant reforms, economic growth is likely to converge to the historical average of around 0.7 percent over time. Inflation is expected to gradually decline to around 2 percent.

The FSM economy remains highly vulnerable to shocks, such as an increase in global commodity prices, extreme climate events, and potential delays of the COFA agreement. Moreover, the acceleration of outward migration would severely jeopardize already constrained labor supply, impacting implementation of large public projects. The underdeveloped private sector remains vulnerable, and deteriorating infrastructure hinders growth and social goals, especially on health. The adverse impact of climate change is increasingly being felt raising food security concerns.

Executive Board Assessment[2]

Executive Directors positively noted the new Compact of Free Association (COFA) agreement with the United States, which presents an opportunity to adopt a transformative reform

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[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.

[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.

agenda, and welcomed the envisaged economic recovery in the near term. Noting the medium-term outlook challenges related to the country's vulnerabilities to climate change and natural disasters, significant structural bottlenecks, and outward emigration, Directors underscored the need for reforms to support private sector-led growth and pursue an enhanced climate strategy. Building social consensus and ensuring policy coordination among all domestic stakeholders will be important. Directors also stressed the importance of continued financial and capacity building support by the international community.

Directors agreed that in the short term, fiscal policy should remain cautious until the new COFA is implemented and stressed the importance of pressing ahead with the authorities' public financial management reform roadmap. They recommended developing a new fiscal framework and strengthening public investment management to enhance the implementation and efficiency of public investment. This will help promote higher sustainable growth while ensuring fiscal sustainability. Further initiatives to improve revenue mobilization, such as modernizing revenue administration and strengthening the tax system, will also be needed over time.

Directors encouraged structural reforms to improve the business environment, and investments in education and training, and digitalization. They emphasized the need to prioritize land reform and reducing barriers to foreign direct investment which is critical to promote the development of the private sector and disincentivize outward emigration. Directors also recommended further efforts to improve economic statistics to enhance transparency and accountability.

Directors agreed that financial sector could play a stronger role in supporting economic development. They welcomed its overall soundness, while noting that further enhancing the regulatory and supervisory frameworks could further boost its resilience. Directors also emphasized the importance of strengthening financial deepening and inclusion to support private sector development. Continued progress in the AML/CFT framework is also important.

Directors agreed with the urgency to strengthen the country's resilience to climate change and called for prompt actions to develop and implement a comprehensive National Adaptation Plan.

Table 1. Micronesia: Selected Economic Indicators, FY2021–FY2025 1/

Nominal GDP (FY2022): US$430 million
Population (FY2022): 94,768
GDP per capita (FY2022): US$4,540
IMF Quota: SDR 7.2 million

	FY2021	FY2022	FY2023	FY2024	FY2025
	Est.	Est.	Projections		
Real sector (annual percent change)					
Real GDP	3.0	-0.9	0.8	1.1	1.7
Consumer prices	1.8	5.0	6.2	4.0	3.0
Consolidated government finance (in percent of GDP)					
Revenue and grants	71.3	67.0	59.4	61.2	65.4
Revenue	37.3	41.7	34.9	33.1	34.0
Tax revenue	15.9	21.7	16.5	16.7	16.9
of which: corporate income tax	2.9	9.5	4.6	4.6	4.6
Non-tax revenue	20.6	20.0	18.5	16.5	17.0
of which: Fishing license fees	17.7	17.0	15.4	13.4	14.0
Grants 2/	33.9	25.3	24.5	28.1	31.4
Expenditure	66.8	59.2	57.9	60.0	65.8
Expense	63.6	55.5	53.4	53.3	57.2
Net acquisition of nonfinancial assets	3.2	3.7	4.5	6.7	8.5
Gross Public Investment	9.4	9.5	10.0	12.0	13.5
Net lending/borrowing	4.5	7.8	1.6	1.3	-0.4
Net lending/borrowing (excl. grants)	-29.5	-17.5	-22.9	-26.8	-31.8
Public debt (outstanding stock, end of period)	17.0	14.6	12.4	10.6	10.6
Balance of trust funds 3/	351.5	287.7	323.2	330.9	381.0
Commercial banks (in percentage of GDP; end of period)					
Loans /4	13.3	12.8	11.1	11.3	11.5
Deposits	111.7	99.5	96.2	94.2	92.9
Interest rates (in percent, average for FY)					
Consumer loans	14.2	13.7	14.3	...	...
Commercial loans	5.8	5.1	4.8	...	...
Balance of payments (in millions of U.S. dollars)					
Trade balance	-161.4	-162.4	-169.9	-181.0	-203.5
Net services and income	22.2	26.5	29.3	21.9	26.4
Private and official transfers	147.7	172.4	155.9	162.8	180.9
Current account	8.5	36.6	15.3	3.7	3.8
(in percent of GDP)	2.2	8.5	3.3	0.8	0.8
External debt (in millions of U.S. dollars; end of period)					
Outstanding stock	62.9	59.4	54.3	49.2	51.3
(in percent of GDP)	16.1	13.8	11.8	10.2	10.1
Memorandum items:					
Real effective exchange rate 5/	100.9	106.9	114.8	...	...
Nominal GDP (in millions of U.S. dollars)	390.0	430.2	460.5	484.0	507.1

Sources: FSM authorities and IMF staff estimates and calculations.

1/ Fiscal year ends on September 30. Data for FY2019-22 is estimate from authorities and subject to revision.

2/ Excludes contributions to the Compact Trust Fund.

3/ Compact Trust Fund and FSM Trust Fund.

4/ Includes only domestic lending and does not account for loans to customers outside the country.

5/ Calendar year. 2010=100. The U.S. dollar is legal tender and the official currency.

INTERNATIONAL MONETARY FUND

FEDERATED STATES OF MICRONESIA

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION

February 7, 2024

KEY ISSUES

Context. Economic growth has been volatile since the Covid-19 pandemic, and inflation reached decade-high levels mainly due to higher prices of imported food and energy. High vulnerability to climate change is also intensifying food security concerns. Despite the weak domestic economy, the fiscal and external current accounts posted large surpluses, partly thanks to foreign grants and taxes paid by foreign firms. The high uncertainty around medium-term external financing and economic prospects diminished significantly with the signing of a new Compact of Free Association (COFA) agreement between the FSM and the United States government, which includes larger grants for the next 20 years and will enable much needed public investment and reforms. However, the agreement still needs to be ratified by the US Congress.

Recommendations: Economic policies should focus on leveraging the new COFA to boost sustainable and strong economic growth. Main policy recommendations include:

- **Fiscal policy.** Keeping current spending levels relatively stable in FY2024 would be prudent given the uncertainty around the start of the new COFA, while implementing delayed grant-funded public investment. Strengthening the fiscal framework would help ensure better quality spending and manage risks. Upgrading public investment management and implementing the PFM reform agenda are key.

- **Climate policies.** Improving coordination among states and central government and coordinating the development and climate agendas would enhance climate adaptation efforts. Needed efforts include developing and implementing a comprehensive National Action Plan, incorporating climate resilience and adaptation strategies in the budget process, and improving social protection programs.

- **Structural policies.** Achieving the desired stronger private sector-led growth will require tackling long-standing reform needs. Among the priorities are improving the business environment, reducing the barriers to FDI, and land reform. This will require building consensus between the central and states. Continue to invest in the digital infrastructure and reforms to promote greater financial deepening over time.

Approved By
Thomas Helbling (APD) and Pritha Mitra (SPR)

Discussions took place in Palikir and Kolonia during November 28 – December 11, 2023. The mission comprised Paulo Medas (Head), Pranav Kumar Gupta, Choonsung Lim, Kavita Ram (all APD), and Bo Zhao (SEC). To-Nhu Dao and Seble Abebe (both APD) provided superb research, editorial, and logistical assistance for the discussions and the preparation of this report.

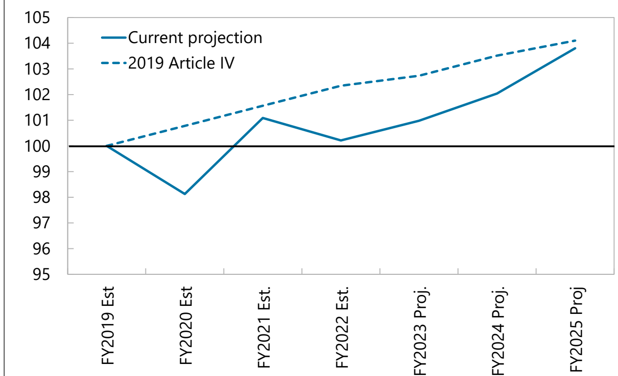
CONTENTS

ANNEXES

CONTEXT

1. **The Federated States of Micronesia (FSM) experienced an economic rebound in FY2021, but growth has since stagnated due to additional shocks**. Economic growth rose to 3 percent in FY2021[1], despite a border closure until August 2022, driven by a strong performance of the fisheries sector and government support to households in response to COVID. However, the rebound was short-lived, and the economy contracted by 0.9 percent in FY2022 driven mainly by the fisheries sector, which suffered from higher costs (including logistics and fuel) and volatile demand for tuna. In FY2023, growth is projected at 0.8 percent, reflecting a gradual pick up in construction, transport, and tourism, and an increase in national government wages. Inflationary pressures intensified, with inflation reaching a decade high 6.2 percent in FY2023 mainly due to higher import prices for food and fuel and supply side constraints (Annex III).

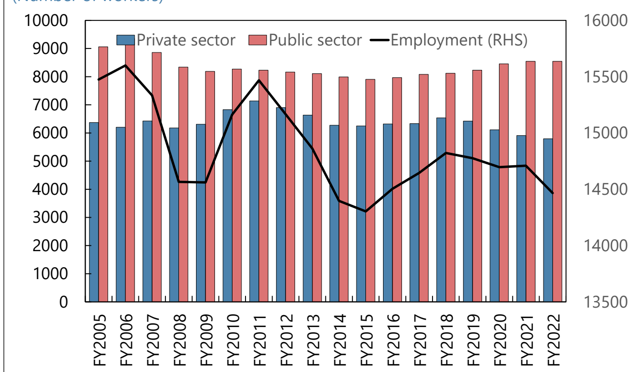
Real Gross Domestic Product Path
(FY2019=100)



Source: IMF staff estimates and projections.

2. **Increased outward emigration is hurting growth prospects**. Outward emigration has created a chronic shortage of skilled labor in both the private and public sectors. According to recent estimates, FSM's population is estimated to have fallen by around 10-15 percent in the last decade.[2] Part of the technical skills gap has been filled by foreign workers, but they were also restricted during the COVID crisis. To retain staff, the national government has granted a 45 percent pay rise across the board in FY2023 after almost two decades without increases. In addition, employment in the private sector has fallen faster as the economy is increasingly dependent on the public sector. The expected return of foreign workers could ease labor supply constraints.

Employment
(Number of workers)



Sources: FSM authorities; and U.S. Graduate School.

3. **The fiscal and external sectors posted large surpluses mainly due to large foreign grants, and sizeable fish license fees and tax revenues from foreign companies.** Given the weak domestic private sector, the public sector is heavily dependent on external sources. Large fishing royalties and corporate income tax (CIT) revenues from Japanese companies—as well as,

[1] Fiscal Year in FSM is from October to September.

[2] The final population data will only be known when the new census is published in 2024.

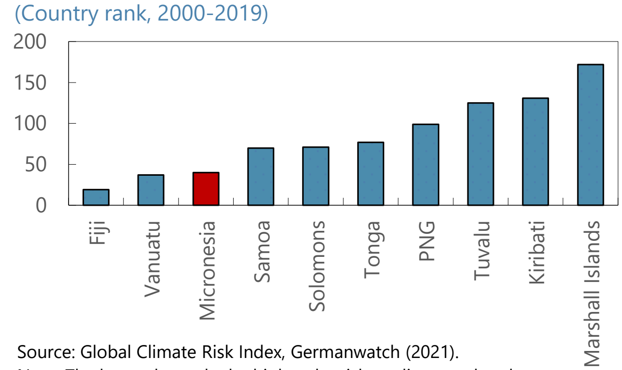
under-execution of public investment, led to substantial fiscal surpluses in FY2021-22. In FY2023, the surplus is projected to have declined significantly, driven by a gradual recovery in investment and higher public wages. Public debt declined to 12.4 percent of GDP in FY2023, while the assets of the two trust funds reached a total of 323 percent of GDP. Similarly, the external current account (CA) surpluses in FY2022-23 were large, primarily stemming from the sizeable, but volatile, fishing royalties, CIT, and donor grants. The external sector position of the FSM is assessed to be substantially stronger than the level implied by medium-term fundamentals and desirable policies (Annex VI).[3]

OUTLOOK AND RISKS

4. **In the near term, the growth momentum is expected to be supported by a gradually increase in public investment and higher public sector wages.** Growth in FY2024 and FY2025 is projected to accelerate to 1.1 percent and 1.7 percent, respectively, underpinned by increases in government spending (thanks to the new COFA-related grants), including higher public sector wages at the state level (expected to follow national wages with a lag). Growth in the transportation and tourism sectors is also projected to recover to pre-pandemic levels, given the end of the border closures. Inflation in 2024 is expected to moderate only gradually due to the higher growth and increase in public wages.

5. **In the medium term, economic growth is expected to return to levels below 1 percent in the absence of structural reforms**. The decline reflects FSM's geographical dispersion, climate-related shocks, low private sector participation, lack of skilled workers, and low efficiency of public investment. If coupled with deep structural reforms, the revised COFA could strengthen private sector development, which would enhance employment opportunities and boost potential growth.

Climate Risk
(Country rank, 2000-2019)



Source: Global Climate Risk Index, Germanwatch (2021).
Note: The lower the rank, the higher the risk to climate-related extreme weather events.

6. **Risks to the outlook are tilted to the downside**. FSM's high vulnerability to climate change and natural disasters pose a significant risk as it can further damage the deteriorated infrastructure and aggravate food security. Increases in global energy and food prices could worsen the CA balance, increase inflation, and hamper the economic recovery. There is also a risk of a more prolonged delay in implementing the new COFA (expected to start in FY2025), but its potential adverse impact on the fiscal and external balances could be mitigated

[3] The assessment for FY2023 is based on projections for a decline in the current account surplus, and not actual data. For FY2022, based on preliminary data, the assessment would still show an external position substantially stronger than the level implied by fundamentals and desirable policies. However, these assessments should be treated with caution given data gaps and large uncertainty around the balance of payment flows.

by the financial assets in the trust funds (enough to cover funding needs for more than a decade) with changes to the rules governing their use. Moreover, the acceleration of outward migration would severely jeopardize already constrained labor supply, impacting implementation of large public projects.

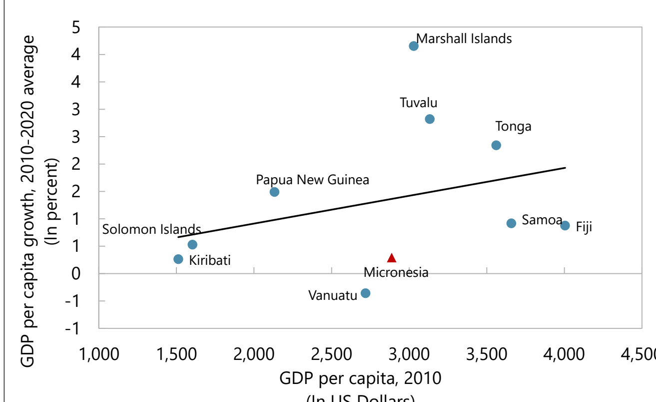
Authorities' Views

7. **The authorities agreed with the overall assessment of the economic outlook and risks.** Authorities noted that the transient period of economy recovery in FY2021 and subsequent economy contraction in FY2022 was due to significant decline in fisheries and border closures. They stressed the challenges of geographical isolation, exposure to climate change, and labor shortages. They acknowledged staff's assessment of the need for a well-designed long-term reform agenda, but noted it will require significant additional capital resources to support implementation and achieve economic growth above its historical average growth.

POLICY DISCUSSIONS

8. **There was broad agreement on the need to leverage the new COFA to achieve sustainable higher economic growth led by the private sector.** The disruptions from Covid-19 and border closures contributed to outward migration and loss of access to skilled foreign workers that led to delays in critical maintenance and investment projects. Deteriorating infrastructure undermines growth prospects and social goals, especially on health (sanitation and water). The private sector remains underdeveloped and is highly vulnerable to shocks. Climate change is also putting more urgency on the need for adaptation efforts and ensuring food security. The revised COFA, when approved, will bring larger grants for the next 20 years (Annex IV). However, previous surges in public investment have not led to higher potential growth (Box 1), highlighting the need for accompanying reforms.

Pacific Islands: Growth and GDP per Capita



Sources: World Economic Outlook; and IMF staff calculations.

9. **Discussions centered on the set of needed reforms, the implementation capacity, and building public support**:

- ***Reviving the reform momentum***. A set of ambitious, mutually reinforcing, and transformative reforms is needed for higher, sustainable economic growth led by the private sector and tackling climate change. It will require building broad consensus across all states on critical, but difficult long-standing reforms and support from the international community.[4] The ongoing work on a new strategic development plan is timely. Creating a group to monitor implementation of the reforms and address emerging issues could help. This group could include representatives of the national and state governments and other stakeholders (e.g., large donors). It could publish periodical reports on progress and challenges to keep the reform momentum going and promote accountability.

- ***Strengthening public investment management to achieve larger growth dividends***. Developing a medium-to long-term fiscal framework and public investment management capacity will be key to promote sustainable economic growth and better manage risks.

- ***Removing the obstacles to the development of the private sector,*** which remains underdeveloped contributing to the lack of good jobs. Reversing this trend will require, as key priorities, improving the business environment for private and foreign investors and advancing the land reform; but also, gradually building up transportation and communication (including digital) infrastructure and promoting financial deepening.

- ***Addressing climate challenges, including food security***, will require greater efforts on climate adaptation with donor support. The climate and development strategies being developed will be more effective if well integrated.

A. Fiscal Policy

10. The fiscal surplus is expected to remain broadly stable in FY2024 as uncertainty around COFA renewal timing and capacity constraints contain the spending increase. While the renewal of COFA is taking longer than initially expected, COFA-related current grants in FY2024 are expected to continue at the FY2023 level as the U.S. Congress authorized temporary support. Nevertheless, given the uncertainty, keeping current spending levels broadly stable in FY2024 would be prudent, especially as inflation is still high. In addition, states can press ahead with implementation of delayed grant-funded public investment.[5] Some spending restrain at the national level is likely, given the loss of revenues under the recently adopted new revenue-sharing agreement, which requires the national government to transfer half of the fishing royalties to the states. On the other hand, states are expected to boost spending, including granting large wage increases to keep workers—but these could be prudently delayed depending on the renewal and implementation of the new COFA.

[4] The FSM's four states (Chuuk, Pohnpei, Yap and Kosrae) have their own constitutions and considerable autonomy, including on areas such as healthcare, education, and economic development. Many of the reforms will require coordination between the national and state governments to be successful.

[5] States have large unused capital grants as projects were delayed in recent years.

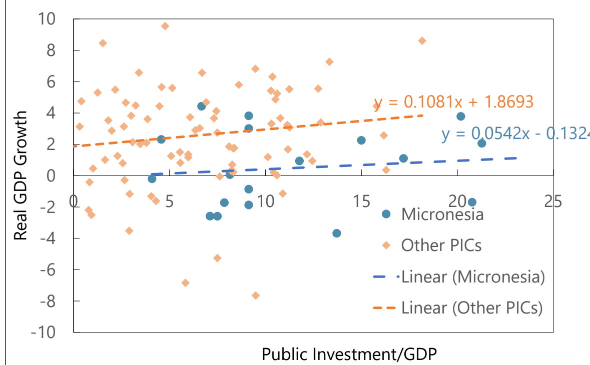
Box 1. Public Investment and Growth in the FSM

Public investment can play a crucial role in promoting economic growth. Better infrastructure, for example, can enhance connectivity, reduce transportation costs, and improve market access. These improvements could boost trade, attract private sector investment, and raise potential growth.

Despite substantial infrastructure spending, economic growth in the FSM has remained subdued and highly volatile. While FSM's average annual infrastructure spending, 12 percent of GDP in FY2004-19, is broadly in line with other PICs, it has not been accompanied by significant economic growth. Over this period, FSM's average growth rate was 0.3 percent, well below the 2.9 percent growth rate observed among other PICs.

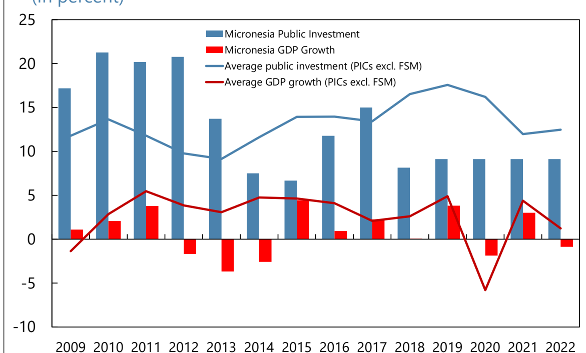
Several factors contributed to the weak relationship between investment and growth. Firstly, weaknesses in public investment management undermine the planning, implementation, and maintenance of investment. In the FSM, public investment has been characterized by high volatility, which can lead to reduced capital accumulation, inefficient resource allocation, and increased uncertainty for businesses. Secondly, barriers to private sector development—including business environment and labor shortages—also limit the potential benefits to sustainable economic growth. In particular, the increase in emigration has resulted in a chronic shortage of skilled labor and delay in investment projects. Thirdly, the remote geographical location makes it more challenging and expensive to implement projects (e.g. import of construction material). Finally, the FSM's vulnerability to climate change and natural disasters requires more attention to make the economy resilient to these risks.

Public Investment Vs. Growth



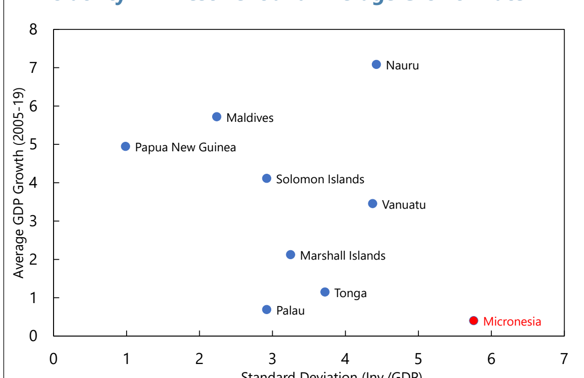
Sources: World Economic Outlook; and IMF staff calculations.

Public Investment and GDP Growth
(In percent)



Sources: World Economic Outlook; and IMF staff calculations.

Volatility in Investment and Average Growth Rate



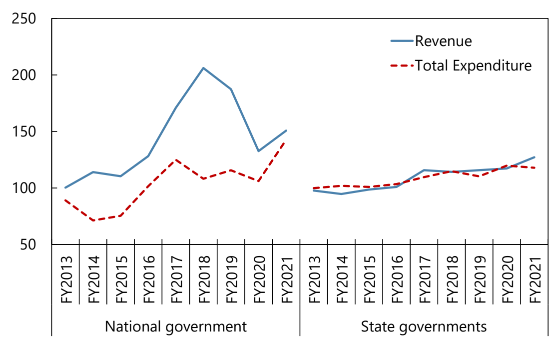
Source: World Economic Outlook

Staff analysis suggests that implementing reforms can lead to higher potential growth and lower vulnerability to climate shocks. Simulation results using the IMF's DIGNAD model indicate that potential growth could increase substantially by 2043 if public investment remains less volatile and efforts are made to address capacity constraints and improve PFM.[1] Additionally, investing in resilient infrastructure would help mitigate the loss of output caused by severe natural disasters.

[1] See Selected Issues Paper "Public Investment, Economic Growth and Resilience: A Model Based Approach"

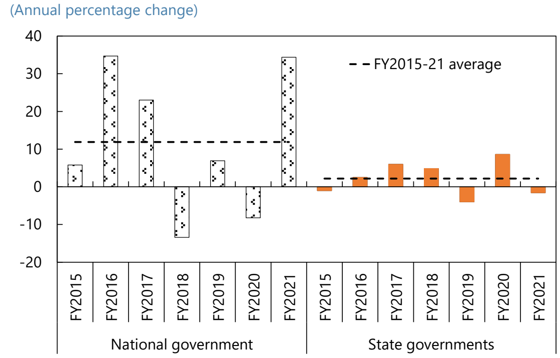
11. The medium-term fiscal outlook is much improved with the new COFA but will depend on the use of the Compact funds and revenue-sharing agreements. Once approved, the new agreement will bring substantial new resources to fund development and climate measures. Public debt dynamics will be on a much stronger and sustainable path—although risks remain, especially due to climate-related shocks (see Debt Sustainability Analysis). Under the revenue-sharing agreements, states will be the main beneficiaries of the new grants (see Annex IV). The agreement will require fiscal discipline at the national level, given the loss of revenues. This situation is a reversal from past years, when the national government benefited from surging revenues and states were facing tight budget constraints, as grants fell as share of GDP.

Fiscal: National and State Governments
(million USD)



Sources: FSM authorities and IMF staff estimates and calculations

Total Expenditure Growth: National and State Governments
(Annual percentage change)



Sources: FSM authorities and IMF staff estimates and calculations

12. Against this backdrop, a new medium-to long-term fiscal framework would help promote the growth and climate agendas, while ensuring long-term fiscal sustainability. [6] The fiscal strategy could include:

- Developing a stable and sustainable spending path over the medium term—to reduce volatility and preserve public services—and accumulating appropriate fiscal buffers to manage risks and save for future generations (as grants will fall over time as a share of GDP). The authority's broad policy goals appropriately involve preserving the large financial assets in the trust funds, limiting new borrowing, while scaling up public investment. It will also be important that the sharing of revenues and grants are done in a way that ensures a better equilibrium between spending responsibilities and revenue assignments at all levels of government.

- Strengthening capacity to plan and implement public spending, especially investment, and programs (including for core services like public utilities). A gradual increase in spending, in conjunction with the improvement in capacity, would be more effective. Continuing donor involvement is crucial to build capacity. In addition, improved public investment management could allow to scale up high quality public investment faster-than-projected to address the significant needs, including on climate adaptation. While this could lead to larger fiscal deficits in

[6] See also Selected Issues Paper.

early years, it would have significant benefits for debt dynamics over time given stronger growth dividends and greater resilience to natural disaster shocks.

- Addressing sustainability of the social security over time. Social security funds have been in a manageable deficit, but it can worsen if emigration persists. Reforms to promote private sector growth and reverse the fall in population could have a large positive impact.

13. Strengthening public financial management (PFM) would ensure better use of public resources, especially regarding public investment management.

- The ongoing implementation of the authorities' PFM reforms (2023-26 PFM Roadmap)[7] will promote better, sustainable policies. There has been good progress to strengthen the budget process that should help avoid excessive use of supplementary budgets. However, the delay on the new financial management information system if not addressed will significantly jeopardize progress. Over time, efforts to ensure regular and timely publication of budget documents, reports and fiscal statistics would help promote greater fiscal transparency and accountability—the planned publication of the first citizen budget is welcomed. It will also be useful to continue strengthening debt management.[8]

- Building capacity for public investment management (planning, allocation, and implementation), especially at the state level, is urgent to prevent past problems including long delays and waste. Developing multi-year plans would help ensure timely implementation and payments to contractors and adequate funding for the large maintenance needs.

14. Improving revenue administration and modernizing the tax system would help develop more stable revenue sources and support the private sector. A short-term priority is to implement the Tax Administration System (TAS) and the Automated System for Customs Data (ASYCUDA) to strengthen the administrative systems. Moving ahead with planned reforms—including the introduction of a VAT and the replacement of the turnover tax with a net profit tax—would make the tax system more efficient and raise stable tax collection in the future. This would help alleviate the tight budgetary constraints at the central level and prepare for when grants fall.

Authorities' Views

15. The authorities highlighted the uncertainty around the approval of the COFA and that the large climate-related needs will put pressure on the budget. They confirmed that the continuous resolutions (CRs), approved by the US congress, temporarily offered COFA-

[7] The government published a 2023-26 reform roadmap to address key PFM weaknesses. Among the key reforms are (i) implement a new financial management information system; (ii) strengthen budget regulations and procedures; (iii) frequent publication of budget reports and fiscal statistics; and (iv) strengthen debt management.

[8] Since December 2021, the Government has been publishing debt bulletins with information on size and composition of public and publicly guaranteed debt.

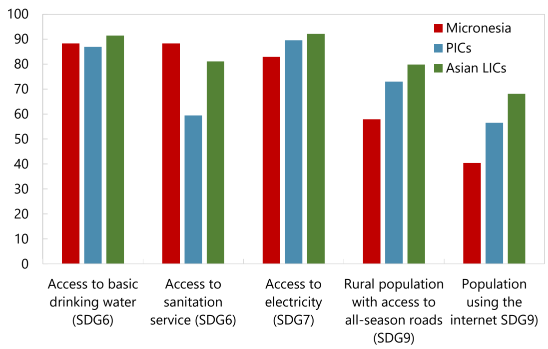
related current grants and services at the FY2023 levels, and that unspent capital grants from the expired COFA are allowing to press ahead with large projects in health and education sectors. However, they noted that disbursements under the CRs are slow and putting pressure on all levels of government (especially for current spending). They noted that the new COFA, as agreed, falls significantly short of their initial request, hence, significant pressure on the budget is expected from climate-related needs and capital investments needed to escape the low-growth scenario.

16. The authorities stressed they aim to preserve the large financial assets in the trust funds for the future even while the central government faces tighter budgetary constraints. The new revenue-sharing rules will reduce the share of revenues at the central government, while the previously mandatory contributions to the FSM trust fund have been repealed (fishing royalties and CIT revenue). The authorities noted they still plan to preserve the financial assets in the trust funds and limit government debt, but this stance is becoming increasingly challenging given elevated fiscal needs. They acknowledged the planning and implementation capacity needs to be improved to scale up their investment and underscored the shortage of skilled workers and geographical challenges. They noted the ongoing efforts to implement the PFM roadmap and promote better coordination among all levels of government to improve the implementation of public investment despite the challenges.

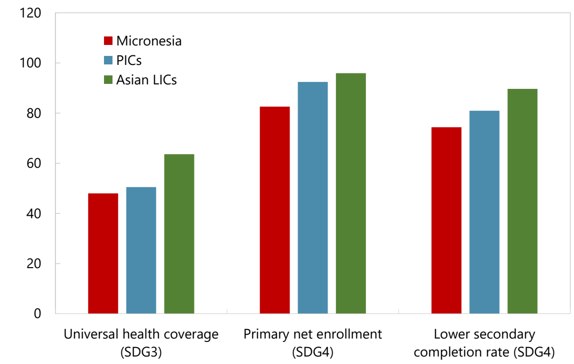
B. Structural Reforms to Boost Private Sector Growth

17. Tackling the obstacles to private sector growth should be the key driver of the transformative reform agenda. The private sector remains substantially underdeveloped. Besides the country's geographical challenges, there are significant obstacles hindering private sector growth, FDI and job creation. These challenges primarily arise from a substantial regulatory burden on investments and new businesses, limited education and technical skills, ageing infrastructure, expensive and unreliable energy provision, and limited health services. Barriers to FDI, which is almost nonexistent, impede the development of large projects that could boost growth and jobs. Progress in addressing longstanding issues, including the land reform and adopting a new Foreign Investment Act, remains slow (Annex I). Furthermore, despite some progress towards achieving the Sustainable Development Goals (SDGs), the FSM lags its peers, including on education and infrastructure. In particular, the population with access to the internet and all-season roads remains significantly below peer countries reflecting weak infrastructure which hinders private sector growth and employment opportunities.

Sustainable Development Goals in Infrastructure, 2023



Sustainable Development Goals in Health and Education, 2023



Source: United Nations Sustainable Development Report, 2023.
Note: Scores range from 0 (worst) to 100 (best performer) following Sachs et al (2020). Column plots indicate the means for PICs and LICs in Asia.

18. Developing a comprehensive strategy and undertaking long-standing reforms would boost private sector growth resulting in more jobs. This will require prioritizing and building wide support for difficult reforms towards:

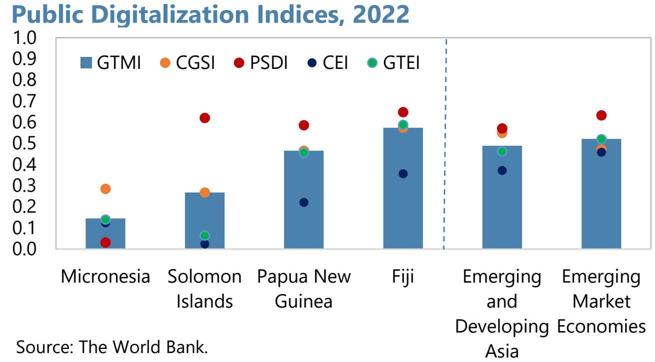
- Improving the business environment (e.g., reduce business startup costs, improve the quality of the judicial process, and enhance coordination across states). Ensuring reliable supply of basic services (energy, water, sanitation) is also critical. Furthermore, providing adequate funding to public utilities, and allowing more flexibility to charge tariffs, is key so they can cover operational and maintenance costs and implement needed investment to replace ageing infrastructure.

- Creating an environment supportive to FDI, which is critical to bring additional financial and human resources and know-how. These will include amending the Foreign Investment Act and overcoming resistance to land reforms aimed at reducing barriers to foreign ownership of business and use of land.

- Improving human capital by investing more on education and skills development programs, including business skills. Promoting entrepreneurship and innovation can improve productivity and lead to more job creation.

19. Improving digitalization would unlock new pathways for rapid economic growth, innovation, job creation, and access to services. Internet accessibility remains low, and the FSM lags its peers in the digital transformation in the public sector. Improving digital usage could raise labor force participation, enhance

Public Digitalization Indices, 2022



Source: The World Bank.
Note: GTMI=GovTech Maturity Index, CGSI=Core Government Systems Index, PSDI=Public Service Delivery Index, DCEI=Digital Citizen Engagement Index, GTEI=GovTech Enablers Index.

education and health outcomes, and accelerate private sector development (Annex V). There are several important initiatives ongoing—including recent liberalization of the telecom sector, connecting homes and business to faster internet access in the main islands, and developing satellite alternatives for the outer islands—that once fully implemented could have large benefits. FSM will also benefit from international efforts to build submarine cables to link different pacific island countries. The government has started efforts towards greater digitalization and while it will take time given capacity constraints, the potential social and economic benefits can be large.

Authorities' Views

20. The authorities agreed that promoting private sector development was crucial for economic growth and job creation. They acknowledged challenges with outward emigration due to lack of well-paying private sector jobs and agreed with the need to tackle longstanding reforms, including land reform, and opening to foreign investors. However, they noted that the issues are complex, and require building consensus with the states, and domestic business sector, on crucial reforms–especially, regarding land ownership. The authorities emphasized the importance of economic diversification. They have initiated work on a long-term development plan with priority areas in the marine economy, tourism, agriculture, education, energy, and infrastructure. However, implementation success of these policy reforms will require significant financial resources, beyond what is current available.

21. The authorities recognized the necessity to enhance digital connectivity and agreed on its importance, including to improve public services. Considering the limited transportation options between the islands in the nation, improving digital connectivity is crucial for economic development. They also noted that ongoing initiatives, such as the digitalization project in partnership with the World Bank, would contribute to expanding internet access and ensuring affordability.

C. Financial Sector Development

22. The FSM's financial sector is generally sound but plays a limited role in supporting economic development. Addressing bottlenecks to credit supply and demand will take time but would support the efforts to boost private-sector led growth. Loans to firms and households represent a small portion of total commercial bank assets and bank capital remains well above prudential limits. The banking sector is generally sound and has a large deposit base, around 100 percent of GDP, but the size of loans remains very limited at around 12 percent of deposits.[9] The low domestic lending activity reflects to a large degree the informal nature of most businesses (SMEs without proper accounting and management skills) and restrictions on land ownership and transactions that limit collateral availability. In addition to these, enhancing financial inclusion and literacy, and promoting digitalization and e-banking would be beneficial.

[9] Excluding around 38% of total loans offered to customers abroad.

23. Strengthening the FSM Development Bank (FSMDB) would help balance its policy objectives and maintain sound finances. The FSMDB has around 7 percent of GDP in outstanding loans, and more than 60 percent of the bank's loans are extended to private enterprises, mainly SMEs. It has played a role in supporting the riskier sectors of the economy (especially tourism), but the quality of its assets was hit by the pandemic. The proportion of non-performing loans (NPLs), after spiking in 2022, has fallen to 37 percent by October 2023, following the restructuring of loans—and has tourism recovers, it should further help strengthen the balance sheet—during the same period, FSMDB increased its loan loss provisions to NPLs to 53 percent. The FSMDB was recently accredited by the Green Climate Fund (GFC) which will help access climate financing. Enhancing the institutional framework for the FSMDB and addressing gaps in corporate governance would promote an appropriate balance between policy goals, including more action on climate efforts, and risk management.

24. Over time, as the financial sector expands, it will be important to ensure that lending to the private sector is under prudential regulatory frameworks for both commercial banks and non-banking credit institutions. The US FDIC's insurance and supervisory role over the two commercial banks continues despite the expiration of the COFA, which helps ensure the soundness of the system. Nevertheless, extending the FSM Banking Board (FSMBB) supervisory authority and placing FSMDB and credit unions under its supervision, and introducing prudential regulation for non-banking credit institutions, would help protect consumers and contain possible future fiscal and financial risks. It would also be useful the FSMBB continues upgrading its legal and regulatory framework, including developing supervisory tools adjusted for FSMDB's specific business model.

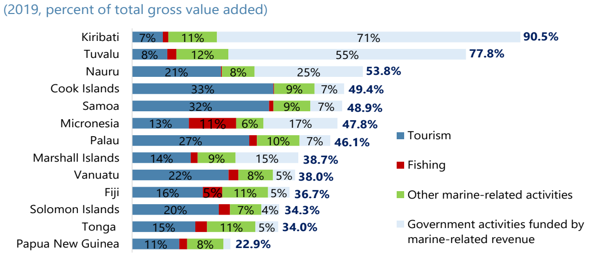
Authorities' Views

25. The authorities agreed the banking sector is sound and noted the ongoing efforts to strengthen the FSM banking board. While agreeing with staff on the main bottlenecks, they noted the possibility of lowering lending rates to promote credit provision to private sector. In addition, the authorities requested IMF Technical Assistance to continue help FSMBB to upgrade its legal and regulatory framework, including possibly placing FSMDB under its umbrella for regulation and supervision.

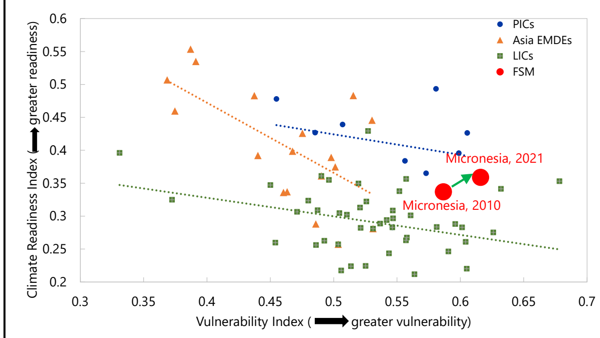
D. Climate Adaptation

26. Addressing FSM's high exposure to climate shocks will require greater investment towards climate adaptation. FSM's high exposure to extreme climatic events can result in losses in agriculture output, increase vulnerability of critical infrastructure, reduce labor productivity, and have negative effects on human health. Furthermore, rising ocean temperatures and

Share of Blue Economy in Total Gross Value Added
(2019, percent of total gross value added)



Source: Gonguet and Zhou (forthcoming), based on EMERGING database, IMF IFS database, and authorities' data.



Source: Notre Dame Global Adaptation Initiative.

acidification pose risks to the marine environment and resources, affecting the fishing sector (and fiscal revenues)—the "blue economy" represents a large share of FSM. The decline in tuna catches, due to climate change, could have large GDP losses (see Selected Issues Paper). The FSM has made progress on mitigation, but adaptation investment has been hindered by capacity constraints, limited policy coordination, high costs and weak public financial management.[10] Integrating climate adaption in investment projects has proved burdensome and costly. The new COFA will provide some financial support, alleviating to some degree the financing constraints in the years ahead.

27. Implementing a comprehensive National Adaptation Plan (NAP) in coordination with states is a key step to an effective climate agenda. Although some work has been undertaken, there are multiple challenges due to capacity constraints and lack of coordination. The development of the NAP with the support of the GFC is in an early stage, while progress in setting up a Presidential Sustainable Development Council—responsible for policies pertaining to climate change and climate finance—is underway. To be more effective, the NAP should be closely coordinated with other ongoing development initiatives, including by incorporating climate adaptation measures in the budget and PFM processes.

28. Scaling up initiatives in the agriculture sector would help address food security. Climate change is threatening FSM's food security due to degradation of arable land, crop losses, and saltwater intrusion. There are a few pilot projects funded by the GCF to test crop varieties resistant to salt water with support from several agencies. The international community is also helping in setting up field trials for root crops in the states. While these initiatives are promising, further efforts to ensure food security are required, including donor support to develop climate-resilient crops.

29. Other efforts to make the economy more resilient include the adoption of new building codes, and the strengthening of early warning systems and post-disaster assistance. Improving administrative capacity and adopting building codes, land use policies, and hazard mapping will be essential to enhance the climate adaptation strategy. A strengthening of the early warning systems will be required for a timely and effective response to natural disasters, as will the establishment of disaster contingency fund. Coordination with international partners could help in implementing projects and developing multilateral risk-sharing mechanisms.

[10] The IMF's Climate Change Assessment Policy (CCPA; 2019) estimated total financing needs of US$1.1-1.3 billion.

Authorities' Views

30. The authorities agreed with the significant risks posed by climate change and the adverse impact on the economy, including fishing sector, and food security. They agreed that climate adaptation investment is needed and should be part of the project components, however, the cost of integrating climate adaptation in infrastructure projects is very expensive. The authorities further agreed that NAP should be accelerated including a holistic approach that involves State and National Government initiatives to make FSM more resilient to the risk associated with climate change. They highlighted that access to climate finance has been challenging, and despite global promises and ambitions to fight climate change, the flow of climate finance from global sources has been extremely slow with excessive access requirements.

E. Other Issues

31. Addressing data weaknesses would help strengthen the effectiveness of public policies, increase transparency and accountability and enhance macroeconomic surveillance. Despite some improvements, there are still significant capacity constraints and legal hurdles to having comprehensive and timely economic statistics. Many macroeconomic statistics are only available with substantial time lags. The long delays result from the lack of resources at the statistic agency, legal hurdles to access critical data from other agencies, and delays on audits of the public sector financial statements.

32. Efforts are needed to improve the data collection process, strengthen the capacity of the statistical agency, and promote greater disclosure of data across all government levels and agencies. Legal and regulatory measures could be taken to facilitate and promote data sharing and collaborations between various agencies and states. Technical Assistance (TA) has resumed since 2022 in macroeconomic programing, tax administration and government finance statistics. Further capacity building on PFM and public investment management, financial sector supervision and macroeconomic projections would help address FSM's challenges.

Authorities' Views

33. The authorities acknowledged the importance of reliable and timely data collection and appreciated IMF and PFTAC TA support. They highlighted that the recent delay in data collection was mainly due to the lingering effects of the COVID-19 and border closure and that substantial progress had been made recently. They also noted ongoing efforts to set up a new statistical website that will help with increasing transparency. They also expressed interest in receiving TA to strengthen their capacity in compiling various macroeconomic statistics and reiterated the need for long-term in country-based TA as the best model for sustainable capacity development for small islands like Micronesia.

STAFF APPRAISAL

34. Economic growth in the near term is expected to accelerate, but medium-term prospects remain challenging. The economy is expected to continue to rebound after the Covid-related border closures ended and as large public infrastructure projects are implemented. However, in the absence of structural reforms, economic growth is likely to return to past low levels in the medium term and the outward migration trend could accelerate. The greater impact of climate change, including on food security, adds urgency to adaptation efforts.

35. The new COFA presents an opportunity to adopt a transformative reform agenda anchored on a vibrant private sector and an enhanced climate resilient strategy. Long-standing challenges have been exacerbated by Covid-19, which raises the urgency of reforms to spur private sector jobs and reverse the trend of outward migration. The new COFA, when approved, will ensure critical resources for infrastructure investment and the climate policy agenda. However, the increased spending will need to be accompanied by ambitious reforms to raise sustainable, private sector-led economic growth. Such reforms will require building broad domestic consensus and support from the international community.

36. In the short term, fiscal policy conduct should remain cautious until the new COFA is implemented. Keeping current spending stable, while gradually increasing public investment funded by existing grants would be prudent and consistent with capacity constraints to implement large projects. Pressing ahead with the implementation of the authorities' 2023-26 PFM reform roadmap, and increasing budget transparency, would help ensure more efficient spending and greater accountability.

37. A new fiscal framework would help to better manage public resources and strengthen their growth impact, while ensuring long-term fiscal sustainability. A comprehensive medium-to long-term fiscal framework would help better plan the use the resources more effectively and enhancing risk management. Developing public investment management is crucial to get more growth dividends from public investment. Strengthening revenue administration and modernizing the tax system will help develop more stable revenue sources.

38. Decisive reforms are needed to support private sector development. Boosting private sector growth should be the key driver of the transformative reform agenda. A comprehensive approach is needed, including improve the business environment, ensure reliable supply of basic services, further invest in education and training, and digitalization. Creating an environment supportive to FDI is critical to bring additional financial and human resources and know-how but will require overcome ingrained resistance by states and some vested interests. Together with land reform, these are crucial to promote higher economic growth, innovation, and job creation. In addition, while the current account is assessed as substantially stronger than the level implied by fundamentals and desirable policies, the current strength is driven by a few and highly volatile factors, and the current account is expected to deteriorate in the medium term. The structural reforms proposed by staff would help diversify the export base and reduce external risks.

39. The financial sector could play an increased role to support economic development. Strengthening the private sector, especially the formal sector with necessary accounting standards and capacity to develop business plans, will be a necessary step for further financial deepening. Measures to enhance financial inclusion and literacy and promote e-banking would be beneficial. Placing the FSMDB and credit unions under the FSM Banking Board's regulation and supervision would help strengthening the financial system and protect consumers.

40. Investment in climate adaptation is crucial given the high exposure to climate shocks and safeguarding food security. The development and implementation of a comprehensive National Adaptation Plan (NAP), involving state and national government, should aim to better coordinate climate policies and access climate finance. It will also be important to ensure the climate and other ongoing development initiatives are closely coordinated, including by incorporating climate adaptation in the budget and PFM processes. To improve resilience to climate change, should also strengthening early warning systems, improving administrative capacity, and upgrade safety nets for post-disaster assistance.

41. Prompt actions are required to address data weakness. Improving economic statistics will take time, given the need to build capacity, but some steps can be accelerated to address the large delays since Covid. This includes promote greater disclosure of data across all government levels and agencies and having timely audits. Legal and regulatory measures could be taken to facilitate and promote data sharing and collaborations between various agencies and states.

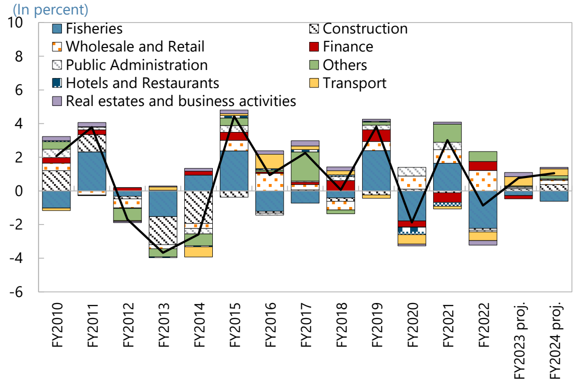
42. It is recommended that the next Article IV consultation take place on the current 24-month cycle.

Figure 1. Federated States of Micronesia: Real Sector Developments

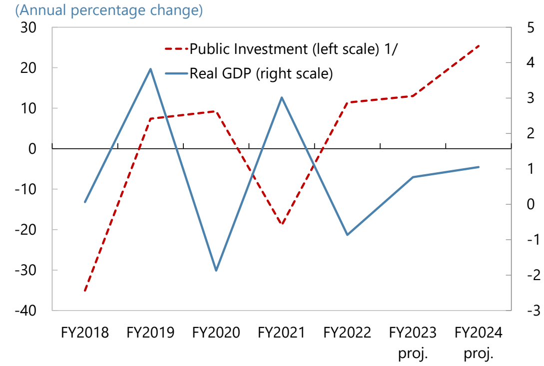
The FSM economy has rebounded after the border reopening…

…largely driven by resuming public projects.

Contribution to Growth
(In percent)



Public Investment and Growth
(Annual percentage change)

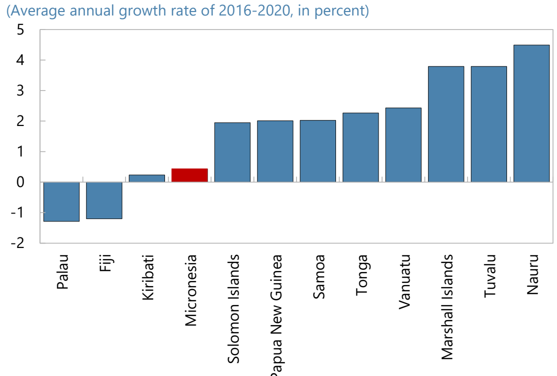


1/ Net acqusition of non-financial assets and consumption of fixed capitals

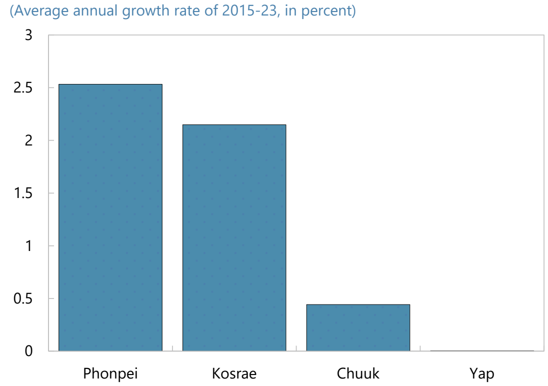
However, the growth of FSM's real GDP has lagged its peers, suggesting low long-term growth.

The real GDP growth has been heterogeneous across states.

Real GDP Growth Rate
(Average annual growth rate of 2016-2020, in percent)



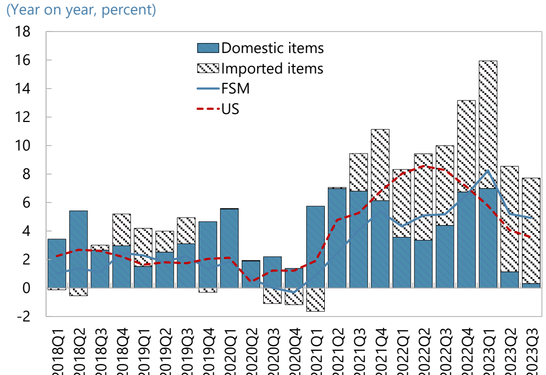
Real GDP Growth Rate by States
(Average annual growth rate of 2015-23, in percent)



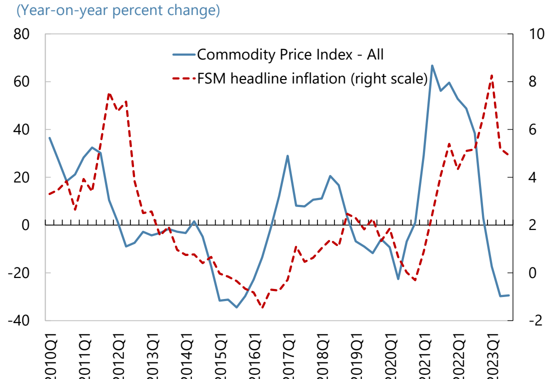
Inflation increased due to high imported prices…

…with the lagged impact of elevated global commodity prices.

Inflation Rate
(Year on year, percent)



Global Commodity Price and FSM Headline Inflation
(Year-on-year percent change)

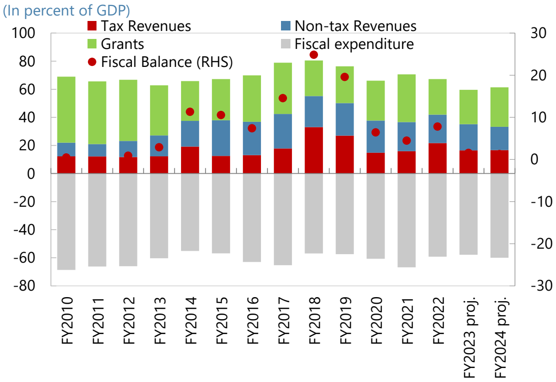


Sources: FSM authorities; IMF World Economic Outlook database; and IMF staff estimates and calculations.

Figure 2. Federated States of Micronesia: Fiscal Developments

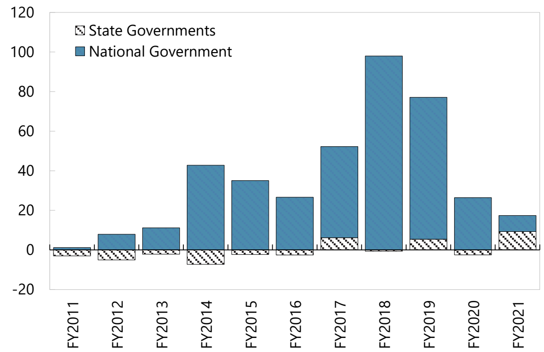
Fiscal balances have been in a surplus thanks to revenue windfalls and foreign grants.

Fiscal Balance
(In percent of GDP)



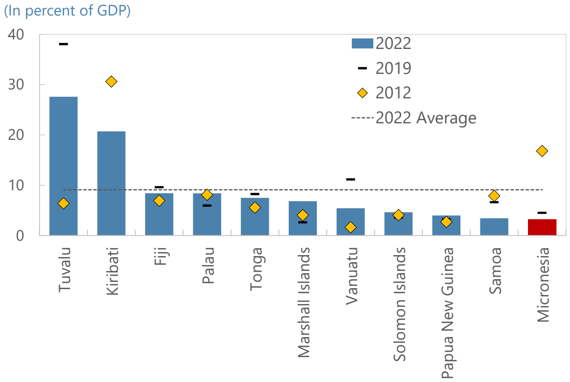
The fiscal surplus was mainly driven by the national government, amid balanced budget in state governments.

Fiscal Balance: National and State Governments
(In millions of USD dollars)



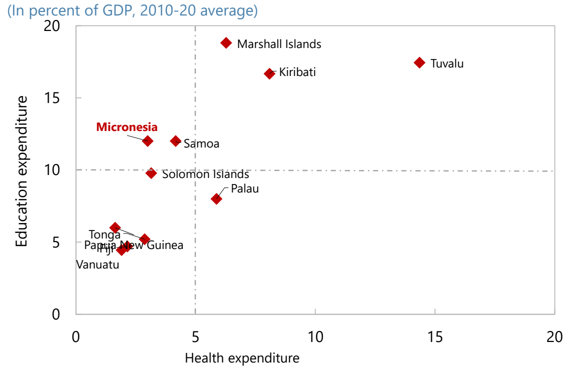
Nevertheless, capital spending has been subdued.

Government Capital Expenditure
(In percent of GDP)



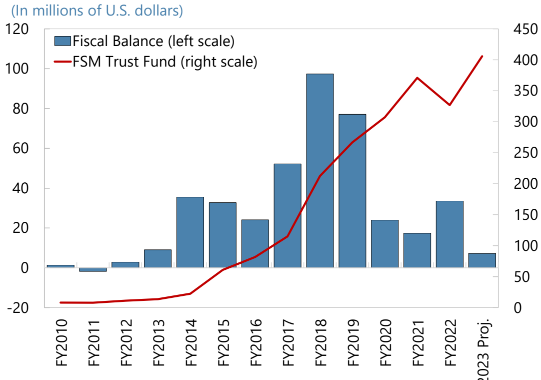
Public spending on health is low, while education expenditure is relatively high.

Pacific Islands: Public Expenditure in Health and Education
(In percent of GDP, 2010-20 average)



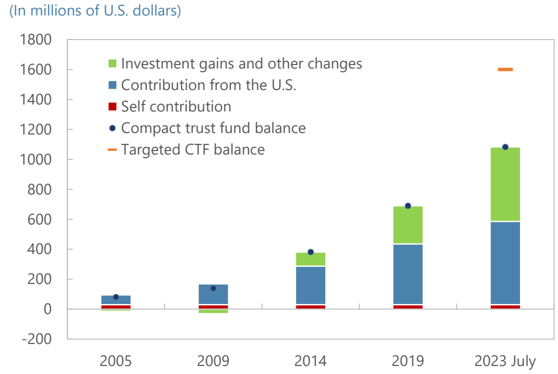
Instead, the FSM's trust fund balance has been accumulating significantly amid large fiscal surpluses.

Trust Fund Balance
(In millions of U.S. dollars)



Compact trust fund (CTF) balances have also risen but are likely to fall short of the 2023 target.

Compact Trust Fund Outstanding
(In millions of U.S. dollars)

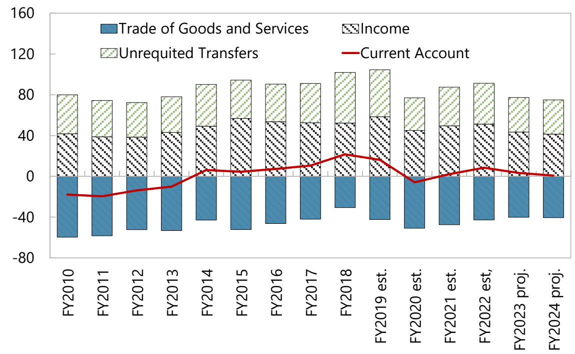


Sources: FSM authorities, World Bank's World Development Indicator database, Gratcheva and Emery (2021), and IMF staff estimates.

Figure 3. Federated States of Micronesia: External Sector Developments

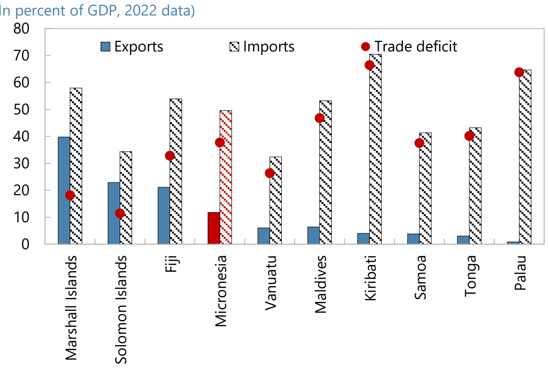
The current account balance registered a surplus in recent years, supported by rising fishing license fees, large foreign grants and corporate tax windfalls.

Balance of Payments
(In percent of GDP)



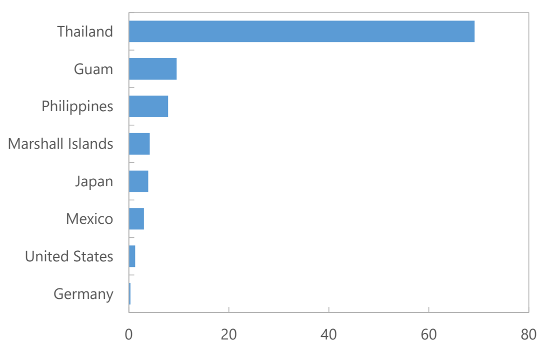
Limited exports and local production led to large trade deficits.

Trade Balances
(In percent of GDP, 2022 data)



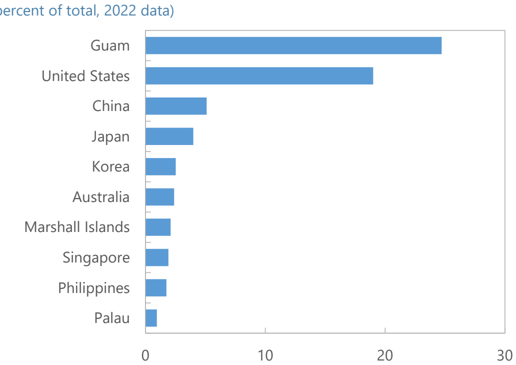
The FSM's main export partners are related to the fishing industry's supply chains.

Exports by Trading Partners
(In percent of total, 2022 data)



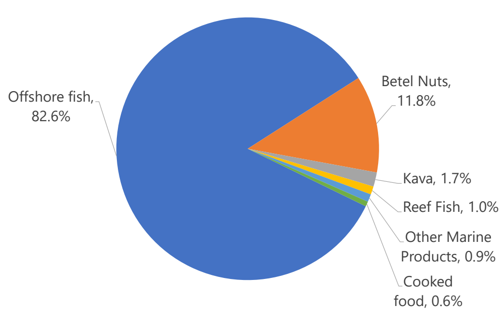
Imports come mostly from the Guam and the United States, reflecting proximity and strong economic ties.

Imports by Trading Partners
(In percent of total, 2022 data)



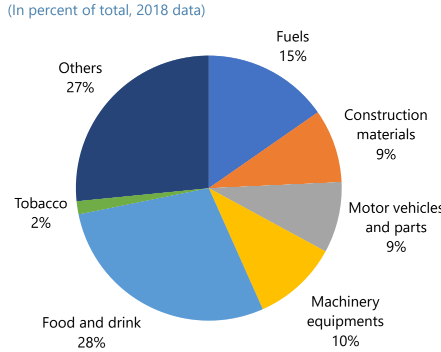
Offshore fish remains the FSM's primary export good.

Main Export Products
(In percent of total, 2018 data)



The FSM's import basket is diversified.

Main Import Products
(In percent of total, 2018 data)

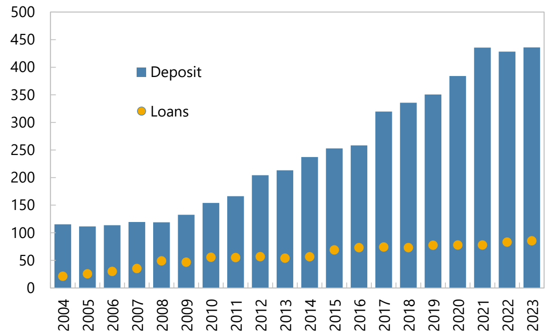


Sources: FSM Statistics, IMF Direction of Trade Statistics, IMF World Economic Outlook database, and IMF staff calculations.

Figure 4. Federated States of Micronesia: Monetary and Financial Sector Developments

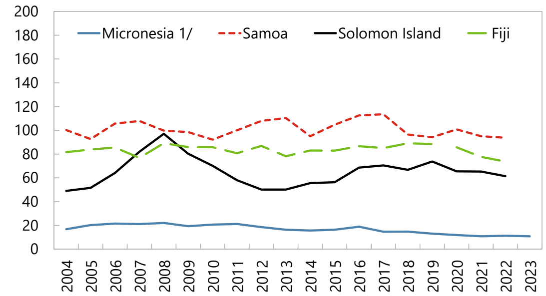
The FSM's bank deposits continued to grow in recent years, but loans were relatively flat.

Commercial Bank Deposits vs. Loans
(In millions of U.S. Dollars)



As a result, the loan-to-deposit ratio remains at historically low levels.

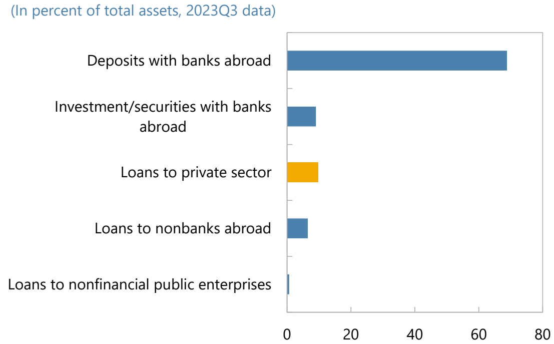
Loan-to-Deposit Ratio
(In percent)



1/ Excludes loans to non-banks abroad.

Excess deposits were invested in deposits and investment securities with banks abroad.

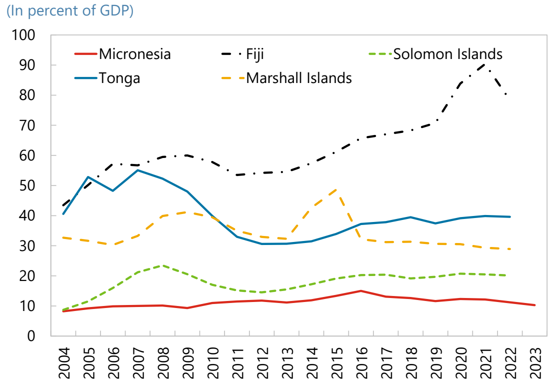
Major Components of Commercial Bank Assets 1/
(In percent of total assets, 2023Q3 data)



1/ Comprises two commercial banks in FSM.

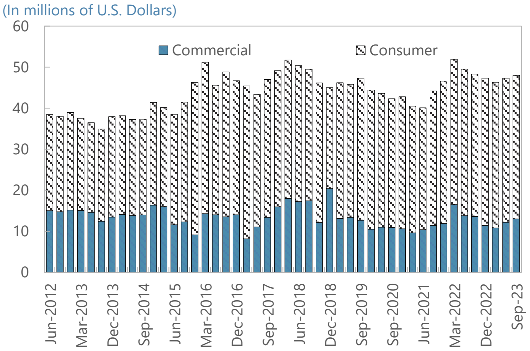
Financial deepening lags peers.

Commercial Bank Credit to Private Sector
(In percent of GDP)



Domestic lending is dominated by consumer credit.

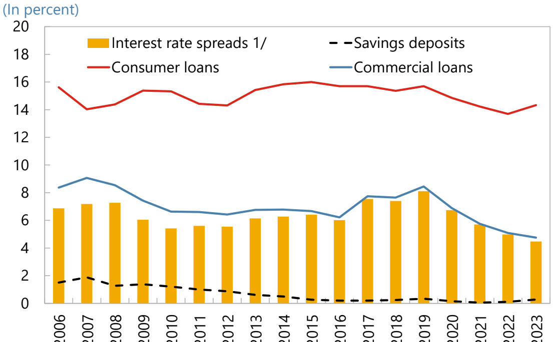
Private Loan Distribution 1/
(In millions of U.S. Dollars)



1/ Comprises commercial banks' domestic lending to private sector.

High credit spreads continued to hinder access to credit.

Interest Rates
(In percent)



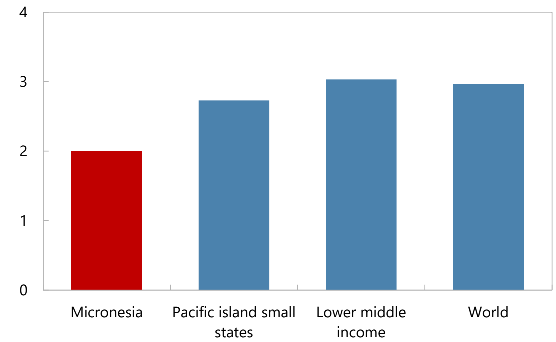
1/ Difference between interest rates for commercial loans and savings deposits.

Sources: FSM Banking Board, IMF World Economic Outlook database, and IMF staff calculations.

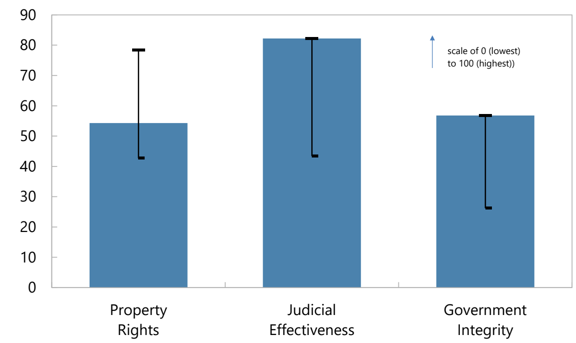
Figure 5. Federated States of Micronesia: Bottlenecks to Growth 1/

The FSM's structural bottlenecks remain large, including heavy regulatory burdens for businesses and weak institutions.

Business Regulatory Environment
(2019-2021 average, 1=lowest to 6=highest)

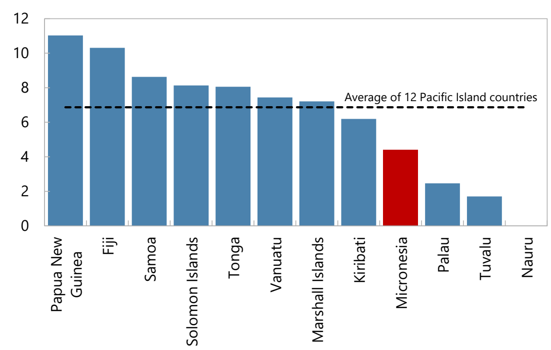


Rule of Law
(2021-2023 average, black line shows the score range for 8 Pacific Island countries)



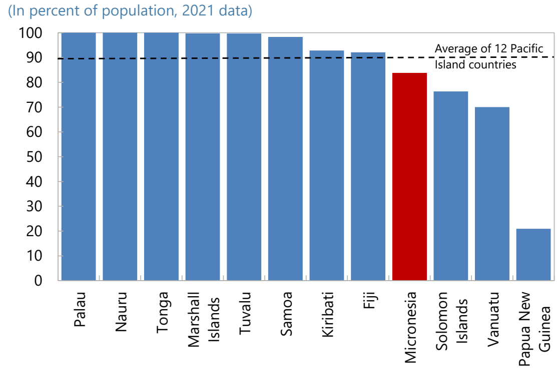
The FSM's geographical dispersion and remoteness hinders physical connectivity.

Liner Shipping Connectivity Index
(Maximum value = 100, 2021 data)



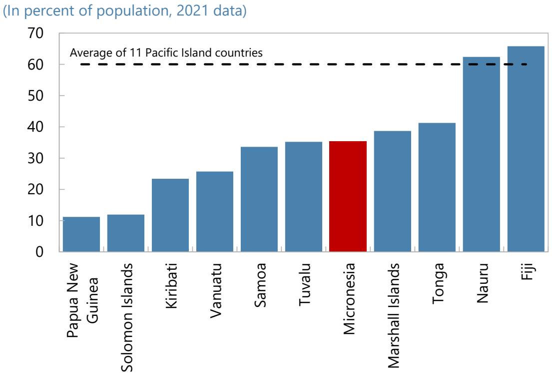
The availability of essential infrastructure lags peers.

Access to Electricity
(In percent of population, 2021 data)

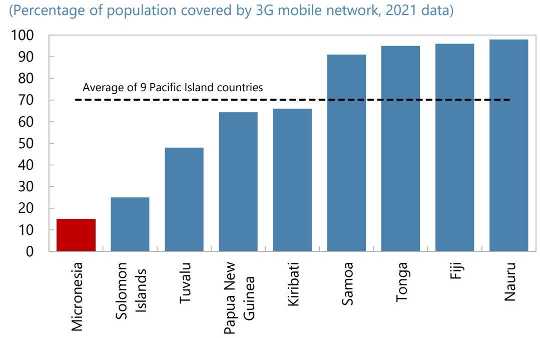


Digital and mobile technology could enhance the FSM's connectivity, but the country is lagging in terms of access.

Individuals using the Internet
(In percent of population, 2021 data)



3G Mobile Network
(Percentage of population covered by 3G mobile network, 2021 data)



Sources: World Bank's Country Policy and Institutional Assessment (CPIA), World Development Indicator database, World Telecommunication/ICT Indicators database, and Terry Miller, Anthony B. Kim and James M. Roberts, *Index of Economic Freedom* (Washington: The Heritage Foundation).

1/ The World Bank's CPIA assess the conduciveness of a country's policy and institutional framework to poverty reduction, sustainable growth, and the effective use of development assistance. The rule of law indicators are components of the Heritage Foundation's Economic Freedom Index, reflecting the country's business climate. Non-IMF indicators provide qualitative information about country policy and institutional framework. They do not represent the IMF's assessment of the quality of policies and institutions.

Table 1. Federated States of Micronesia: Selected Economic Indicators, FY2021-25 1/

Nominal GDP (FY2022):	US$430 million
Population (FY2022):	94,768
GDP per capita (FY2022):	US$4,540
IMF Quota:	SDR 7.2 million

	FY2021	FY2022	FY2023	FY2024	FY2025
	Est.	Est.	Projections		
Real sector (annual percent change)					
Real GDP	3.0	-0.9	0.8	1.1	1.7
Consumer prices	1.8	5.0	6.2	4.0	3.0
Consolidated government finance (in percent of GDP)					
Revenue and grants	71.3	67.0	59.4	61.2	65.4
Revenue	37.3	41.7	34.9	33.1	34.0
Tax revenue	15.9	21.7	16.5	16.7	16.9
of which: corporate income tax	2.9	9.5	4.6	4.6	4.6
Non-tax revenue	20.6	20.0	18.5	16.5	17.0
of which: Fishing license fees	17.7	17.0	15.4	13.4	14.0
Grants 2/	33.9	25.3	24.5	28.1	31.4
Expenditure	66.8	59.2	57.9	60.0	65.8
Expense	63.6	55.5	53.4	53.3	57.2
Net acquisition of nonfinancial assets	3.2	3.7	4.5	6.7	8.5
Gross Public Investment	9.4	9.5	10.0	12.0	13.5
Net lending/borrowing	4.5	7.8	1.6	1.3	-0.4
Net lending/borrowing (excl. grants)	-29.5	-17.5	-22.9	-26.8	-31.8
Public debt (outstanding stock, end of period)	17.0	14.6	12.4	10.6	10.6
Balance of trust funds 3/	351.5	287.7	323.2	330.9	381.0
Commercial banks (in percentage of GDP; end of period)					
Loans /4	13.3	12.8	11.1	11.3	11.5
Deposits	111.7	99.5	96.2	94.2	92.9
Interest rates (in percent, average for FY)					
Consumer loans	14.2	13.7	14.3	…	…
Commercial loans	5.8	5.1	4.8	…	…
Balance of payments (in millions of U.S. dollars)					
Trade balance	-161.4	-162.4	-169.9	-181.0	-203.5
Net services and income	22.2	26.5	29.3	21.9	26.4
Private and official transfers	147.7	172.4	155.9	162.8	180.9
Current account	8.5	36.6	15.3	3.7	3.8
(in percent of GDP)	2.2	8.5	3.3	0.8	0.8
External debt (in millions of U.S. dollars; end of period)					
Outstanding stock	62.9	59.4	54.3	49.2	51.3
(in percent of GDP)	16.1	13.8	11.8	10.2	10.1
Memorandum items:					
Real effective exchange rate 5/	100.9	106.9	114.8	…	…
Nominal GDP (in millions of U.S. dollars)	390.0	430.2	460.5	484.0	507.1

Sources: FSM authorities and IMF staff estimates and calculations.
1/ Fiscal year ends on September 30. Data for FY2019-22 is estimate from authorities and subject to revision.
2/ Excludes contributions to the Compact Trust Fund.
3/ Compact Trust Fund and FSM Trust Fund.
4/ Includes only domestic lending and does not account for loans to customers outside the country.
5/ Calendar year. 2010=100. The U.S. dollar is legal tender and the official currency.

Table 2a. Federated States of Micronesia: General Government Operations, FY2021-25 1/

(In millions of U.S. dollars)

	FY2021	FY2022	FY2023	FY2024	FY2025
	Est.	Est.	Projections		
Revenue	277.9	288.5	273.6	296.4	331.5
Tax revenue	62.0	93.5	75.9	80.7	85.9
Wage and salary tax	10.6	10.7	12.1	13.1	14.1
Gross revenue tax	23.4	24.8	27.1	28.5	29.9
Corporate Tax	11.2	41.0	21.0	22.1	23.1
Import taxes	16.4	16.5	15.2	16.5	18.3
Other taxes	0.4	0.4	0.4	0.5	0.5
Grants 2/	132.4	108.9	112.7	136.0	159.1
Current	132.0	108.1	106.4	119.9	133.8
U.S. Compact sector grants	70.3	70.8	73.3	73.3	89.3
Other U.S. grants	34.1	20.9	22.2	23.0	23.7
Other	27.6	16.5	10.9	23.6	20.8
Capital	0.4	0.8	6.4	16.1	25.4
U.S. Compact sector grants	0.2	0.6	3.5	10.0	20.0
Other U.S. grants	0.1	0.1	0.1	0.2	0.2
Other	0.0	0.0	2.7	5.9	5.2
Other	0.0	0.0	0.0	0.0	0.0
Non-tax revenue	80.2	86.1	85.0	79.7	86.4
Fishing license fees	69.0	73.0	71.0	65.0	71.0
Dividend and interest income	-1.4	0.6	0.6	0.7	0.7
Other nontax revenues	12.6	12.5	13.4	14.1	14.7
Distributions from trust funds	0.0	0.0	0.0	0.0	0.0
Other	12.6	12.5	13.4	14.1	14.7
Expenditure	260.5	254.9	266.4	290.3	333.5
Expense	248.0	238.9	245.9	258.0	290.3
Wages and salaries	86.1	89.8	99.2	110.2	122.0
Purchases of goods and services	89.8	94.2	106.1	111.5	131.8
Interest payments	0.9	0.6	0.6	0.6	0.5
Subsidies	2.9	2.7	2.8	3.0	3.1
Grants	9.6	8.7	9.7	5.2	5.5
Other expenses	58.8	42.8	27.5	27.4	27.3
Net acquisition of nonfinancial assets	12.5	16.0	20.5	32.3	43.2
Gross Public Investment	36.7	40.9	46.2	57.9	68.7
Gross operating balance	29.9	49.6	27.7	38.4	41.2
Net lending/borrowing	17.4	33.6	7.2	6.1	-2.0
Memorandum items:					
U.S. Compact sector grants	70.6	71.4	76.8	83.3	109.3
Other U.S. grants	34.3	21.0	22.3	23.2	23.9
Net lending/borrowing excluding:					
Total grants	-115.0	-75.4	-105.5	-129.8	-161.2
U.S. grants	-87.4	-58.9	-91.8	-100.3	-135.2
Balance of trust funds	1,370.7	1,237.8	1,488.3	1,601.6	1,931.7
Compact Trust Fund	999.8	910.7	1,082.5	1,175.6	1,484.3
FSM Trust Fund	371.0	327.0	405.8	426.1	447.4
Nominal GDP	390.0	430.2	460.5	484.0	507.1

Sources: FSM authorities and IMF staff estimates and calculations.

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

2/ Excludes contributions to the Compact Trust Fund.

Table 2b. Federated States of Micronesia: General Government Operations, FY2021-25 1/

(In percent of GDP)

	FY2021	FY2022	FY2023	FY2024	FY2025
	Est.	Est.		Projections	
Revenue	71.3	67.0	59.4	61.2	65.4
Tax revenue	15.9	21.7	16.5	16.7	16.9
Wage and salary tax	2.7	2.5	2.6	2.7	2.8
Gross revenue tax	6.0	5.8	5.9	5.9	5.9
Corporate Tax	2.9	9.5	4.6	4.6	4.6
Import taxes	4.2	3.8	3.3	3.4	3.6
Other taxes	0.1	0.1	0.1	0.1	0.1
Grants 2/	33.9	25.3	24.5	28.1	31.4
Current	33.9	25.1	23.1	24.8	26.4
U.S. Compact sector grants	18.0	16.4	15.9	15.1	17.6
Other U.S. grants	8.8	4.8	4.8	4.8	4.7
Other	7.1	3.8	2.4	4.9	4.1
Capital	0.1	0.2	1.4	3.3	5.0
U.S. Compact sector grants	0.1	0.1	0.8	2.1	3.9
Other U.S. grants	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.6	1.2	1.0
Other	0.0	0.0	0.0	0.0	0.0
Non-tax revenue	20.6	20.0	18.5	16.5	17.0
Fishing license fees	17.7	17.0	15.4	13.4	14.0
Dividend and interest income	-0.4	0.1	0.1	0.1	0.1
Other nontax revenues	3.2	2.9	2.9	2.9	2.9
Distributions from Compact Trust Fund	0.0	0.0	0.0	0.0	0.0
Other	3.2	2.9	2.9	2.9	2.9
Expenditure	66.8	59.2	57.9	60.0	65.8
Expense	63.6	55.5	53.4	53.3	57.2
Wages and salaries	22.1	20.9	21.5	22.8	24.1
Purchases of goods and services	23.0	21.9	23.0	23.0	26.0
Interest payments	0.2	0.1	0.1	0.1	0.1
Subsidies	0.7	0.6	0.6	0.6	0.6
Grants	2.5	2.0	2.1	1.1	1.1
Other expenses	15.1	10.0	6.0	5.7	5.4
Net acquisition of nonfinancial assets	3.2	3.7	4.5	6.7	8.5
Gross Public Investment	9.4	9.5	10.0	12.0	13.5
Gross operating balance	7.7	11.5	6.0	7.9	8.1
Net lending/borrowing	4.5	7.8	1.6	1.3	-0.4
Memorandum items:					
Primary balance	3.9	7.8	1.6	1.3	-0.4
U.S. Compact sector grants	18.1	16.6	16.7	17.2	21.6
Other U.S. grants	8.8	4.9	4.8	4.8	4.7
Net lending/borrowing excluding:					
Total grants	-29.5	-17.5	-22.9	-26.8	-31.8
U.S. grants	-22.4	-13.7	-19.9	-20.7	-26.7
Balance of trust funds	351.5	287.7	323.2	330.9	381.0
Compact Trust Fund	256.4	211.7	235.1	242.9	292.7
FSM Trust Fund	95.1	76.0	88.1	88.0	88.2
Public external debt	16.1	13.8	11.8	10.2	10.1

Sources: FSM authorities and IMF staff estimates and calculations.

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

2/ Excludes contributions to the Compact Trust Fund.

Table 3. Federated States of Micronesia: Balance of Payments, FY2021-25

	FY2021	FY2022	FY2023	FY2024	FY2025
	Est.	Est.	Projections		
	(In millions of U.S. dollars)				
Current account balance	8.5	36.6	15.3	3.7	3.8
Trade balance	-161.4	-162.4	-169.9	-181.0	-203.5
Exports, f.o.b.	46.6	50.9	53.9	53.9	56.2
Imports, f.o.b.	208.0	213.2	223.8	234.9	259.6
of which: petroleum products	33.8	43.0	57.6	60.5	63.4
Services account	-23.5	-21.5	-15.0	-15.4	-15.7
Receipts	31.8	39.6	71.9	75.6	79.2
of which: travel	3.1	6.0	33.9	35.6	37.3
Payments	55.3	61.1	86.9	91.0	94.9
of which: freight and insurance	25.7	27.3	30.2	31.8	33.3
of which: transportation 1/	1.5	1.6	12.7	13.4	14.0
Income, net	45.7	48.0	44.3	37.3	42.1
Receipts	76.6	81.0	79.6	74.3	80.6
of which: fishing license fees	66.9	70.8	68.9	63.1	68.9
Payments	30.9	33.0	35.3	37.0	38.5
of which: foreign workers earnings	4.4	4.9	5.2	5.5	5.8
Transfers	147.7	172.4	155.9	162.8	180.9
Private	17.1	55.4	37.6	39.4	42.0
Inflows 2/	34.2	72.9	55.4	57.3	60.0
Outflows	17.0	17.6	17.7	17.9	18.0
Official	130.6	117.1	118.3	123.4	138.9
US Compact	70.3	70.8	73.3	73.3	89.3
Other	60.2	46.3	45.1	50.1	49.6
Capital account balance	17.4	17.8	23.4	33.1	42.4
Capital inflow	17.4	17.8	23.4	33.1	42.4
Compact Capital grants	0.2	0.6	3.5	10.0	20.0
Other	17.2	17.2	19.9	23.1	22.4
Financial account balance	25.9	54.4	38.7	36.8	46.2
Direct Investment (net)	-0.2	-0.2	-0.2	-0.3	-0.3
Portfolio investment (net)	-7.8	16.4	37.3	3.8	-4.7
Other investment (net)	24.2	38.3	1.7	33.3	51.2
Errors and Omissions	0.0	0.0	0.0	0.0	0.0
	(In percent of GDP)				
Current account balance	2.2	8.5	3.3	0.8	0.8
Trade balance	-41.4	-37.7	-36.9	-37.4	-40.1
Exports	12.0	11.8	11.7	11.1	11.1
Imports	53.3	49.6	48.6	48.5	51.2
Service	-6.0	-5.0	-3.3	-3.2	-3.1
Income (net)	11.7	11.2	9.6	7.7	8.3
Receipts	19.6	18.8	17.3	15.3	15.9
of which: fishing license fees	17.2	16.5	15.0	13.0	13.6
Payments	7.9	7.7	7.7	7.6	7.6
Transfers	37.9	40.1	33.9	33.6	35.7
Private 2/	4.4	12.9	8.2	8.1	8.3
Official	33.5	27.2	25.7	25.5	27.4
Capital account balance	4.5	4.1	5.1	6.8	8.4
Capital grants	4.5	4.1	5.1	6.8	8.4
of which Compact capital grants	0.1	0.1	0.8	2.1	3.9
Financial account balance	6.7	12.7	8.4	7.6	9.1
Direct investment (net)	-0.1	-0.1	-0.1	-0.1	-0.1
Portfolio investment (net)	-2.0	3.8	8.1	0.8	-0.9
Other investment (net)	6.2	8.9	0.4	6.9	10.1
Errors and omissions	0.0	0.0	0.0	0.0	0.0

Sources: FSM authorities and IMF staff estimates and calculations.

1/ Refers to passenger services transportation.

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

Table 4. Federated States of Micronesia: Medium Term, FY2021-29 1/

(In percent of GDP, unless otherwise noted)

	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029
	Est.	Est.	Projections						
Real sector (annual percent change)									
Real GDP	3.0	-0.9	0.8	1.1	1.7	1.1	0.8	0.7	0.7
Consumer prices	1.8	5.0	6.2	4.0	3.0	2.5	2.1	2.0	2.0
Consolidated government finance (in percent of GDP)									
Revenue and grants	71.3	67.0	59.4	61.2	65.4	66.1	65.8	65.7	64.8
Revenue	37.3	41.7	34.9	33.1	34.0	33.9	33.6	33.3	33.2
Tax revenue	15.9	21.7	16.5	16.7	16.9	17.1	17.1	17.1	17.1
of which: corporate income tax	2.9	9.5	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Non-tax revenue	20.6	20.0	18.5	16.5	17.0	16.8	16.5	16.2	16.1
of which: Fishing license fees	17.7	17.0	15.4	13.4	14.0	13.7	13.4	13.2	13.0
Grants 2/	33.9	25.3	24.5	28.1	31.4	32.2	32.2	32.4	31.6
Expenditure	66.8	59.2	57.9	60.0	65.8	67.0	67.0	66.8	66.4
Expense	63.6	55.5	53.4	53.3	57.2	57.8	57.3	57.1	56.9
Net acquisition of nonfinancial assets	3.2	3.7	4.5	6.7	8.5	9.3	9.7	9.7	9.4
Gross Public Investment	9.4	9.5	10.0	12.0	13.5	14.1	14.4	14.5	14.5
Net lending/borrowing	4.5	7.8	1.6	1.3	-0.4	-1.0	-1.1	-1.1	-1.6
Net lending/borrowing (excl. grants)	-29.5	-17.5	-22.9	-26.8	-31.8	-33.1	-33.4	-33.5	-33.2
Public debt (outstanding stock, end of period)	17.0	14.6	12.4	10.6	10.6	10.7	11.0	11.3	12.1
Balance of trust funds 3/	351.5	287.7	323.2	330.9	381.0	436.5	447.5	458.9	470.2
Commercial banks (in percentage of GDP; end of period)									
Loans /4	13.3	12.8	11.1	11.3	11.5	11.7	11.9	12.1	12.3
Deposits	111.7	99.5	96.2	94.2	92.9	91.8	90.7	89.6	89.6
Interest rates (in percent, average for FY)									
Consumer loans	14.2	13.7	14.3	…	…	…	…	…	…
Commercial loans	5.8	5.1	4.8	…	…	…	…	…	…
Balance of payments (in millions of U.S. dollars)									
Trade balance	-161.4	-162.4	-169.9	-181.0	-203.5	-211.8	-218.4	-224.7	-232.2
Net services and income	22.2	26.5	29.3	21.9	26.4	26.5	27.4	27.3	28.0
Private and official transfers	147.7	172.4	155.9	162.8	180.9	188.5	192.8	198.6	201.2
Current account	8.5	36.6	15.3	3.7	3.8	3.1	1.9	1.2	-3.0
(in percent of GDP)	2.2	8.5	3.3	0.8	0.8	0.6	0.3	0.2	-0.5
External debt (in millions of U.S. dollars; end of period)									
Outstanding stock	62.9	59.4	54.3	49.2	51.3	53.9	57.4	61.3	67.4
(in percent of GDP)	16.1	13.8	11.8	10.2	10.1	10.2	10.6	11.0	11.8
Memorandum items:									
Real effective exchange rate 5/	100.9	106.9	114.8	…	…	…	…	…	…
Nominal GDP (in millions of U.S. dollars)	390.0	430.2	460.5	484.0	507.1	525.5	540.8	555.9	571.0

Sources: FSM authorities and IMF staff estimates and calculations.

1/ Fiscal year ends on September 30. Data for FY2019-22 is estimate from authorities and subject to revision.

2/ Excludes contributions to the Compact Trust Fund.

3/ Compact Trust Fund and FSM Trust Fund.

4/ Includes only domestic lending and does not account for loans to customers outside the country.

5/ Calendar year. 2010=100. The U.S. dollar is legal tender and the official currency.

Table 5. Federated States of Micronesia: Deposit Money Banks, FY2019-23
(In millions of U.S. dollars, unless otherwise noted)

	FY2019	FY2020	FY2021	FY2022	FY2023
Assets and liabilities					
Assets	389.7	423.3	474.1	464.0	488.0
Foreign assets 1/	329.2	362.2	304.2	399.0	426.2
Claims on private sector	45.7	45.8	47.4	51.2	48.0
Consumer loans	32.4	31.4	32.8	34.8	35.0
Commercial loans	13.4	10.9	11.4	13.6	13.0
Claims on nonfinancial public enterprises	5.1	4.9	4.3	3.7	3.2
Others assets	9.7	10.3	10.1	10.1	10.6
Liabilities	389.7	423.3	474.1	464.0	488.0
Deposits	350.7	384.1	435.5	428.2	442.9
Of which: national government	82.7	87.4	90.1	85.3	75.5
Capital accounts	28.9	28.7	27.9	25.0	33.4
Other liabilities	10.1	10.4	10.7	10.8	11.7
Memorandum items:					
Loan/deposit ratio (in percent) 2/	14.5	13.2	11.9	12.8	11.6
Deposits (percent change)	4.5	9.5	13.4	-1.7	3.4
Loans (percent change)	1.3	-0.1	1.9	6.4	-6.9
Interest rates (percent)					
Deposit rates					
Savings deposits 3/	0.3	0.2	0.1	0.1	0.3
CDs	0.4	0.2	0.1	0.1	0.4
Time Deposits	0.1	0.1	0.0	0.0	0.0
Loans rates 4/					
Consumer loans	15.7	14.9	14.2	13.7	14.3
Commercial loans	8.4	6.9	5.8	5.1	4.8

Sources: FSM authorities and IMF staff estimates and calculations.

1/ Includes loans to abroad.

2/ Excludes loans to abroad.

3/ Average rates offered by the deposit money banks.

4/ Average rates charged by the deposit money banks.

Table 6. Federated States of Micronesia: Vulnerability Indicators, FY2021-25

	FY2021	FY2022	FY2023	FY2024	FY2025
	Est.	Est.	Proj.		
Deposit money banks					
Deposits (in percent of GDP)	111.7	99.5	96.2	94.2	92.9
Deposits (Year-on-year percent change)	13.4	-1.7	3.4	2.9	3.3
Loans (in percent of GDP)	13.3	12.8	11.1	11.3	11.5
Loans (Year-on-year percent change)	1.9	6.4	-6.9	7.0	6.6
Loan to deposit ratio (in percent)	11.9	12.8	11.6	12.0	12.4
Foreign assets (in percent of GDP)	78.0	92.7	92.6	…	…
Equity capital (in percent of total asset)	5.9	5.4	6.8	…	…
FSM Development Bank					
Loans (in percent of GDP) 1/	8.8	9.0	7.3	…	…
External indicators					
Exports (goods & services, y/y percent change)	21.9	15.4	39.0	2.9	4.5
Imports (goods & services, y/y percent change)	3.7	4.2	13.2	4.9	8.8
Current account balance (percent of GDP)					
Including official transfers	2.2	8.5	3.3	0.8	0.8
Excluding official transfers	-31.3	-18.7	-22.4	-24.7	-26.6
Total external debt					
In millions of U.S. dollars	62.9	59.4	54.3	49.2	51.3
In percent of exports of goods and services	80.2	65.7	43.2	38.0	37.9
In percent of GDP	16.1	13.8	11.8	10.2	10.1
Debt service					
In millions of U.S. dollars	6.1	5.4	6.2	6.1	5.9
In percent of exports of goods and services	7.8	6.0	4.9	4.7	4.4
In percent of GDP	1.6	1.3	1.3	1.3	1.2

Sources: FSM authorities, FSMDB and IMF staff estimates and calculations.

1/ Loans are calendar year data.

Table 7. Federated States of Micronesia: Financial Soundness Indicators, 2020-23
(In percent)

	Dec-20	Jun-21	Dec-21	Jun-22	Dec-22	Jun-23	Sep-23
Capital adequacy							
Regulatory capital to risk-weighted assets	37.6	40.6	37.2	38.1	38.5	37.4	40.8
Regulatory Tier 1 capital to risk-weighted assets	37.6	40.6	37.2	38.1	38.5	37.4	40.8
Non-Performing Loans (NPL) net of provisions to capital	1.0	1.4	2.9	2.8	3.7	3.5	2.2
Asset quality							
NPL to total gross loans	0.1	0.2	0.3	0.3	0.3	0.3	0.2
Sectoral distribution of loans							
Residents	14.0	12.8	14.2	15.3	14.2	12.6	12.1
Deposit-takers	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Central bank	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial corporations	0.0	0.0	0.0	0.0	0.0	0.0	0.0
General government	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Nonfinancial corporations	11.7	11.6	13.1	13.5	12.6	11.8	11.4
Other domestic sectors	1.3	1.2	1.1	1.7	1.6	0.8	0.8
Nonresidents	87.0	87.2	85.8	84.7	85.9	87.4	87.9
Earnings and profitability							
Return on assets	0.9	0.6	0.7	0.9	3.3	3.0	4.7
Return on equity	13.3	9.2	11.7	16.6	59.1	50.0	73.9
Interest margin to gross income	85.1	83.6	82.4	78.9	84.5	90.8	91.2
Non-interest expenses to gross income	57.7	65.3	64.7	56.2	44.7	35.2	34.2
Personnel expenses to noninterest expenses	51.8	50.4	50.2	47.7	48.7	45.1	45.0
Liquidity							
Liquid assets to total assets	58.5	66.9	67.4	64.8	60.4	59.1	59.5
Other							
Capital to assets	5.6	5.4	5.3	5.6	5.6	5.7	5.7
Gross asset position in financial derivatives to capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross liability position in financial derivatives to capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Trading income to total income	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Customer deposits to total (non-interbank) loans	506.4	584.5	553.6	498.9	493.7	525.1	533.3
Foreign-currency-denominated loans to total loans	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Foreign-currency-denominated liabilities to total liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: FSM authorities

Annex I. Main Recommendations of the 2021 Article IV Consultation

Fund Recommendations	Policy Actions
Fiscal policy	
Maintain policy support until the recovery is firmly underway. Subsequently, phase in a gradual medium-term fiscal adjustment through both domestic revenue mobilization and expenditure rationalization. Timely and effective implementation of key tax reforms including the introduction of VAT will be crucial for success.	**Partially implemented.** Fuel subsidy to a state utility company in 2023 helped to reduce household's electricity bills in response to high inflation. Tax reform proposals including the introduction of a VAT and the replacement of the turnover tax with a net profit tax remain under discussion.
Public financial management and public investment management reforms should be accelerated, to help identify further expenditure savings, enhance foreign aid effectiveness, and reduce leakages.	**Partially implemented.** The authorities adopted a PFM reform roadmap for FY2023–26 in January 2023 and published an implementation report in July 2023. The roadmap is currently being implemented, but some reforms such as introducing FMIS are delayed and more needs to be done to improve public investment management.
Climate policies	
Develop an overarching National Adaptation Plan and a comprehensive disaster resilience strategy and the joint state action plans should be reconciled. Strengthen public financial management and public investment management to help improve access to climate finance and expedite project implementation.	**Limited implementation.** The authorities are working with GFC to develop a National Adaptation Plan.
Structural reforms, financial sector supervision, and statistics	
The authorities should continue to upgrade the legal and regulatory framework for banking supervision and its supervisory capacity. The FSMDB and credit unions should be placed under the supervision of the Banking Board to ensure effective supervision and prudent lending. The AML/CFT risk-based supervision should be strengthened to ensure banks' ability to comply with relevant international standards and secure U.S. dollar CBRs.	**Partially implemented.** Work on upgrading the Banking Act supported by IMF and PFTAC TA is ongoing after being disrupted by the pandemic and board closure.
To help ease credit supply bottleneck, the authorities should upgrade the management of land tenure including through digitalizing the land registry.	**Not implemented.**

Fund Recommendations	Policy Actions
To improve the business climate and attract foreign investment, the amendment of Foreign Investment Act should be expedited. Reform efforts should focus on ease of doing business, improving governance, and enhancing coordination across states.	**Not implemented.**
Develop a clear digitalization strategy, a roadmap to expand e-government, and a regulatory framework for data protection and cybersecurity. Increase digital literacy.	**Limited implementation due to capacity constraints.**
There is a need to improve the adequacy and timeliness of economic data. Need further efforts to ensure coordination between agencies and address the delayed release of key statistics.	**Limited implementation.** Efforts to improve statistics have been hampered by Covid, limited resources, and lack of coordination between agencies. While tax data sharing recently resumed, the delayed key statistics have yet to be officially released.

Annex II. Risk Assessment Matrix[1]

Source of Risk	Relative Likelihood	Source	Time Horizon	Expected Impact	Direction of Impact	Main Impacts → Recommended Policy Actions
Extensive delays in US Congress approval of the new COFA agreement	Medium	Domestic, External	MT	Medium	⬇	The impact depends on the nature and extent of the delay. Extensive delays would increase uncertainty about future financial assistance, resulting in lower growth and higher public debt. → Find interim arrangements to avoid a large fiscal gap (including using financial assets), mobilize domestic revenue, and contain government spending growth.
Commodity price volatility	High	External	ST, MT	Medium	⬇	A succession of supply disruptions (e.g., due to conflicts, uncertainty, and export restrictions) and demand fluctuations causes recurrent commodity price volatility, external and fiscal pressures in EMDEs, contagion effects, and social and economic instability. → Provide targeted fiscal assistance to vulnerable households, accelerate transition to renewable energy, and increase domestic food production.
Extreme climate events	High	Domestic	MT	High	⬇	Extreme climate events driven by rising temperatures cause loss of human lives, severe damage to infrastructure, supply disruptions, lower growth, and financial instability. → Develop an overarching National Adaptation Plan, speed up implementation of adaptation investment projects, strengthen capacity for public investment management, and mobilize external grant financing.
Systemic financial instability	Medium	External	ST, MT	Medium	⬇	Sharp swings in real interest rates and risk premia, and asset repricing amid economic slowdowns and policy shifts trigger insolvencies in countries with weak banks or non-bank financial institutions, causing market dislocations and adverse cross-border spillovers. This could result in large losses in the trust funds. → Mobilize domestic revenue to reduce the reliance on the trust funds to finance government spending.
Delays in key structural reforms and infrastructure projects	High	Domestic	MT	Medium	⬇	Slow implementation of growth-friendly structural reforms and infrastructure projects to address growth bottlenecks will depress potential growth. → Prioritize reforms to improve the business environment and facilitate private sector development.

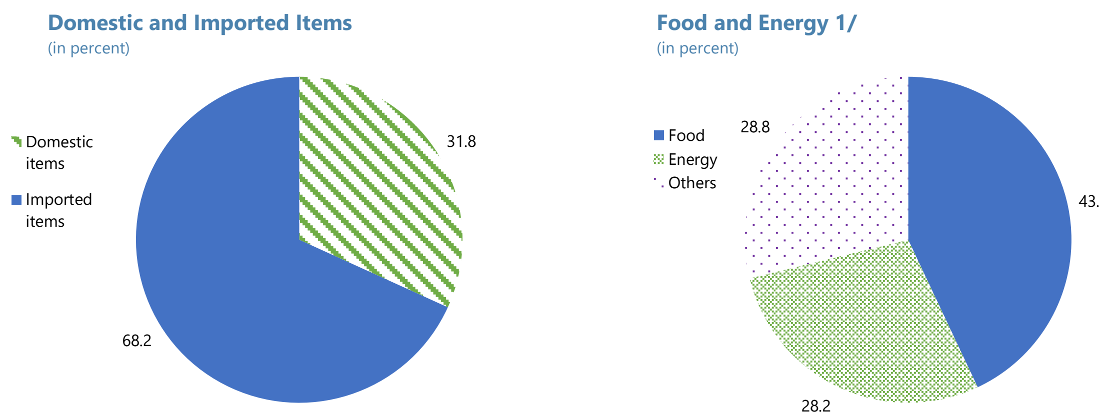
[1]The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("L" (low) is meant to indicate a probability below 10 percent, "M" (medium) a probability between 10 percent and 30 percent, and "H" (high) a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Annex III. Impact of Global Commodity Prices on FSM's Inflation[1]

Global commodity prices are a key driver of FSM's inflation given the heavy dependence on food and energy imports. Headline inflation follows the change in global commodity prices with a lag of 2 to 3 quarters. Staff analysis shows that the impact of global commodity price shocks could be persistent. Considering the delayed pass-through from recent commodity price increase along with demand-side pressures from the recovery and public sector wage increase, inflation in FSM will likely fall only gradually and remain above recent averages for some time.

1. **FSM heavily depends on imports, especially for food and energy** (Figure 1). Food and energy items combined represent more that 70 percent of the CPI basket. At the same time, the share of imported items in the FSM's CPI basket is 68.2 percent and, according to WTO, food and fuel represents over half of imports.[2] Therefore, estimating the impacts of global oil and food prices on inflation is key to understand the inflation dynamics in the FSM.

Figure 1. FSM CPI Basket Weights



Source: FSM authoroties, and IMF staff calculations

1/ Weights for food and energy are approximated due to lack of granularity. Food includes *Food and non-alcoholic beverages* category. Energy includes *Housing, water, electricity and gas* (15.4 percent) and *Transport* (12.8 percent) categories.

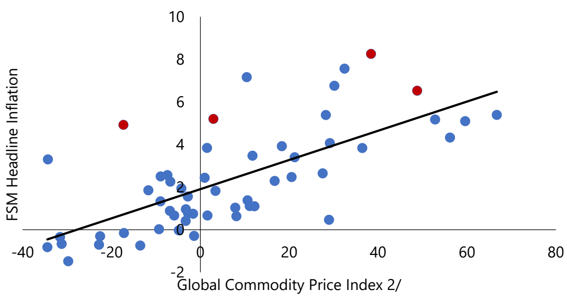
2. **Over the past decade, FSM's headline inflation has closely followed the change of global commodity prices with a lag of 2-3 quarters** (Figure 2). The rise in inflation seen until 2022 is by in large attributed to the rise in food and energy prices--which contributed to over 90 percent of the headline inflation in 2022. Recent data for FY2023 (red dots in left panel of Figure 2) suggests a gradual moderation of domestic inflation, with a lag, due to the easing of global commodity prices (mainly energy; Figure 3).

[1] Prepared by Choonsung Lim (APD).

[2] The shares of food and fuels in FSM's merchandise imports in 2013 marked 27.7 percent and 29.8 percent, respectively.

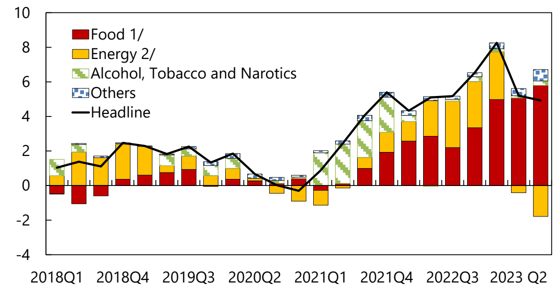
Figure 2. Relationships Between Global Commodities and FSM Inflation

Global Commodity Prices and FSM's CPI, 2010Q1-23Q3 1/
(year-on-year percent change)



Source: FSM authoroties, IMF, and IMF staff calculations
1/ Latest 4 quarters in red.
2/ Two quarters lagged.

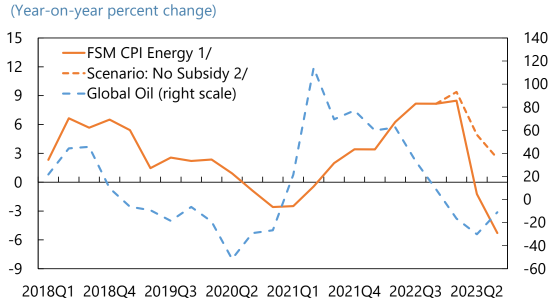
Contributions to Annual Inflation
(yoy change, percentage points)



Sources: FSM authorities, and IMF staff calculations
1/ Food and non-alcoholic beverages.
2/ Housing, water, electricity and gas, and Transport categories.

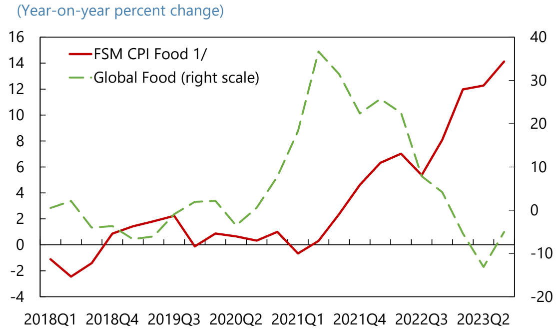
Figure 3. Recent Developments in Food and Energy Prices

Global and FSM Energy Inflation
(Year-on-year percent change)



Sources: FSM authorities, IMF, and IMF staff calculations
1/ Housing, water, electricity and gas, and Transport categories.
2/ The quarter-on-quarter change of housing, water, electricity in Pohnpei is assumed to follow that in non-Pohnpei starting from 2023 Q1.

Global and FSM Food Inflation
(Year-on-year percent change)



Sources: FSM authorities, IMF, and IMF staff calculations
1/ Food and non-alcoholic beverages.

3. **To better understand the links between global commodity prices and FSM inflation, we use econometric analysis based on data from 2008-2022.** In particular, we employ the local projection method by Jorda (2005) to estimate the impacts of global commodity price shocks on FSM's inflation over a 6-quarter period during the period from 2008Q2 to 2022Q4, excluding the fuel subsidy period [3]. The model follows the specification by Teulings and Zubanov (2014), which corrects for the downward bias of the coefficient estimates.[4]

$$Ln(CPI_{t+h}) - Ln(CPI_{t-1}) = \alpha_h + \sum_{i=1}^{k} \rho_i \Delta Ln(CPI_{t-i}) + \sum_{j=0}^{k} \{\beta_j \Delta Ln(COM_{t-j}) + \psi_j \Delta Ln(NEER_{t-j})\}$$
$$+ \sum_{p=1}^{h} \{\theta_p \Delta Ln(COM_{t+p}) + \gamma_p \Delta Ln(NEER_{t+p})\} + \epsilon_{t+h}$$

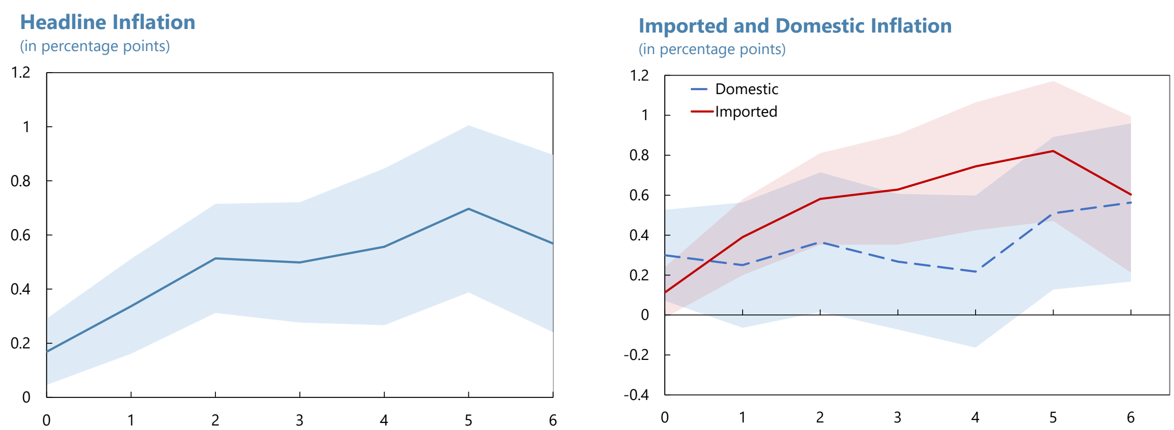
[3] The fuel subsidy has been disbursed to Pohnpei Utilities Corporation (PUC) since the beginning of 2023, leading to reduced electricity bills for households. The subsidy is scheduled to terminate by the end of 2023.

[4] Using the methodology by Teulings and Zubanov (2014), the local projection equation is augmented with the leads of the independent variables (global commodity prices and NEER) between forecast horizon 't' and 't+h' in order to correct for the downward bias of the coefficient estimates.

where *CPI* is FSM's quarterly headline, imported or domestic CPI, *COM* is either global oil prices or food commodity prices index, and *NEER* is Nominal Effective Exchange Rate. *h* represents the number of quarters of forecast horizon, while *k* represents the number of lags. The lag selection is based on the BIC criteria. Inference is based on Newey-West standard errors, which are robust to heteroskedasticity and autocorrelation.

4. **The estimation results indicate that a 10-percent shock to global oil prices could increase headline inflation by 0.7 percentage points 5 quarters after shock** (Figure 4). The cumulative impact of the shock increases to 0.5 percent in the second quarter and peaks at 0.7 percent five quarter after the shock. The right panel of Figure 4 shows that the inflation effects from global oil price shocks are larger in import prices, but the lagged second-round impact on the domestic inflation is significant after 4 quarters.

Figure 4. Cumulative Impulse Response of FSM Inflation to Oil Price Shocks 1/

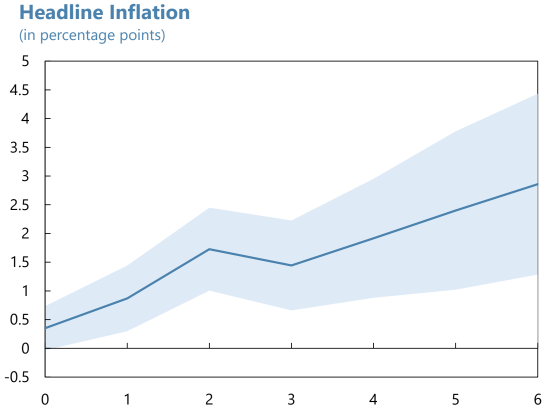


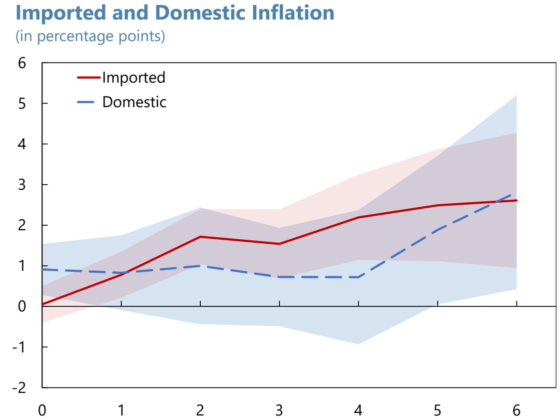
Source: FSM authorities, and IMF staff estimates

1/ The impulse response is measured in percentage points of inflation in response to a 10-percentage point shock in the quarter-on-quarter growth rate of the oil price. The range represents confidence interval at 90 percent.

5. **Importantly, the impact of food price shocks appears to be larger and more persistent than that of oil price shocks, with a similar response pattern** (Figure 5). The impact amounts to 1.7 percentage points and 2.9 percentage points, respectively, 2 quarters and 6 quarters after a 10-percent shock to global food prices. Similar to the impact of oil prices, there is evidence of second-round impacts on domestic inflation starting from the fifth quarter after the shock. The significant impact aligns with the substantial weight of food (43 percent) in FSM's CPI basket.

Figure 5. Cumulative Impulse Response of FSM Inflation to Food Price Shocks 1/





Source: FSM authorities, and IMF staff estimates

1/ The impulse response is measured in percentage points of inflation in response to a 10-percentage point shock in the quarter-on-quarter growth rate of the food price. The range represents confidence interval at 90 percent.

6. **Looking ahead, the inflation in FSM is expected to decrease only moderately.** The delayed pass-through into domestic prices will slow the fall in domestic inflation. According to the estimated impulse responses, the delayed pass-through into domestic prices can slow the fall in inflation. Particularly, food inflation has not yet peaked by end-FY2023, even though the annual growth of global food prices peaked in mid-2022. Additionally, the electricity rate is about to rise, as the related fuel subsidy is expected to be discontinued at the end of 2023.

Annex IV. Fiscal Support Under the Compact[1]

A new Compact of Free Association (COFA) agreement has been negotiated with the US government, although it still awaits congressional approval. The previous COFA included sector grants, contributions to a Compact Trust Fund (CTF), and other federal programs and services that played a crucial role in FSM's budget and the economy. The new COFA promises more generous sector grants and increased contributions to the CTF, offering potential large economic benefits. However, past experiences highlight the need to strengthen capacity and accelerate reforms for greater growth-enhancing effects.

1. **The COFA agreement expired end-FY2023 and a new one is expected to be implemented by FY2025.** The original COFA agreement was set for the period FY1987-FY2003 and was amended in 2003 to continue assistance for the following 20 years (FY2004-FY2023). The amended COFA agreement expired in September 2023. The US and the FSM governments amended the COFA agreement again in May 2023 to extend the assistance. However, a bill for the new COFA is still under consideration by the US Congress. In the meantime, the US Congress approved keeping grants at the FY2023 level for the beginning of FY2024. Nevertheless, there is uncertainty about the timing of implementation for the new agreement and the continuation of temporary support in case of extensive delay.

2. **The expired 2003 COFA agreement comprised three main features: sector grants, a Compact Trust Fund (CTF), and other federal programs and services**.

- *Sector grants*. The agreement provided the FSM with annual budgetary support for six core sectors—education, health, infrastructure, environment, private sector development, and public sector capacity building—prioritizing the education and health sectors. The total amount of annual sector grants was designed to decrease from $76 million in FY2004 to 62.4 million in FY2023, although it included a partial adjustment to inflation.

- *Compact Trust Fund*. The 2003 COFA initiated the trust fund to help the FSM accumulate sufficient savings to replace the COFA grants with a distribution from CTF after the expiration of the COFA. However, the CTF balance only stood at $1 billion as of July 2023, and the investment returns were smaller than the full amount of grants in the last year of the COFA.

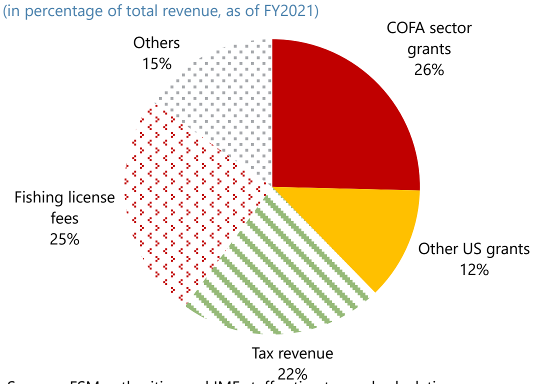
- *Federal programs and services*. The FSM is eligible for a wide range of Federal programs and services under the COFA. These services include, for instance, post-disaster relief and reconstruction by the Federal Emergency Management Agency and US Agency for International Development, weather and postal services, deposit insurance, among others.

3. **US grants play a significant role in the FSM budget.** The COFA sector grants in FY2021 covered 26 percent of the total revenue in the FSM government. When other US grants are also considered, the dependency on US grants increased to 38 percent of total revenue. More than 60 percent of state

[1] Prepared by Choonsung Lim (APD).

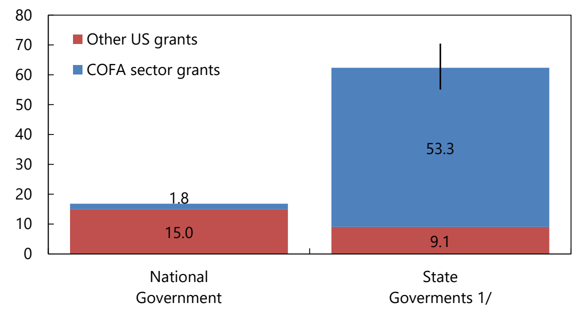
government revenues relied on COFA sector grants (53.3 percent) and other US grants (9.1 percent). Consequently, a delay in the approval of the new COFA by the US Congress can have a significant budgetary impact, including for government services, especially for education and health services.[2]

Share of Revenue Sources, consolidated
(in percentage of total revenue, as of FY2021)



Sources: FSM authorities and IMF staff estimates and calculations

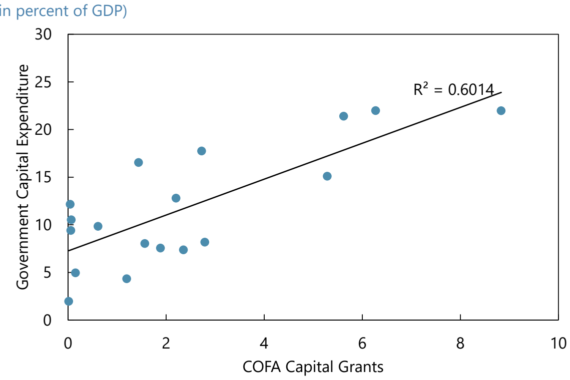
Importance of US Grants
(Percent of revenue, as of FY2021)



Sources: FSM authorities and IMF staff estimates and calculations
1/ Average of 4 state governements. The black vertical line represents the range of the share of total US grants in the each state revenue.

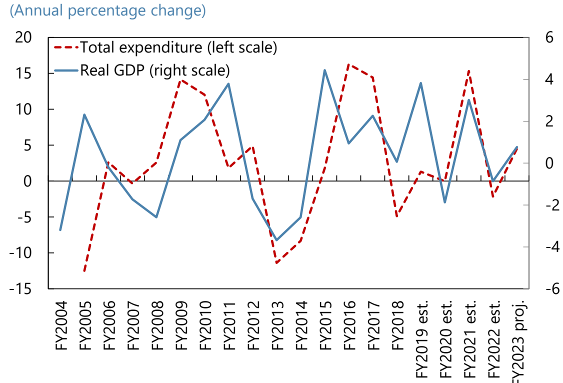
4. The experiences of the past two decades shows that extensive budgetary support does not automatically translate into stable and robust economic growth. The limited capacity in planning and executing led to volatile public investment and expenditures. When COFA capital grants were more than 5 percent of GDP, public capital expenditure increased over 20 percent of GDP. On the other hand, the capital expenditure fell to less than 2 percent of GDP, when the capital grants were close to zero.[3] This volatile government expenditure contributed to volatile and low long-term growth (see Box 1 in main text). Additionally, the decreasing grants-to-GDP ratio has constrained growth. While capital grants exhibited volatility, COFA current grants have been on a downward trend, peaking at 24 percent in FY2007 and falling to 18 percent in FY2021, primarily due to an annual decrease of $0.8 million and only partial inflation adjustment.

COFA Capital Grants and Capital Expenditure, FY2004-21
(in percent of GDP)



Sources: FSM authorities, and IMF staff calculations

Fiscal Expenditure and Growth
(Annual percentage change)



Sources: FSM authorities and IMF staff estimates and calculations

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[2] More than 75 percent of the US grants disbursed to states are for education and health sectors (US GAO, 2022).

[3] Important to note that the COFA-related capital grants were only made available after the investment projects were approved. Given weak planning capacity, a substantial share of the potential capital grants were not distributed.

5. **The new COFA agreement envisages more generous sector grants and additional large contributions to the CTF with more flexible rules.** Key elements of the agreement are the following (still to be approved by the US Congress):

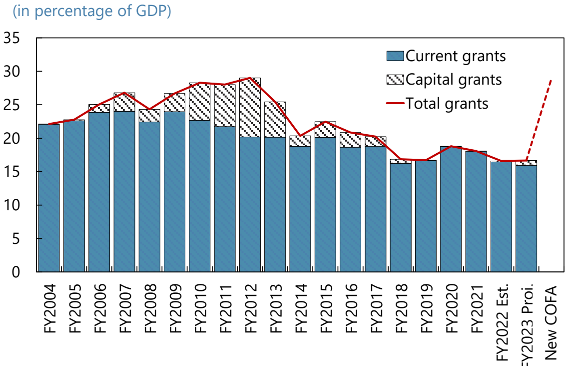
- *Size of annual grants*. In the new COFA, the annual grants amount increases to $140 million over twenty years, while continuing federal programs and services. The ratio of COFA grants to GDP is projected to rise by 10 percentage points, to 28.9 percent in FY2024. Since there is no inflation adjustment, grants are projected to decline in real terms—from $140 million in FY2024 to $94.9 million in FY2043 in constant prices).

- *Compact Trust Fund (CTF)*. The US is scheduled to deposit $250 million into the CTF in both the first and second year of the new agreement. This large injection of cash alone is expected to increase the balance to above $4 billion by FY2043, assuming a 5 percent annual return and no withdrawal. In our baseline, including additional contributions from unspent current grants, the outstanding balance could exceed $4.2 billion by FY2043. Assuming historical average annual returns (6.3 percent), it could reach $5.3 billion.

- *Change in the rules of the Compact*. Under the new agreement, there is greater flexibility in the use of resources in the CTF and on the pre-award process of sector grants. While the CTF was originally purposed for a distribution after FY23, when the fiscal support under the COFA was expected to expire, under the new agreement a distribution of the resources in the CTF is possible even during the grant period (FY2024-FY2043) for certain purposes such as inflation adjustment for sector grants or additional adaptation plan. As regards pre-award process, the new fiscal procedure does not require annual budget consultation, whereby US previously evaluated the FSM's implementation plan before the consideration of the committee.

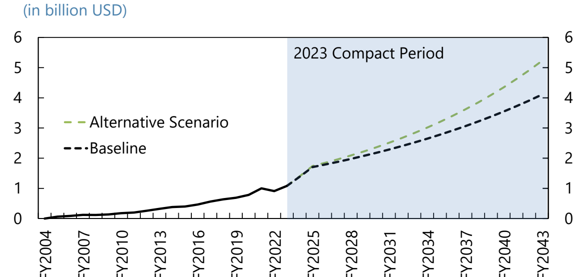
- *Extension of COFA*. The new COFA agreement opens the possibility of the extension of the new COFA. The amendment indicates that the continued provision of sector grants, trust fund contributions, and federal programs and services at similar favorable levels beyond FY2043 may be agreed between US and FSM

COFA sector grants
(in percentage of GDP)



Sources: FSM authorities and IMF staff estimates and calculations

Compact Trust Fund balance 1/
(in billion USD)



Sources: FSM authorities and IMF staff estimates and calculations
1/ Historical data is available up until July 2023. Afterward, the balance is estimated, based on the scheduled US contributions and investment gains. The annual return of the CTF is assumed 5 percent in the baseline and a historical average (6.3 percent) in the alternative scenario. Assumed no withdrawal.

6. **The past experience shows the importance of having sufficient capacity to use effectively the resources from the new COFA agreement.** This includes developing capacity to spend well, including on planning and implementing investment, as well as other supportive reforms that can increase the impact on economic developments.

Annex V. Digital Transformation[1]

Enhancing digital connection is critical for the FSM's development agenda. The FSM has embarked on digital transformation reforms, focusing on enhancing internet accessibility and promoting a digital government. To fully reap the social and tax revenue benefits, it is essential to establish institutional frameworks to safeguard against risks related to cybersecurity, secure fiscal space for public investment on digital infrastructure, and enhance the adoption of GovTech solutions through capacity development and training.

A. Where the FSM Stands on the Digitalization Transformation?

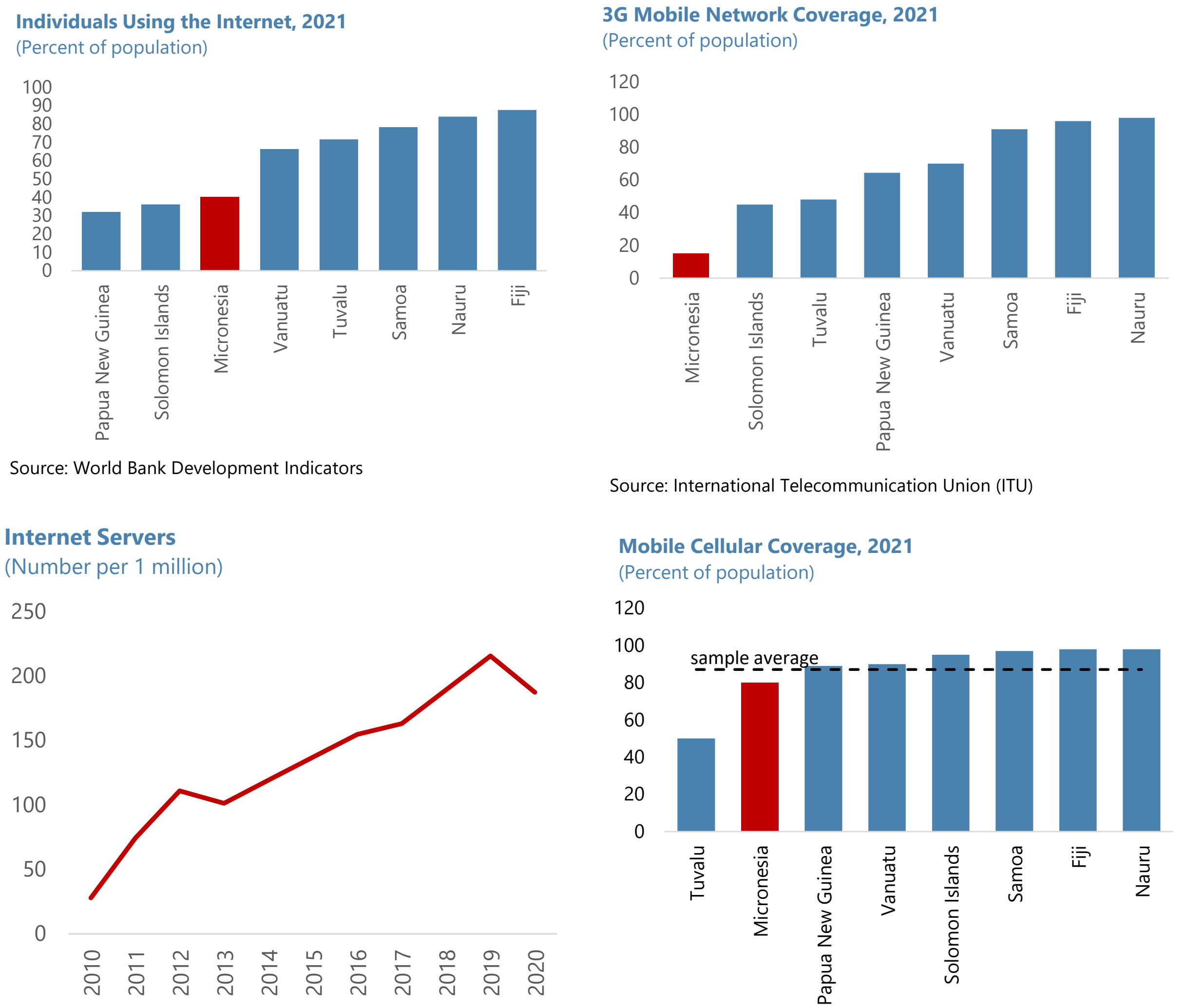
1. **Digitalization presents a transformative opportunity to unlock new pathways for rapid economic growth, innovation, job creation, and access to services.** The FSM government in 2018 created the Micronesia Telecommunications Corporation (MTC), a state-owned telecommunications company, to provide internet access to all areas of the country. In 2020, the MTC launched a new satellite-based internet service to provide high-speed internet access to remote and rural areas. The government has also developed a Digital Government Strategic Framework and Implementation Roadmap to: (i) implement Digital Government across priority Government agencies and activities; (ii) advance digital inclusion for all FSM citizens; (iii) strengthen governance and efficiency; (iv) promote data sharing and a service-oriented information systems architecture; and (v) enhance citizen engagement.

2. **To close the wide digital divide, the FSM will need to improve digital connectivity.** Internet accessibility remains low, with only about 40 percent of the population having access to the internet (Figure 1). The mobile penetration rate and the coverage of 3G network are 19 percent and 15 percent, respectively—the lowest among the Pacific Islands peers—and the fixed broadband subscription rate is around 5 percent. The number of internet servers, which measures the extent of availability of digital infrastructure, has increased by 6 times since 2010. The coverage of the mobile network stands at 80 percent of the population, vis-à-vis the average 87 percent observed in the Pacific Islands peers.

3. **The FSM lags its peers in the progress of digital transformation in the public sector.** As per the World Bank's GovTech Maturity Index, the FSM has a large gap in public service delivery. This is in line with the UN Government Online Services Index that measures the use of information and communications technology (ICT) by governments for the delivery of public services (Figure 2). Over the past 10 years, while the digital public service delivery has somewhat improved in the PICs, it remains relatively low in the FSM. Substantial room for improvement can be found in digital citizen engagement (public participation platforms, citizen feedback mechanisms, open data, and open government portals), GovTech enablers (strategy, institutions, laws, and regulations, as well as digital skills, and innovation policies and programs, to foster GovTech), and core government systems.

[1] Prepared by Jiemin Ren.

Figure 1. Internet Accessibility



Source: World Bank Development Indicators

Source: International Telecommunication Union (ITU)

Source: World Bank Development Indicators

Source: International Telecommunication Union (ITU)

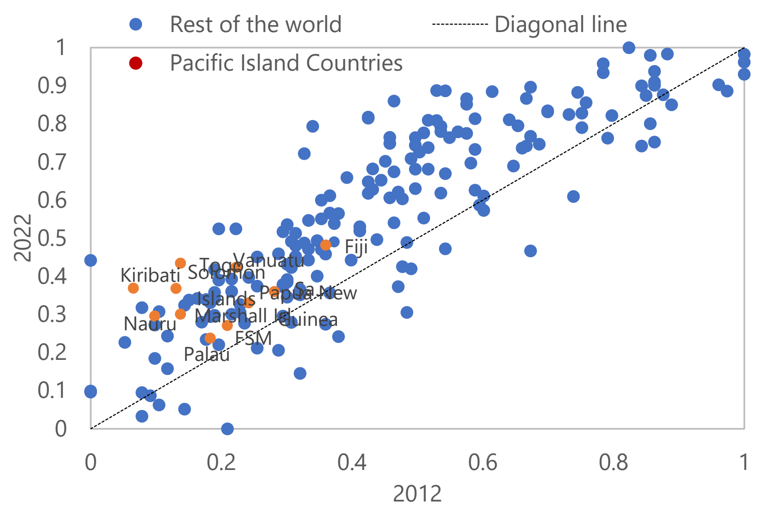
4. **The government has taken steps to upgrade and improve connectivity infrastructure throughout all states.** In May 2023, the government inaugurated a Digital FSM Office (DFO) to enhance governance, improve service delivery, and empower the lives of the people through technology.[2] The DFO has been launched as the lead implementation group of FSM digital transformation plan and the central authority for digital strategy, governance, enterprise architecture as well as the central interface to all government departments and sectors. The new services that the DFO provides will allow citizens to remotely apply for licenses, benefits, register businesses, and access educational resources. The implementation of the new e-governance system will also enhance transparency, accountability, and efficiency in the government operations. In April 2022, the FSM joined more than fifty-five countries in signing a declaration for

[2] FSM launches the fledgling Digital FSM Office for enhanced access to government services, https://issuu.com/kpressfsm/docs/kpress_vol23_iss_14_-_07_june_23/s/25855916

the future of the internet to promote an inclusive and affordable access to the internet and combat cybercrime and malicious cyber activities.[3]

Figure 2. Government Online Services

Government Online Service Index



Source: UN e-Government Development Database, and staff estimates

5. Further progress has been made to enhance the digital transformation with support of development partners. In July 2023, a grounded-breaking joint program on accelerating SDG achievement through digital transformation was launched by the joint forces of the governments of Palau, FSM, Marshall Islands, Nauru, and Kiribati and the United Nations. Financed through a US$3.8 million grant provided by the UN Joint SDG Fund, the joint program will provide a platform for collaborative actions to develop solutions and policy framework aimed at leveraging the potential of technology and digitally empower small island developing states across the Pacific Island Countries.[4] Since April 2018, significant progress has been made on the WB and ADB financed project which helps install a submarine cable connection between the FSM, Kiribati, and Nauru. The project has increased people's access to new or enhanced broadband internet connection, and will help lower transaction costs, create new economic opportunities, and facilitate communication and delivery of services to currently isolated domestic communities.

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[3] The Federated States of Micronesia Joins the United States of America, Canada, Australia, Japan, the European Union, and Other Like-minded Countries, in Signing a Declaration for the Future of the Internet, https://gov.fm/index.php/component/content/article/35-pio-articles/news-and-updates/603-the-federated-states-of-micronesia-joins-the-united-states-of-america-canada-australia-japan-the-european-union-other-like-minded-countries-in-signing-a-declaration-for-the-future-of-the-internet?Itemid=177

[4] UN Agencies and Micronesian Governments Unite to Accelerate SDGs Through Digital Transformation, https://micronesia.un.org/en/239356-un-agencies-and-micronesian-governments-unite-accelerate-sdgs-through-digital-transformation

B. Greater Digitalization Can Bring Large Benefits and Help Achieve the Development Agenda

6. Digital technology can generate significant social benefits through increased connectivity and access to information, particularly in terms of employment opportunities, education, and health. While the outcomes will vary on country specific conditions, the international experience suggests that:

- Increasing internet usage from the current 40 percent in the FSM to 100 percent could raise the labor force participation by 9.2 percentage points (Kumar, Amaglobeli, and Moszoro 2023). This impact is more pronounced for women, with an increase of 12 percentage points, compared to 5.9 percentage points for men.

- Empirical findings also underscore that increasing internet adoption from 40 to 100 percent could raise secondary education test scores by 26.7 points (Kumar, Amaglobeli, and Moszoro 2023).

- Internet access allows healthcare professionals to access accurate patient data, communicate with other medical facilities (both public and private), and provide telemedicine services to patients. In the FSM, several telehealth initiatives have been taken place during the past few years. Telehealth rooms have been launched in Pohnpei Hospital and in Kosrae Community Health Center since December 2016. The connectivity and the use of technology have resulted in many benefits. In January 2018, the FSM started practicing tele-pathology with the Hokkaido Cancer Center in Sapporo, Japan (PBTRC 2018). While sending pathology test off-island normally would take from 2 weeks up to 3 months to receive a result, now it just takes a few minutes for local doctors to provide a diagnosis by transmitting digitized images to Japanese pathologists.

7. Embracing GovTech can enhance revenue collection and fiscal transparency and elevate spending efficiency. For instance, transition from zero to 100 percent e-filing could boost tax revenue by 3 percent of GDP, while the adoption of e-invoicing and electronic fiscal devices could lead to an increase in tax revenue by 0.7 percent and 0.5 percent of GDP, respectively, based on a cross-country panel regression analysis (Amaglobeli and others 2023).[5] Digitalization in public finance management, for example, the automation of budgetary transactions using digital technologies and the integration of an e-procurement platform, can refine budget management and

[5] The cross-country estimated revenue yields, which provide a reasonable upper-bound estimate on average, need to be interpreted with caution and can vary depend on country characteristics. For example, a study by Santoro et al. (2022) shows that while e-filing results in an increase in reported taxable income, actual payment does not correspondingly increase. Similarly, Bellon et al. (2021) illustrates that although e-invoicing leads to increase in tax payable, firms choose to use the tax credits they hold with the tax authority instead of responding with an increase in their payments (Nose and Mengistu 2023).

enhance fiscal transparency. Furthermore, digitalization is generally linked to the enhancement of expenditure efficiency, especially in health and education spending.[6]

8. **The success of GovTech reforms in revenue mobilization is contingent on the strength of complementary digital enabling environment, including human resources and infrastructure**. The literature shows that the revenue yield of on-line filing is more relevant in countries with sufficient digital connectivity, larger ICT investments, enough staffing of tax officials, and higher quality of tax officials in terms of their work experiences and skill level, and higher governance quality (Nose and Mengistu 2023). To fully reap the social benefits of digitalization and tax revenue benefits of GovTech, it is essential to establish institutional frameworks to safeguard against risks related to cybersecurity, secure fiscal space for public investment on digital infrastructure, and enhancing enhance the adoption of GovTech solutions through capacity development and training.

[6] Cross-sectional correlations of health and education efficiency scores with the GovTech public service quality index are 0.52 and 0.72 (both significant at the 1 percent level) (Garcia-Escribano, Juarros, and Mogues 2022; IMF 2021).

Annex VI. External Sector Assessment

Overall Assessment: *The FSM's external position is assessed to be substantially stronger than the level implied by fundamentals and desirable policies, based on projected data and EBA-lite model results.*[1] *However, because of data gaps for FY2019-FY2023, the FSM's heavy dependence on volatile foreign grants, foreign corporate tax revenue, and fishing license fees, these results should be interpreted with caution. Economic support under the now likely renewal of the Compact Agreement with the United States also significantly impacts the assessment.*

Potential Policy Responses: *As the current account balance is projected to deteriorate in the medium-to long-term, structural reforms to promote private sector development and diversify the export base could help improve competitiveness and reduce risks of a future worsening of the external balance. In addition, the new Compact agreement will provide a significant and reliable increase in capital inflows and financial support to strengthen FSM's external position.*

Current Account

Background. The current account balance reached at surplus, projected at 3.3% of GDP, in FY2023, as the inflows of donor grants, fishing license fees and foreign corporate income tax windfalls were used to finance the trade deficit and accumulate savings. The current account surplus in FY2023 is lower than the large surplus of 8.5 percent of GDP in FY2022, which is mostly due to the large windfalls of foreign corporate tax revenue, 8.8 percent of GDP, accompanied by increasing remittance inflows. The FSM had a positive net international investment position (NIIP) of 183 percent of GDP at end-FY2023, mainly reflecting a large share of bank deposits invested abroad and the buildup of the FSM Trust Fund[2].

Assessment. The external balance assessment (EBA) suggests that the external sector position of the FSM is substantially stronger than the level implied by fundamentals and desirable policies. However, the assessment should be treated with caution given data gaps and large uncertainty around the BOP flows.

- The adjusted current account balance is at a surplus of 3.3 percent in FY2023 after considering model-based cyclical contributions. The EBA-lite methodology estimates the FSM's current account norm, the level consistent with fundamentals and desirable policies to be -3.0 percent of GDP[3]. This implies a model-estimated current account gap of around 6.3 percent of GDP. The EBA-lite identified policy gaps of about 4.9 percent of GDP, mainly due to a tighter fiscal policy—which reflected the uncertainty around the renewal of the COFA in FY2023 and is not taken into account in the model.

Micronesia Fed. States of: EBA-lite Model Results, 2023

	CA model 1/ (in percent of GDP)
CA-Actual	**3.3**
Cyclical contributions (from model) (-)	0.0
Adjusted CA	**3.3**
CA Norm (from model) 2/	**-3.0**
Adjusted CA Norm	**-3.0**
CA Gap	**6.3**
o/w Relative policy gap	4.9
Elasticity	-0.3
REER Gap (in percent)	**-20.4**

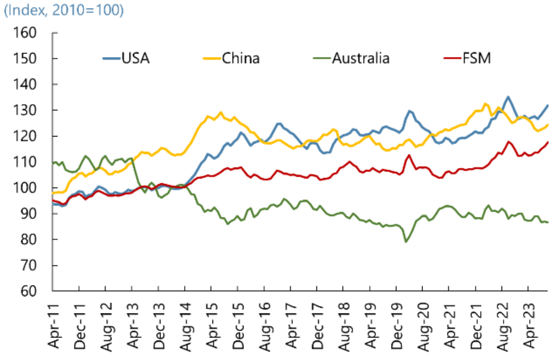
1/ Based on the EBA-lite 3.0 methodology
2/ Cyclically adjusted, including multilateral consistency adjustments.

- On balance, staff assesses the external position in FY2023 to be substantially stronger than the level implied by fundamentals and desirable policies, while noting the data limitations, large uncertainties surrounding the model estimates and the special characteristics of the FSM economy. In particular, the high uncertainty around large BOP flows (tax revenues from foreign companies, fishing licenses, and foreign grants) justified a more precautionary approach and accumulation of savings in recent years. The new COFA agreement represents a major change as implies the need for less savings. In addition, the current account balance is anticipated to decrease markedly in subsequent years.

Real Exchange Rate

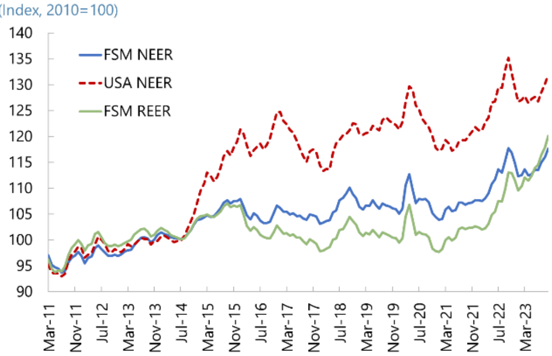
Background. The US dollar is used as legal tender and official currency in FSM, and there is no central bank. The nominal and real effective exchange rates appreciated by 4 percent and 8 percent (monthly average) respectively in FY2023, mimicking the strengthening of the U.S. dollar.

Nonimal Effective Exchange Rate
(Index, 2010=100)



Source: IMF staff estimates.

FSM: Nominal and Real Effective Exchange Rates (EER)
(Index, 2010=100)



Source: IMF staff estimates.

Assessment. The use of the U.S. dollar as the official currency is appropriate given the small size of the economy, close financial and trade linkages with the United States, and limited administrative capacity for independent monetary and exchange rate policies.

Capital and Financial Accounts

Background. Both capital and financial account have been in surplus in recent years. Capital account surplus is estimated to be 5.1 percent of GDP in FY2023, which is mainly composed of inflows of capital grants from the U.S. Compact and other IFIs or donors. For financial accounts, foreign direct investment (FDI) is likely to remain a negligible source of financing. The portfolio investment account is projected to increase driven by returns on government investment in foreign securities.

FX Intervention and Reserves Level

Background. The FSM does not have a central bank or foreign exchange reserves. The national government's bank deposits were around 16 percent of GDP at the end of FY2023, which corresponds to 3 months of imports and 4 months of general government current expenditure. In addition, the FSM government has large financial assets in the FSM trust fund.

Assessment. Government deposits and large financial assets in the trust fund could play a role in absorbing short-term liquidity shocks.
[1] The Real Effective Exchange Rate approach is not applied due to data limitations. Furthermore, the external sustainability approach is not applicable, due to the FSM's positive NIIP in both historical and projection years. [2] The NIIP does not include accumulated U.S. contributions to the Compact Trust Fund. [3] The current account norm is substantially lower than the surplus of 2.6 percent of GDP estimated in the 2021 Article IV. This significant difference is in part rooted in the assumptions regarding the renewal prospects of the COFA. In FY2021, there was significant uncertainty of COFA renewal, prompting a pressing need for fiscal consolidation. However, with the anticipated renewal of COFA, the urgency for such fiscal adjustment has diminished.

INTERNATIONAL MONETARY FUND

FEDERATED STATES OF MICRONESIA

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

February 7, 2024

Prepared By

Asia and Pacific Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of January 31, 2024)

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

General Resources Account:

	SDR Million	Percent Quota
Quota	7.20	100.00
Fund holdings of currency	6.68	92.71
Reserve tranche position	0.53	7.30

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	11.71	100.00
Holdings	12.70	108.51

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to Fund[1]

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2024	2025	2026	2027	2028
Principal					
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

Exchange Rate Arrangement

The de jure and de facto exchange rate arrangement is an arrangement with no separate legal tender. The U.S. dollar is legal tender and the official currency. The Federated States of Micronesia (FSM) maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions and multiple currency practices.

Article IV Consultation

The Federated States of Micronesia is on a 24–month consultation cycle. The 2021 Article IV consultation discussions were held during July 19–30, 2021. The Executive Board discussed the staff report and concluded the consultation on October 27, 2021.

Technical Assistance: PFTAC, FAD, and STA have provided technical assistance on macroeconomic programing and analysis, tax policy and administration, and government finance statistics.

Resident Representative: The IMF Regional Resident Representative Office based in Suva, Fiji covers 12 IMF member countries in the Pacific, including the FSM. Mr. Neil Saker is the current Resident Representative.

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

RELATIONS WITH OTHER INTERNATIONAL FINANCIAL INSTITUTIONS AND PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTER

Relations with other International Financial Institutions:

- World Bank Group: http://projects.worldbank.org/search?lang=en&searchTerm=&countrycode_exact=FM
- Asian Development Bank: https://www.adb.org/countries/micronesia/main

Relations with Pacific Financial Technical Assistance Center:

- Pacific Financial Technical Assistance Center: https://www.pftac.org/content/PFTAC/en1.html

STATISTICAL ISSUES

(As of January 24, 2024)

I. Assessment of Data Adequacy for Surveillance
General: Data provision has serious shortcomings that significantly hamper surveillance. While coverage of key macroeconomic data is broadly sufficient, data lags make it difficult to undertake an accurate and timely evaluation of economic developments on an ongoing basis. The most affected areas are external sector statistics with a lag of five years (previously, data was typically compiled annually with a lag of nearly one year). National accounts data is available until FY2022, but the statistics for FY2019-22 are only preliminary estimates and subject to revision. Government finance statistics are available only until FY2021. Additionally, the unavailability of the statistics homepage has disrupted access to even historical data.
National accounts: National accounts have been prepared, with the support of the Graduate School USA (GSUSA), dating back to FY1995. Annual GDP estimates based on the production and income approaches had been compiled and disseminated with a lag of about a year. However, the production of GDP estimates has experienced significant delays due to the lack of sharing of tax data from the Department of Finance and Administration since FY2018. Sharing of data resumed in 2023, facilitating the production of preliminary estimates for FY2019-22. However, the most recent public release of GDP data is only for FY2018. A decennial national census for 2020 has yet to finish. A household survey was conducted in 2013 and 2014 and an Integrated Agriculture Census in 2016.
Employment: Data on employment and wages are available until FY2022. No unemployment data are available except for 2013 when the household survey was conducted.
Price statistics: A quarterly consumer price index (CPI) is published for the FSM and for each state. The CPI was rebased to 2017Q1 and utilizes expenditure weights derived from an earlier household survey. However, data releases are often delayed.
Government finance statistics: Fiscal data for the budgetary central government and 4 state governments have been prepared, with the support of GSUSA, going back to FY2004. Data are compiled in line with *Government Finance Statistics Manual 2014 (GFSM 2014)* based on annual audit reports of the budgetary central and 4 state governments. The fiscal accounts are consolidated between the national and state governments. However, government agencies and local governments (municipalities) are not covered. There is potential to expand the coverage to the general government by including extrabudgetary units of the central government and the social security funds if the source information is available from the annual financial statements. Financial information is also readily available for public corporations and compilation of public sector GFS may commence, taking into consideration local capacity.
Monetary and financial statistics: FSM uses U.S. dollar as a currency and does not have a central bank. The Banking Board compiles monthly monetary data with a three-month lag. The data comprise interest rates, and the accounts of the two commercial banks. The depository survey data are not compiled based on IMF's standardized report forms (SRFs), hindering international comparability. The FSM also reports some data and indicators of the Financial Access Survey (FAS), including the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).

Financial sector surveillance. The FSM started compiling Financial Soundness Indicators (FSIs) data in 2016 with a twenty-month lag. As a result of the FSIs technical assistance mission provided by STA in November 2020, the FSM has reported quarterly FSIs in line with the 2019 FSI Guide and with a three-month lag.	
External sector statistics: The authorities have been compiling annual balance of payments and international investment position (IIP) statistics in broad conformity with the sixth edition of the *Balance of Payments and International Investment Position Manual (BPM6),* with assistance from the USGS since 2006. The balance of payments data is regularly published on the FSM Division of Statistics website and available up to FY2018. Large errors and omissions in the balance of payments undermine the usability of these data for assessment of external sustainability. A PFTAC technical assistance mission in April 2018 recommended enhancements to the source data and estimation methods for re-exports of fuel, imports, travel credits/debits, personal transfers, interest payments, transactions and positions of direct and other investment liabilities to enhance the quality of the balance of payments and IIP. The mission noted the requirement of further TA and training covering the financial account, IIP, and external debt statistics.	
II. Data Standards and Quality	
Participant in the Fund's General Data Dissemination System (GDDS) since November 2014. Implemented the enhanced GDDS (e-GDDS) in July 2017. The National Summary Data Page (NSDP) is available at: https://www.fsmstatistics.fm/fsm-national-summary-data-page-nsdp/[1]	Data ROSC is not available.

[1] Summary of dissemination practices under the eGDDS is available here: https://dsbb.imf.org/e-gdds/country/FSM/summary-of-dissemination

Federated States of Micronesia: Table of Common Indicators Required for Surveillance

(As of January 24, 2024)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates[1]	NA	NA	NA	NA	NA
International Reserve Assets and Reserve Liabilities of the Monetary Authorities [1]	NA	NA	NA	NA	NA
Reserve/Base Money[1]	NA	NA	NA	NA	NA
Broad Money[1]	NA	NA	NA	NA	NA
Central Bank Balance Sheet[1]	NA	NA	NA	NA	NA
Consolidated Balance Sheet of the Banking System	2023Q3	Dec 2023	Q	Q	Q
Interest Rates[2]	FY2023	Dec 2023	A	A	A
Consumer Price Index	2023Q3	Nov 2023	Q	Q	Q
Revenue, Expenditure, Balance/Composition of Financing[3] General Government[4] and Central Government	FY2021	Nov 2023	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2023Q2	Dec 2023	Q	Q	Q
External Current Account Balance	FY2018	Sep 2019	A	A	A
Exports and Imports of Goods and Services	FY2019	Nov 2023	A	A	A
GDP/GNP	FY2022	Nov 2023	A	A	A
Gross External Debt	FY2018	Sep 2019	A	A	A
International Investment Position[6]	FY2018	Sep 2019	A	A	A

[1] The U.S. dollar is legal tender and the official currency. FSM does not have a central bank.
[2] Includes the interest rate on consumer loans and commercial loans, as well as deposit rates.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra-budgetary funds, and social security funds) and state and local governments.
[5] Including currency composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).

FEDERATED STATES OF MICRONESIA

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION —DEBT SUSTAINABILITY ANALYSIS

February 7, 2024

Approved By
Thomas Helbling, Pritha Mitra (IMF), Manuela Francisco and Lalita Moorty (IDA)

Prepared by the staff of the International Monetary Fund and the International Development Association (IDA)[1,2]

Risk of external debt distress	Moderate
Overall risk of debt distress	Moderate
Granularity in the risk rating	Substantial space
Application of judgment	Yes: The forecast horizon is extended to 20 years to take account of a continuous upward trajectory of debt indicators in stress tests.

The Federated States of Micronesia (FSM) is assessed at moderate risk of debt distress under the Low-Income Country Debt Sustainability Framework (LIC DSF), improved from the previous high-risk assessment in October 2021. Incorporating the likely renewal of the Compact of Free Association (COFA) in the baseline, which includes a large increase in U.S. grants to the FSM, the mechanical ratings on a 10-year forecast horizon indicate low risk. However, the risk of debt distress is assessed as moderate for the 20-year horizon as stress tests indicate that natural disaster shocks and export shocks could increase the present value (PV) of external debt-to-GDP, and external debt service-to-exports ratios above their thresholds. As such, the risk of external debt distress is assessed as moderate, with substantial space to absorb shocks. The PV of public debt-to-GDP also appears vulnerable to shocks of growth and natural disasters within 20 years, while it does not breach the benchmark in the baseline. As a result, the overall risk of debt distress is also assessed as moderate. This assessment has significant uncertainties, particularly regarding the timing of the new COFA's enactment. The sizeable Compact and FSM trust funds can be used to mitigate risks in the event of an extensive delay of the new COFA. It is also crucial to build capacity to improve effectiveness of

[1] The FSM's Composite Indicator of 1.72 indicates a weak debt-carrying capacity, based on the October 2023 IMF's World Economic Outlook (WEO) and the 2022 World Bank's Country Policy and Institutional Assessment (CPIA).

[2] This DSA has been prepared jointly by the IMF and World Bank, following the 2018 Guidance Note on the Bank-Fund Debt Sustainability Framework for Low Income Countries.

public spending, accompanied by reforms to promote the development of the private sector, which would help achieve higher sustainable growth and strengthen debt dynamics. Additionally, the FSM's vulnerability to climate change and weather-related natural disasters constitutes a key risk and calls for strategies to strengthen climate change resilience.

PUBLIC SECTOR DEBT COVERAGE

1. **This Debt Sustainability Analysis (DSA) covers debt owed by the national and state governments of the FSM** (Text Table 1). As of June 2023, debt is primarily external and includes guaranteed debt from state-owned enterprises (SOEs). Since the previous DSA, the authorities enhanced debt transparency, including reporting of both guaranteed and on-lent debt by SOEs, thanks to support by the FY2022-2023 Performance and Policy Actions (PPAs) under IDA's Sustainable Development Finance Policy (SDFP).[3] Nevertheless, the coverage of the analysis can be improved by including other elements in the government (e.g. social security fund[4]). There is no non-guaranteed SOE's debt. Against this background, the shock for SOE's debt is set to zero in the contingent liability stress test. There are no Public Private Partnership (PPP). The FSM uses the U.S. dollar as the legal tender and does not have a central bank. The external debt is defined based on the residency criteria.

Text Table 1. Coverage of Public Debt

	Subsectors of the public sector	Sub-sectors covered
1	Central government	X
2	State and local government	X
3	Other elements in the general government	
4	o/w: Social security fund	
5	o/w: Extra budgetary funds (EBFs)	
6	Guarantees (to other entities in the public and private sector, including to SOEs)	X
7	Central bank (borrowed on behalf of the government)	
8	Non-guaranteed SOE debt	

1	**The country's coverage of public debt**	The central, state, and local governments, government-guaranteed debt		
		Default	**Used for the analysis**	**Reasons for deviations from the default settings**
2	Other elements of the general government not captured in 1.	0 percent of GDP	0.0	
3	SoE's debt (guaranteed and not guaranteed by the government) 1/	2 percent of GDP	0.0	SOEs' debt guaranteed by the government already included in debt coverage
4	PPP	35 percent of PPP stock	0.0	Not applicable
5	Financial market (the default value of 5 percent of GDP is the minimum value)	5 percent of GDP	5.0	
	Total (2+3+4+5) (in percent of GDP)		5.0	

1/ The default shock of 2% of GDP will be triggered for countries whose government-guaranteed debt is not fully captured under the country's public debt definition (1.). If it is already included in the government debt (1.) and risks associated with SoE's debt not guaranteed by the government is assessed to be negligible, a country team may reduce this to 0%.

BACKGROUND ON DEBT

2. **The FSM's public sector debt declined to 12.6 percent of GDP at end-June 2023, from a peak of 31.4 percent of GDP in FY2009** (Text Table 2). As the FSM has been running budget surpluses, public sector debt has been on a downward trajectory since FY2009. Most of the debt is concessional and is

[3] To enhance debt transparency, since December 2021, the Government has been publishing debt bulletins, which includes the level of public and publicly guaranteed (PPG) debt, with breakdown by level of government, domestic and external debt, creditor, government guarantees, and debt servicing schedule. Supported by the FY2023 SDFP PPA, the Government has increased the frequency of publication of debt bulletins from semi-annual to quarterly, with historical data and breakdowns from FY2018 as well as a directive mandating the publication of quarterly bulletins online. Further, the non-concessional borrowing ceiling that FSM is subject to under the SDFP will support FSM to mitigate external debt risks over the projection horizon.

[4] The size of the social security fund asset was $58.4 million in 2020 and its liabilities are less than 0.1 percent of GDP.

contracted with official lenders. As of June 2023, 65 percent of the debt is from the Asian Development Bank (AsDB), while the share of the U.S. Department of Agriculture stood at 16.9 percent. The remaining debt (18.1 percent of total) comprises the European Investment Bank (EIB), a commercial private lender, and a domestic entity (FSM Development Bank). All loans except from the EIB (5.9 percent of total) are denominated in U.S. dollars. Total external debt service reached 6 percent of exports in FY2022 and is expected to stabilize over the medium term.

Text Table 2. Stock of Debt Owed by the National and State Governments

	Jun-23		
	In millions of U.S. dollars	As a share of total debt	In percent of GDP
Total public debt	58.0	100.0	12.6
External	54.7	94.3	11.9
Multilateral	41.1	70.9	8.9
Asian Development Bank	37.7	65.0	8.2
European Investment Bank	3.4	5.9	0.7
Bilateral	9.8	16.9	2.1
U.S. Department of Agriculture	9.8	16.9	2.1
Commercial	3.8	6.6	0.8
Domestic	3.3	5.7	0.7
Memorandum item:			
of which: SOE debt 1/	24.4	42.1	5.3

Source: FSM authorities and IMF staff estimates and calculations.
1/ SOE debt comprises guaranteed ($12.4 million) and on-lent ($12.0 million) debts.

BACKGROUND ON MACROECONOMIC FORECASTS

3. **Economic growth is expected to improve in the next few years supported by a boost in public spending; the fiscal balance is expected to deteriorate over time after a period of large surpluses** (Box 1). The economy contracted by 0.9 percent in FY2022, after a short-lived rebound in FY2021, driven by a large contraction in the fisheries sector. The economy is estimated to have grown by 0.8 percent in FY2023 partly supported by a recovery in construction and tourism and higher public wages in the national government. In FY2024-FY2025, growth is projected to accelerate further partly driven by public investment and the implementation of the new COFA from FY2025. Long-term growth is expected to be around 0.7 percent, subdued partly by vulnerability to climate-related disasters, but could be higher if deeper reforms to promote private sector development are adopted. Inflation is projected to gradually converge to 2 percent over the medium term in line with U.S. inflation. The fiscal balance is projected to turn to deficits (1-3 percent of GDP) over the medium-to-long term mainly reflecting large investment needs, amid the phase-out of committed grants, and declining fishing revenues. The financing mix envisages mainly a combination of some drawdown of financial assets and external borrowing, with domestic debt remaining residual. The current account balance is projected to deteriorate through the forecast horizon towards a deficit of around 1 percent of GDP over the long run. The realism tools suggest that macroeconomic and fiscal assumptions are broadly reasonable (Figures 3 and 4).[5]

[5] The changes in the contribution of the fiscal balance to debt during the projection periods are due to significantly lower corporate tax revenue projections, as opposed to the large revenue windfalls in recent years (Figure 3).

Box 1. Key Macroeconomic Assumptions

FSM: Macroeconomic Assumptions

	Current DSA (2023 Article IV)						Previous DSA (2021 Article IV)					
	2022	2023	2024	2025	2026	2027-43	2022	2023	2024	2025	2026	2027-41
Real GDP (y/y growth)	-0.9	0.8	1.1	1.7	1.1	0.7	0.6	3.2	1.9	0.8	0.6	0.5
Inflation (y/y growth)	11.3	6.2	4.0	3.0	2.5	2.0	2.6	2.6	2.6	2.5	2.4	2.0
Fiscal balance (percent of GDP)	7.8	1.6	1.3	-0.4	-1.0	-2.3	2.8	2.4	-4.1	-4.9	-5.0	-5.1
Current account balance (percent of GDP)	8.5	3.3	0.8	0.8	0.6	-0.9	1.1	-0.4	-5.1	-4.9	-5.2	-4.5

Sources: FSM authorities and IMF staff estimates and calculations.

- **The renewal of the COFA with the United States** is assumed to take effect in FY2025.[1] Under the new agreement between the U.S. and FSM governments (which still needs to be ratified by the U.S. Congress), the FSM is expected to have access to $140 million per year in sector grants for the next 20 years, about 1.4 times larger than the previous access. The U.S. will also deposit $500 million in the Compact Trust Fund (CTF) in the first 2 years. Unused sector grants for operational costs will be deposited in the CTF, and a withdrawal from the CTF will be possible during the new COFA period. Given capacity constraints, some accumulation of unused grants is expected during the first 5 years, and CTF withdrawals are expected to start from FY2031 onwards as capacity improves.

- **Real GDP growth** is expected to be higher in the medium term, due to continuation of economy recovery, a gradual scale-up of public investment and the renewal of U.S. budgetary support under the new COFA. FY2023 growth is estimated at 0.8 percent reflecting a rebound in construction, transportation, and tourism. In addition, higher public wages in the national government helped support consumer's real purchasing power. In FY2024-FY2025, growth will accelerate partly due to increasing public investment and other spending. In the medium to long term, FSM is projected to register yearly growth below 1 percent, similar to past periods when public investment was boosted. Strengthening capacity to spend well and additional structural reforms would help boost growth further. Some delays in approval of the new COFA should have a limited impact on growth projections, given public investment in funded by unused past grants, but a more extended delay would undermine growth projections over time.

- **Inflation** is projected to gradually fall in the medium term to 2 percent. Headline inflation rose to 6.2 percent in FY2023 mainly driven by higher import prices. In the medium term, inflation is expected to converge to 2 percent in line with inflation in the United States (the U.S. dollar is the FSM's legal tender). The GDP deflator is assumed to move in tandem with inflation.

- **The fiscal surplus** is projected to turn into a deficit in FY2025. Temporary US grants (to replace COFA-related current grants that expired) in FY2024 are expected to continue at the FY2023 levels.[2] The new COFA grants are expected to start from FY2025. Public investment will expand as grant-funded projects roll out, but at a gradual pace given significant capacity constraints. However, the national government will need to adopt spending restraint given loss of revenues under the new revenue-sharing agreement (transferring 50 percent of fishing royalties to state governments). State governments are expected to boost their spending, thanks to the additional revenue from fishing royalties and grants from the new COFA[3]. In the medium to long term, large investment needs, especially for adaptation, are expected to lead to fiscal deficits amid the phase-out of committed grants and declining fishing revenues.

[1] This is a major change from the previous DSA, which assumed the expiration of the current COFA in FY2023 without renewal.

[2] The US Congress authorized to keep the COFA grants at the FY2023 levels for the beginning of FY2024.

[3] The four state governments have received more than 95 percent of Compact current sector grants since FY2011.

Box 1. Key Macroeconomic Assumptions (concluded)

- **The current account balance** is projected to deteriorate, to a deficit of around 1 percent of GDP in the long run, mainly driven by elevated public consumption and investment, despite large grants.
- **The FSM Trust Fund** (FSMTF) has accumulated large financial assets mainly thanks to fiscal revenue windfalls from fishing license fees and corporate income tax for Japanese domicile companies. The trust fund's balance stood at US$405.8 million, or about 88 percent of GDP, at the end of FY2023. Under the baseline scenario, no additional contributions are assumed in FY2024 and beyond.[4] A partial drawdown of investment gains (around 2 percent of GDP) is assumed to commence from FY2031. Nevertheless, the fund's balance is projected to increase to 97 percent of GDP by end-FY2043 as the rate of investment return[5] is projected to be higher than the nominal GDP growth rate, and that any drawdown from the FSMTF can only be made in a manner that maintains the remaining balance at the previous year's level as a percentage of GDP.
- **Financing mix.** With the fiscal balance remaining in a surplus and grants still abundant, no new debt incurrence is projected in FY2023-24. For instance, the World Bank has provided sizable financial support to the FSM (as of end June 2023, net commitments stood at around 60 percent of GDP and total disbursements were around 16 percent of GDP) and, consistent with the IDA grant allocation framework, such support has been provided as grants. Beyond this, the paths of external and public debt are determined by projected fiscal deficits, GDP growth, interest rates for new debt, and the financing mix for fiscal gross financing needs (GFNs). Use of financial assets, mainly the FSMTF drawdown, are assumed to be used to partially fill GFNs. External project loans (e.g., IDA lending for small economies) are expected to finance 90 percent of the remaining GFNs, while 10 percent is assumed to be financed by domestic borrowing from banks (5.7 percent of total public debt, as of Jun 2023). Such domestic borrowing would unlikely crowd out private sector credit, given the very low loan-to-deposit ratio in the FSM.

[4] FSM Congress repealed the requirements to deposit 20 percent of fishing revenue and 50 percent of revenue from captive insurance companies to the FSMTF.

[5] The annual nominal net return rate of the FSM TF is assumed 5 percent, applied for the CTF. The historical average of the net return rate of the CTF is 6.3 percent, as of end-FY2022.

COUNTRY CLASSIFICATION AND DETERMINATION OF SCENARIO STRESS TEST

4. **The FSM's debt carrying capacity is assessed as weak.** The country's Composite Indicator (CI) index is 1.72, based on October 2023 WEO and 2022 CPIA (Text Table 3). The CI indicates a weak debt-carrying capacity, similar to the previous vintage classification. The DSA thresholds applicable for the FSM are 30 percent for the present value (PV) of external debt-to-GDP ratio, 140 percent for the PV of external debt-to-exports ratio, 10 percent for the external debt service-to-exports ratio, 14 percent for the external debt service-to-revenue ratio, and 35 percent for the PV of public debt-to GDP ratio.

Text Table 3. FSM's Composite Indicator and Applicable Thresholds

Calculation of the CI Index

Components	Coefficients (A)	10-year average values (B)	CI Score components (A*B) = (C)	Contribution of components
CPIA	0.385	2.765	1.06	62%
Real growth rate (in percent)	2.719	0.588	0.02	1%
Import coverage of reserves (in percent)	4.052	2.693	0.11	6%
Import coverage of reserves^2 (in percent)	-3.990	0.073	0.00	0%
Remittances (in percent)	2.022	7.243	0.15	8%
World economic growth (in percent)	13.520	2.889	0.39	23%
CI Score			1.72	100%
CI rating			Weak	

Applicable Thresholds

Applicable	
External debt burden thresholds	
PV of debt in % of	
Exports	140
GDP	30
Debt service in % of	
Exports	10
Revenue	14

Applicable	
Total public debt benchmark	
PV of total public debt in percent of GDP	35

5. **Given the severity and frequency of natural disasters in the FSM, a tailored stress test for a natural disaster shock is added to the standard set of stress test scenarios.** In the natural disaster scenario, a one-off shock of 10 percentage points to debt-GDP ratio in FY2024 is assumed, with real GDP growth and exports growth lowered by 5.0 and 3.5 percentage points, respectively, in the year of the shock.[6] Financial market shocks are considered for contingent liabilities, using the default shock parameters.[7] The scenario with exchange rate depreciation is not considered as the U.S. dollar is the FSM's legal tender.

DEBT SUSTAINABILITY

A. External Debt Sustainability Analysis

6. **Under the baseline scenario, there are no breaches in any external debt indicators vis-à-vis indicative thresholds over the extended 20-year horizon** (Table 1 and Figure 1). The external debt stock is projected to increase from 11.8 percent of GDP in FY2023 to 13.5 percent in FY2033, followed by stabilization at less than 15 percent of GDP through FY2043. The increase in debt is mainly driven by the

[6] The size of the shock on GDP growth (-5 percent), which is larger than the default value of the DSF framework (-1.5 percent), is based on cross-country regression results of Lee and others, 2018, "The Economic Impact of Natural Disasters in Pacific Island Countries: Adaptation and Preparedness," IMF Working Paper No.18/108.

[7] Following the DSA guideline, shocks of SOE' debt and PPP stock are set to zero.

expected scale-up in public investment, including on climate adaptation, and declining fishing license revenue (26 percent of total revenue in FY2023). In addition, some spending restrain at the national level is expected, given loss of revenues under the new revenue-sharing agreement that benefited the states. However, thanks to large grant inflows from the new COFA, all external debt stock and liquidity indicators remain below their thresholds through FY2043. The debt trajectory under the historical scenario differs significantly from that of the baseline scenario (Figure 1). This is mainly because the historical scenario does not account for the expected increase in capital expenditures and lower corporate tax and fishing revenue projections, as opposed to the large revenue windfalls seen in recent years.

7. Stress tests point to the vulnerability of the FSM's external debt dynamics to shocks from natural disasters and exports during the extended 20-year period (Figure 1 and Table 3). In the stress test to natural disaster shocks, the PVs of external PPG debt-to-GDP ratio and debt-to-exports ratio are projected to be on a continuous upward trajectory, resulting in a breach of the threshold starting in FY2036 and FY2041, respectively. The debt service-to-exports ratio also breaches the threshold during the period of FY2033-37 in the stress test including the exports shock.

B. Public Sector Debt Sustainability Analysis

8. Public sector debt follows closely the dynamics of external debt. The ratio of public debt to GDP is projected to rise from 12.4 percent of GDP in FY2023 to 13.7 percent in FY2033 and gradually stabilize at 15 percent in FY2043 (Table 2). The PV of the public debt-to-GDP ratio does not breach the benchmark under the baseline through the 20-year projection horizon.

9. Stress tests indicate overall debt dynamics is vulnerable to real GDP growth and natural disasters shocks (Figure 2 and Table 4). The PV of overall debt-to-GDP ratio is projected to continue to increase, breaching the benchmark in response to a growth shock and a natural disaster shock starting from FY2034 and FY2039, respectively.

RISK RATING AND VULNERABILITIES

10. The risk of external debt distress is assessed at moderate with substantial space to absorb shocks (Figure 5), **upgraded from high in the previous DSA.** Incorporating the potential renewal of the COFA, the DSA's mechanical rating indicates low risk, as none of the DSA thresholds is breached in either baseline or stress tests during the standard 10-year horizon. Nevertheless, the horizon for the FSM is extended to 20 years due to longer term effects on debt from some shocks. While there is still no breach in the baseline within a 20-year forecast, the projected breach of the threshold in stress tests warrants an assessment of moderate risk of external debt distress. External debt dynamics are especially vulnerable to natural disaster and exports shocks.

11. The risk rating of overall debt distress is also upgraded to moderate from high in the previous DSA. The mechanical rating indicates low risk with no breach in both baseline and stress tests within 10 years. Extending the forecast horizon to 20 years, however, the risk of overall debt distress is assessed as moderate. Under the baseline, the PV of public debt-to-GDP ratio is projected to remain below the benchmark over the 20 years. However, in the stress tests with growth shocks and natural disaster shocks, the PV of public debt-to GDP ratio is projected to be on a persistent upward trajectory and above the benchmark within 20 years.

12. The assessment of the risk of debt distress critically depends on the potential renewal of the COFA. A bill for a new 20-year COFA with significantly higher grants—agreed upon by both the FSM and U.S. governments—is currently under consideration by the US Congress. The expectation is that the law will be approved during FY2024; however, there is still uncertainty including on what bridging arrangements would be in place in case of extensive delays. The baseline scenario assumes that the new COFA will begin in FY2025. Longer delays could deteriorate the debt dynamics. However, the potential adverse impact is mitigated by the large financial assets in the Compact and FSM trust funds (323 percent of GDP) which could cover funding needs for more than a decade.

13. The FSMTF and the CTF provide an additional safeguard for debt repaying capacity and debt sustainability. The new agreement allows for greater flexibility on use of the resources. The CTF was originally created to accumulate resources to be distributed after the expiration of the fiscal support under COFA, but a distribution will now be possible during the new COFA period (FY2024-FY2043) if necessary. As regards the FSMTF, the baseline scenario assumes that a partial drawdown from the FSMTF will commence from FY2031, with the condition that the size of the Fund remains at least stable as share of GDP. This strategy implies that the trust funds can facilitate the authorities' capacity to repay the public debt and respond to shocks, helping keep debt in a sustainable path.

14. Additionally, delays in the publication of key statistics are one of the big challenges to the macroeconomic projection and the DSA. Balance of payments statistics are available only until FY2018. GDP statistics are available up until FY2022, but the data for FY2019-22 is still preliminary and subject to revision. Government finance statistics are only available until FY2021.

15. Further efforts can be done to improve public financial management and debt management, which would help support growth and better manage risks.[8] The baseline in the analysis envisages that public investment will rise by 5 percentage points of GDP during FY2022-28 and remain around14.5 percent of GDP afterwards—considerably higher than the historical average (10.6 percent in the last decade)—to address the large development and climate-related needs. However, the implementation rate and effectiveness will depend on overcoming significant capacity constraints. Strengthening public financial management (PFM) and public investment management (PIM) reforms are key to enhance the effectiveness of public investment. It would allow to scale up high-quality public investment faster to address the infrastructure investment needs, including on climate adaptation. While this could lead to larger fiscal deficits in early years, it would also have significant benefits for economic growth and debt dynamics over time as larger and more resilient capital would yield greater growth dividends and diminish the vulnerability to natural disaster shocks. Strengthening debt management would also help manage the higher debt in the future and assess risks.

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[8] Supported by the FY23 SDFP PPA1, the Government strengthened medium-term fiscal sustainability with the amendment of the Financial Management Regulations under the Financial Management Act and further with the approval of the state-level Financial Management Regulations under the FY24 PPA1.

AUTHORITIES' VIEWS

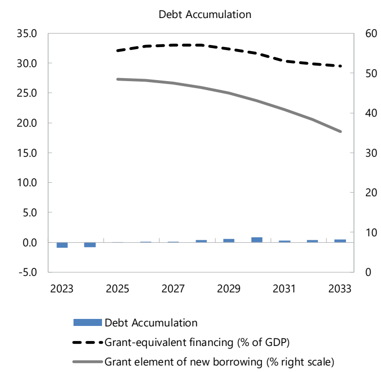
16. The authorities are not convinced that the risk of debt distress for FSM will improve from high to moderate even if the COFA agreement is ratified by the U.S. Congress. There is no assurance that the expected renewal of COFA agreement would significantly improve the debt dynamics given the mounting fiscal needs to address climate vulnerabilities, along with the financing needs to upscale critical infrastructure and remove bottlenecks to investment and sustained growth. Given the significant uncertainty on when the U.S. Congress will pass the bill for the new COFA and how much will be approved, they recommended against inclusion of pending COFA amounts into DSA until full approval to prevent costly policy mistakes on the debt front. Additionally, they stressed the need to fully incorporate large climate-related investment needs, and economic and social investments programs into the DSA model to provide a more useful fiscal policy guidance. While the authority's intent to preserve the financial assets in the trust funds and limit borrowing, they noted that it's becoming increasingly difficult to maintain this policy stance given the increasing frequency and severity of natural disasters, and the continued difficulty to access climate funds.

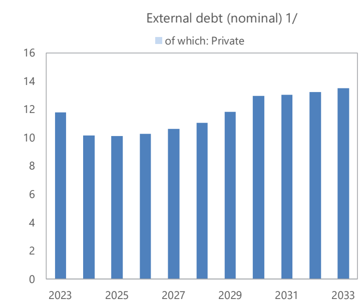
Table 1. Federated States of Micronesia: External Debt Sustainability Framework, Baseline Scenario, 2022-2043

(In percent of GDP, unless otherwise indicated)

	Actual	Projections								Average 8/	
	2022	2023	2024	2025	2026	2027	2028	2033	2043	Historical	Projections
External debt (nominal) 1/	13.8	11.8	10.2	10.1	10.2	10.6	11.0	13.5	14.8	**21.9**	**11.7**
of which: public and publicly guaranteed (PPG)	13.8	11.8	10.2	10.1	10.2	10.6	11.0	13.5	14.8	**21.9**	**11.7**
Change in external debt	-2.3	-2.0	-1.6	0.0	0.1	0.4	0.4	0.3	0.0		
Identified net debt-creating flows	-10.0	-3.4	-0.8	-0.9	-0.7	-0.4	-0.2	1.0	1.0	**-6.6**	**-0.2**
Non-interest current account deficit	-8.7	-3.6	-1.0	-0.9	-0.7	-0.5	-0.4	0.8	0.9	**-6.7**	**-0.3**
Deficit in balance of goods and services	42.7	40.2	40.6	43.2	43.3	43.2	43.1	42.1	39.4	**45.1**	**42.4**
Exports	21.0	27.3	26.8	26.7	26.7	26.7	26.6	26.3	26.3		
Imports	63.8	67.5	67.3	69.9	70.0	69.8	69.8	68.4	65.7		
Net current transfers (negative = inflow)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	**0.0**	**0.0**
of which: official	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Other current account flows (negative = net inflow)	-51.5	-43.7	-41.5	-44.1	-44.1	-43.6	-43.5	-41.2	-38.5	**-51.8**	**-42.7**
Net FDI (negative = inflow)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	**0.1**	**0.1**
Endogenous debt dynamics 2/	-1.3	0.1	0.1	0.0	0.0	0.1	0.1	0.1	0.1		
Contribution from nominal interest rate	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.2	0.2		
Contribution from real GDP growth	0.1	-0.1	-0.1	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1		
Contribution from price and exchange rate changes	-1.6	...	...	...	...	...	...	...	...		
Residual 3/	7.6	1.4	-0.8	0.8	0.8	0.7	0.6	-0.7	-1.1	**5.2**	**0.1**
of which: exceptional financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Sustainability indicators											
PV of PPG external debt-to-GDP ratio	11.1	9.5	8.3	7.8	7.6	7.5	7.6	8.9	10.7		
PV of PPG external debt-to-exports ratio	52.7	34.9	30.9	29.4	28.6	28.2	28.6	34.0	40.6		
PPG debt service-to-exports ratio	6.0	4.9	4.7	4.4	4.0	4.1	2.8	3.1	3.4		
PPG debt service-to-revenue ratio	3.0	3.9	3.8	3.4	3.1	3.3	2.2	2.5	2.9		
Gross external financing need (Million of U.S. dollars)	-32.0	-10.0	1.6	1.5	1.9	3.6	2.4	10.9	15.1		
Key macroeconomic assumptions											
Real GDP growth (in percent)	-0.9	0.8	1.1	1.7	1.1	0.8	0.7	0.7	0.7	**0.6**	**0.9**
GDP deflator in US dollar terms (change in percent)	11.3	6.2	4.0	3.0	2.5	2.1	2.0	2.0	2.0	**2.5**	**2.7**
Effective interest rate (percent) 4/	1.6	1.9	1.8	1.6	1.5	1.4	1.4	1.2	1.6	**2.5**	**1.4**
Growth of exports of G&S (US dollar terms, in percent)	15.4	39.0	2.9	4.5	3.5	2.9	2.8	2.7	2.7	**1.7**	**6.2**
Growth of imports of G&S (US dollar terms, in percent)	4.2	13.2	4.9	8.8	3.8	2.6	2.7	2.3	2.2	**0.4**	**4.3**
Grant element of new public sector borrowing (in percent)	...	...	...	48.4	48.1	47.4	46.4	35.4	32.1	**...**	**43.7**
Government revenues (excluding grants, in percent of GDP)	41.7	34.9	33.1	34.0	33.9	33.6	33.3	32.6	31.3	**41.0**	**33.4**
Aid flows (in Million of US dollars) 5/	108.9	112.7	136.0	163.9	174.0	180.0	184.5	186.4	223.4		
Grant-equivalent financing (in percent of GDP) 6/	...	...	...	32.1	32.9	33.0	33.0	29.5	27.1	**...**	**31.6**
Grant-equivalent financing (in percent of external financing) 6/	...	...	...	97.8	97.8	97.5	98.0	97.3	97.5	**...**	**97.5**
Nominal GDP (Million of US dollars)	430	460	484	507	526	541	556	636	831		
Nominal dollar GDP growth	10.3	7.0	5.1	4.8	3.6	2.9	2.8	2.7	2.7	**3.1**	**3.6**
Memorandum items:											
PV of external debt 7/	11.1	9.5	8.3	7.8	7.6	7.5	7.6	8.9	10.7		
In percent of exports	52.7	34.9	30.9	29.4	28.6	28.2	28.6	34.0	40.6		
Total external debt service-to-exports ratio	6.0	4.9	4.7	4.4	4.0	4.1	2.8	3.1	3.4		
PV of PPG external debt (in Million of US dollars)	47.7	43.9	40.0	39.8	40.0	40.7	42.4	56.7	88.8		
(PVt-PVt-1)/GDPt-1 (in percent)		-0.9	-0.8	0.0	0.0	0.1	0.3	0.4	0.3		
Non-interest current account deficit that stabilizes debt ratio	-6.4	-1.6	0.6	-0.9	-0.9	-0.9	-0.8	0.6	0.9		

Definition of external/domestic debt	Residency-based
Is there a material difference between the two criteria?	Yes





Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g) + Ɛα (1+r)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, ρ = growth rate of GDP deflator in U.S. dollar terms, Ɛ=nominal appreciation of the local currency, and α= share of local currency-denominated external debt in total external debt.

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

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

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

6/ 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).

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

8/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years. The negative historical average for economic growth reflects the Covid-related recession. The pre-covid economic growth average was 0.7 percent.

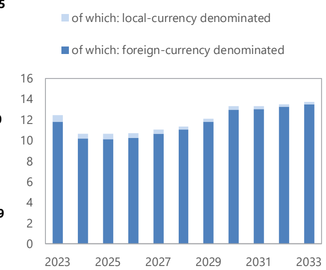
Table 2. Federated States of Micronesia: Public Sector Debt Sustainability Framework, Baseline Scenario, 2022-2043

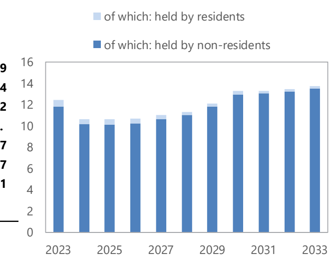
(In percent of GDP, unless otherwise indicated)

	Actual	Projections								Average 6/	
	2022	2023	2024	2025	2026	2027	2028	2033	2043	Historical	Projections
Public sector debt 1/	14.6	12.4	10.6	10.6	10.7	11.0	11.3	13.7	15.0	22.6	12.1
of which: external debt	13.8	11.8	10.2	10.1	10.2	10.6	11.0	13.5	14.8	21.9	11.7
Change in public sector debt	-2.5	-2.2	-1.8	0.0	0.1	0.3	0.3	0.3	0.0		
ed debt-creating flows	-9.3	-1.8	-1.5	0.1	0.7	0.9	0.8	2.4	2.1	-11.3	0.8
Primary deficit	-7.9	-1.7	-1.4	0.3	0.8	1.0	1.0	2.6	2.3	-11.3	1.0
Revenue and grants	67.0	59.4	61.2	65.4	66.1	65.8	65.7	61.6	58.1	71.2	63.5
of which: grants	25.3	24.5	28.1	31.4	32.2	32.2	32.4	29.0	26.7		
Primary (noninterest) expenditure	59.1	57.7	59.8	65.7	66.9	66.9	66.7	64.3	60.4	59.9	64.5
Automatic debt dynamics	-1.3	0.0	-0.1	-0.2	-0.2	-0.1	-0.1	-0.2	-0.2		
Contribution from interest rate/growth differential	0.0	0.0	-0.1	-0.2	-0.2	-0.1	-0.1	-0.2	-0.2		
of which: contribution from average real interest rate	-0.1	0.1	0.0	-0.1	-0.1	-0.1	0.0	-0.1	-0.1		
of which: contribution from real GDP growth	0.1	-0.1	-0.1	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1		
Contribution from real exchange rate depreciation	-1.4	...	...	...	...	...	...	...	...		
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		
Recognition of contingent liabilities (e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
bt relief (HIPC and other)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Other debt creating or reducing flow (please specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Residual	6.8	-0.4	-0.2	-0.1	-0.6	-0.6	-0.5	-2.2	-2.2	10.0	-0.9
ability indicators											
PV of public debt-to-GDP ratio 2/	11.9	10.2	8.7	8.4	8.1	7.9	7.9	9.2	10.9		
PV of public debt-to-revenue and grants ratio	17.7	17.1	14.3	12.8	12.2	12.0	12.1	14.9	18.7		
Debt service-to-revenue and grants ratio 3/	2.1	2.5	2.3	2.0	1.9	2.1	1.5	1.5	1.8		
Gross financing need 4/	-6.5	-0.2	0.0	1.6	2.1	2.4	2.0	3.6	3.3		
croeconomic and fiscal assumptions											
Real GDP growth (in percent)	-0.9	0.8	1.1	1.7	1.1	0.8	0.7	0.7	0.7	0.6	0.9
Average nominal interest rate on external debt (in percent)	1.6	1.9	1.8	1.6	1.5	1.4	1.4	1.2	1.6	2.5	1.4
Average real interest rate on domestic debt (in percent)	-7.6	-3.0	-0.9	0.2	1.5	2.8	3.2	4.2	4.1	0.3	2.2
Real exchange rate depreciation (in percent, + indicates depreciation)	-8.5	...	...	...	...	...	...	...	...	-0.5	...
Inflation rate (GDP deflator, in percent)	11.3	6.2	4.0	3.0	2.5	2.1	2.0	2.0	2.0	2.5	2.7
Growth of real primary spending (deflated by GDP deflator, in percent)	-12.0	-1.6	4.8	11.6	3.0	0.7	0.5	0.0	0.1	0.0	1.7
Primary deficit that stabilizes the debt-to-GDP ratio 5/	-5.5	0.4	0.4	0.3	0.8	0.7	0.7	2.4	2.3	-4.7	1.1
ıntingent liabilities (not included in public sector debt)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		

Definition of external/domestic debt	**Residency-based**
Is there a material difference between the two criteria?	**Yes**

Public sector debt 1/





Sources: Country authorities; and staff estimates and projections.

1/ Coverage of debt: The central, state, and local governments, government-guaranteed debt . Definition of external debt is Residency-based.

2/ The underlying PV of external debt-to-GDP ratio under the public DSA differs from the external DSA with the size of differences depending on exchange rates projections.

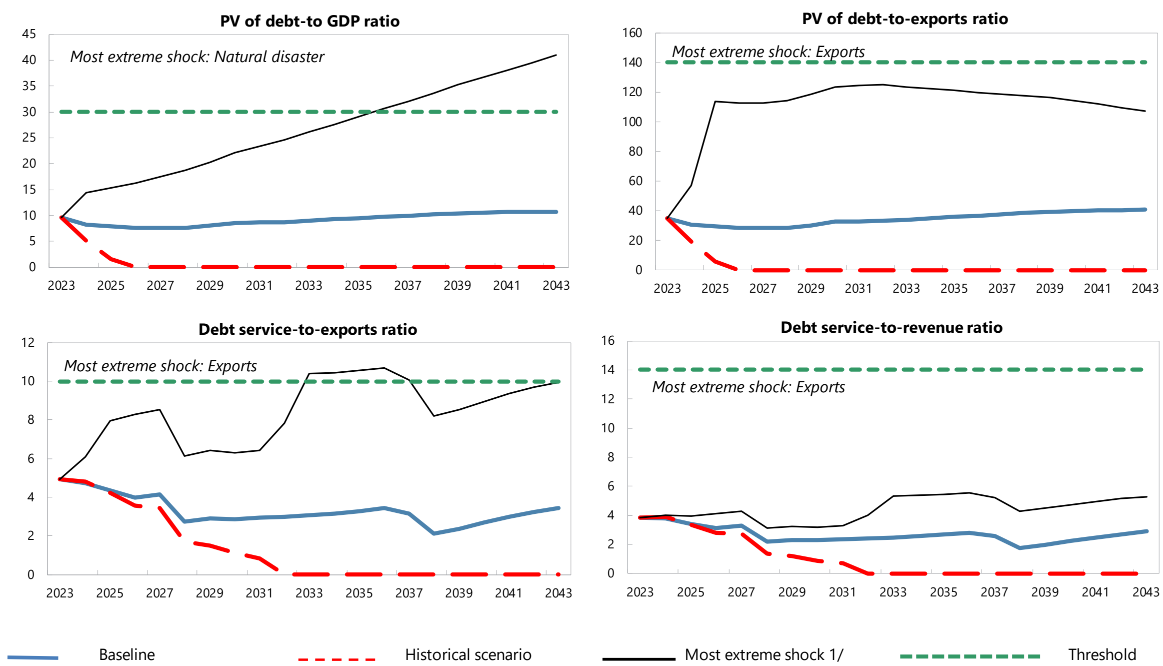
3/ Debt service is defined as the sum of interest and amortization of medium and long-term, and short-term debt.

4/ 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 and other debt creating/reducing flows.

5/ Defined as a primary deficit minus a change in the public debt-to-GDP ratio ((-): a primary surplus), which would stabilizes the debt ratio only in the year in question.

6/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

Figure 1. Federated States of Micronesia: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2023-2043



Customization of Default Settings	Size	Interactions
Standardized Tests	Yes	Yes
Tailored Stress		
Combined CL	Yes	
Natural disaster	No	Yes
Commodity price	n.a.	n.a.
Market financing	n.a.	n.a.

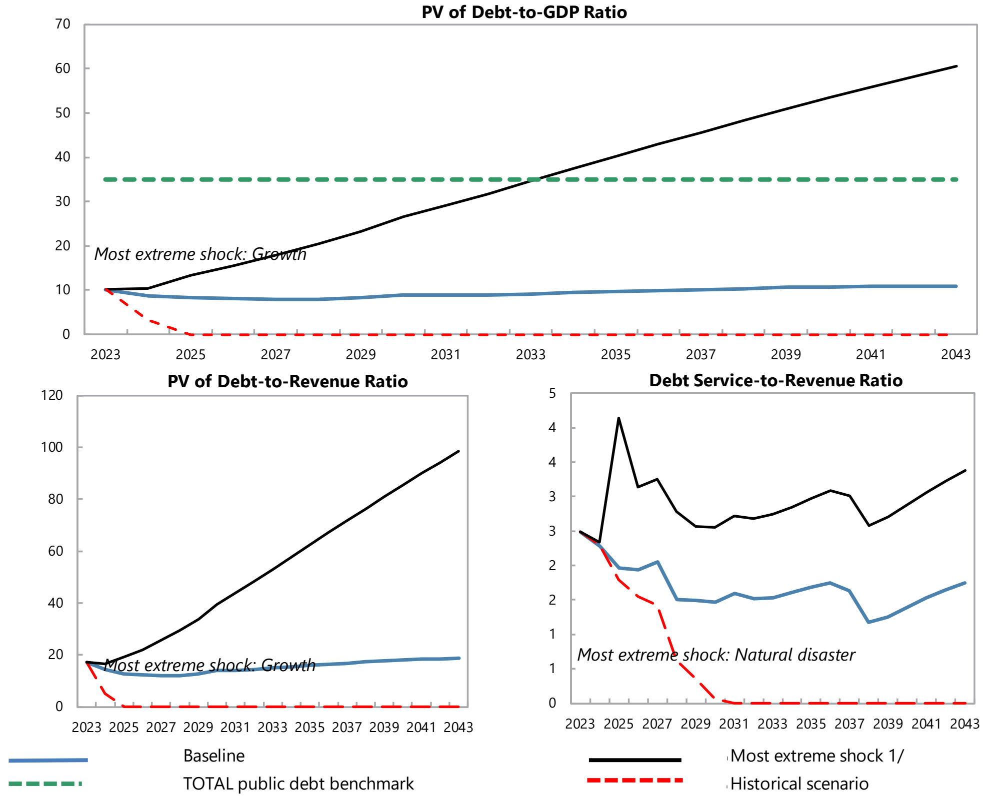
Note: "Yes" indicates any change to the size or interactions of the default settings for the stress tests. "n.a." indicates that the stress test does not apply.

Borrowing assumptions on additional financing needs resulting from the stress tests*	Default	User defined
Shares of marginal debt		
External PPG MLT debt	100%	
Terms of marginal debt		
Avg. nominal interest rate on new borrowing in USD	1.4%	1.4%
USD Discount rate	5.0%	5.0%
Avg. maturity (incl. grace period)	30	30
Avg. grace period	7	7

* Note: All the additional financing needs generated by the shocks under the stress tests are assumed to be covered by PPG external MLT debt in the external DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio in or before 2033. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

Figure 2. Federated States of Micronesia: Indicators of Public Debt under Alternative Scenarios, 2023-2043



Borrowing assumptions on additional financing needs resulting from the stress tests*	Default	User defined
Shares of marginal debt		
External PPG medium and long-term	84%	84%
Domestic medium and long-term	6%	6%
Domestic short-term	11%	11%
Terms of marginal debt		
External MLT debt		
Avg. nominal interest rate on new borrowing in USD	1.4%	1.4%
Avg. maturity (incl. grace period)	30	30
Avg. grace period	7	7
Domestic MLT debt		
Avg. real interest rate on new borrowing	7.1%	7.1%
Avg. maturity (incl. grace period)	4	4
Avg. grace period	1	1
Domestic short-term debt		
Avg. real interest rate	0.3%	0.3%

* Note: The public DSA allows for domestic financing to cover the additional financing needs generated by the shocks under the stress tests in the public DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2033. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

Table 3. Federated States of Micronesia: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2023-2043

(In percent)

	Projections 1/											
	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2043
PV of debt-to GDP ratio												
Baseline	10	8	8	8	8	8	8	9	9	9	9	11
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2023-2033 2/	10	5	1	0	0	0	0	0	0	0	0	0
B. Bound Tests												
B1. Real GDP growth	10	9	9	9	8	9	9	10	10	10	10	12
B2. Primary balance	10	12	15	15	15	16	16	17	17	17	17	19
B3. Exports	10	12	19	19	19	19	20	21	21	21	21	18
B4. Other flows 3/	10	8	8	8	8	8	8	9	9	9	9	11
B5. Depreciation	10	8	8	8	8	8	8	9	9	9	9	11
B6. Combination of B1-B5	10	10	9	8	8	8	9	9	9	9	10	11
C. Tailored Tests												
C1. Combined contingent liabilities	10	11	11	10	10	11	11	12	12	12	12	14
C2. Natural disaster	9.5	14	15	16	17	19	20	22	23	25	26	**41**
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	30	30	30	30	30	30	30	30	30	30	30	30
PV of debt-to-exports ratio												
Baseline	35	31	29	29	28	29	30	33	33	33	34	41
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2023-2033 2/	35	19	6	0	0	0	0	0	0	0	0	0
B. Bound Tests												
B1. Real GDP growth	35	31	29	29	28	29	30	33	33	33	34	41
B2. Primary balance	35	43	56	57	58	59	62	65	65	66	66	70
B3. Exports	35	57	114	113	113	114	119	124	125	125	124	107
B4. Other flows 3/	35	31	30	29	28	29	31	33	33	33	34	41
B5. Depreciation	35	31	29	29	28	29	30	33	33	33	34	41
B6. Combination of B1-B5	35	43	30	38	38	39	41	44	44	44	45	53
C. Tailored Tests												
C1. Combined contingent liabilities	35	40	39	39	39	40	42	44	44	45	46	55
C2. Natural disaster	35	53	57	60	64	69	76	83	87	92	98	**153**
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	140	140	140	140	140	140	140	140	140	140	140	140
Debt service-to-exports ratio												
Baseline	5	5	4	4	4	3	3	3	3	3	3	3
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2023-2033 2/	5	5	4	4	3	2	2	1	1	0	0	0
B. Bound Tests												
B1. Real GDP growth	5	5	4	4	4	3	3	3	3	3	3	3
B2. Primary balance	5	5	5	5	5	3	4	4	4	4	5	6
B3. Exports	5	6	8	8	9	6	6	6	6	8	**10**	10
B4. Other flows 3/	5	5	4	4	4	3	3	3	3	3	3	3
B5. Depreciation	5	5	4	4	4	3	3	3	3	3	3	3
B6. Combination of B1-B5	5	5	6	5	5	4	4	4	4	4	4	5
C. Tailored Tests												
C1. Combined contingent liabilities	5	5	5	4	4	3	3	3	3	3	3	4
C2. Natural disaster	5	5	5	5	5	4	4	4	4	4	4	5
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	10	10	10	10	10	10	10	10	10	10	10	10
Debt service-to-revenue ratio												
Baseline	4	4	3	3	3	2	2	2	2	2	2	3
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2023-2033 2/	4	4	3	3	3	1	1	1	1	0	0	0
B. Bound Tests												
B1. Real GDP growth	4	4	4	4	4	2	3	3	3	3	3	3
B2. Primary balance	4	4	4	4	4	3	3	3	3	4	4	5
B3. Exports	4	4	4	4	4	3	3	3	3	4	5	5
B4. Other flows 3/	4	4	3	3	3	2	2	2	2	2	2	3
B5. Depreciation	4	4	3	3	3	2	2	2	2	2	2	3
B6. Combination of B1-B5	4	4	4	3	4	2	2	2	3	3	3	3
C. Tailored Tests												
C1. Combined contingent liabilities	4	4	4	3	3	2	3	2	3	3	3	3
C2. Natural disaster	4	4	4	4	4	3	3	3	3	3	3	4
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	14	14	14	14	14	14	14	14	14	14	14	14

Sources: Country authorities; and staff estimates and projections.

1/ A bold value indicates a breach of the threshold.

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

3/ Includes official and private transfers and FDI.

Table 4. Federated States of Micronesia: Sensitivity Analysis for Key Indicators of Public Debt, 2023-2043

(In percent)

	Projections 1/											
	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2043
PV of Debt-to-GDP Ratio												
Baseline	10	9	8	8	8	8	8	9	9	9	9	11
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2023-2033 2/	10	3	0	0	0	0	0	0	0	0	0	0
B. Bound Tests												
B1. Real GDP growth	10	10	13	15	18	20	23	27	29	32	35	**61**
B2. Primary balance	10	13	17	17	16	16	17	17	18	18	18	19
B3. Exports	10	12	18	18	18	18	19	19	19	20	19	17
B4. Other flows 3/	10	9	8	8	8	8	8	9	9	9	9	11
B5. Depreciation	10	9	8	8	8	8	8	9	9	9	9	11
B6. Combination of B1-B5	10	12	12	11	10	10	11	11	11	11	12	13
C. Tailored Tests												
C1. Combined contingent liabilities	10	12	11	11	11	11	11	12	12	12	12	15
C2. Natural disaster	10	17	17	18	19	20	21	23	24	26	27	**42**
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
TOTAL public debt benchmark	35	35	35	35	35	35	35	35	35	35	35	35
PV of Debt-to-Revenue Ratio												
Baseline	17	14	13	12	12	12	13	14	14	14	15	19
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2023-2033 2/	17	5	0	0	0	0	0	0	0	0	0	0
B. Bound Tests												
B1. Real GDP growth	17	17	19	22	26	29	34	39	44	48	53	99
B2. Primary balance	17	22	26	25	25	25	26	27	28	28	29	33
B3. Exports	17	20	28	27	27	28	29	30	31	31	31	29
B4. Other flows 3/	17	14	13	12	12	12	13	14	14	15	15	19
B5. Depreciation	17	14	13	12	12	12	13	14	14	14	15	19
B6. Combination of B1-B5	17	20	18	16	15	15	16	17	18	18	18	22
C. Tailored Tests												
C1. Combined contingent liabilities	17	20	17	17	17	17	17	19	19	20	20	25
C2. Natural disaster	17	27	25	26	28	29	32	35	38	40	43	70
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Debt Service-to-Revenue Ratio												
Baseline	2	2	2	2	2	2	1	1	2	2	2	2
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2023-2033 2/	2	2	2	2	1	1	0	0	0	0	0	0
B. Bound Tests												
B1. Real GDP growth	2	2	2	3	3	3	3	3	4	4	4	8
B2. Primary balance	2	2	3	4	3	2	2	2	2	2	3	3
B3. Exports	2	2	2	2	2	2	2	2	2	2	3	3
B4. Other flows 3/	2	2	2	2	2	2	1	1	2	2	2	2
B5. Depreciation	2	2	2	2	2	2	1	1	2	2	2	2
B6. Combination of B1-B5	2	2	2	3	3	2	2	2	2	2	2	2
C. Tailored Tests												
C1. Combined contingent liabilities	2	2	3	2	2	2	2	2	2	2	2	2
C2. Natural disaster	2	2	4	3	3	3	3	3	3	3	3	3
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

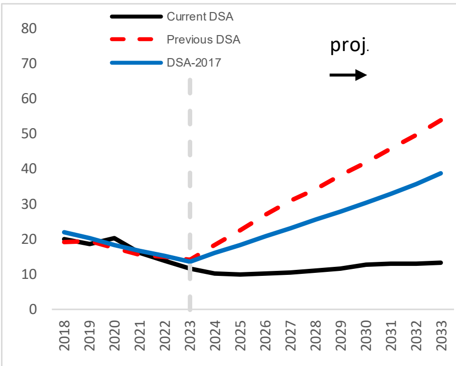
Sources: Country authorities; and staff estimates and projections.
1/ A bold value indicates a breach of the benchmark.
2/ Variables include real GDP growth, GDP deflator and primary deficit in percent of GDP.
3/ Includes official and private transfers and FDI.

Figure 3. Federated States of Micronesia: Drivers of Debt Dynamics—Baseline Scenario

External Debt

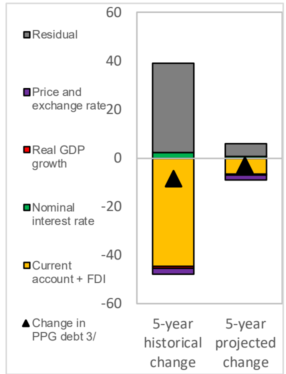
Gross Nominal PPG External Debt

(in percent of GDP; DSA vintages)



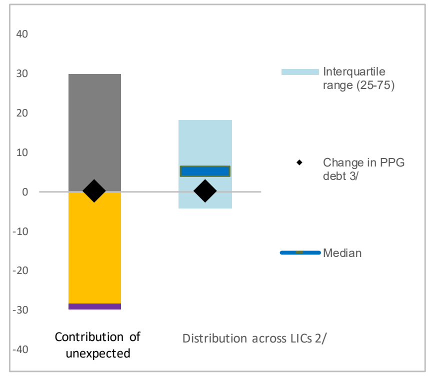
Debt-creating flows

(percent of GDP)



Unexpected Changes in Debt 1/

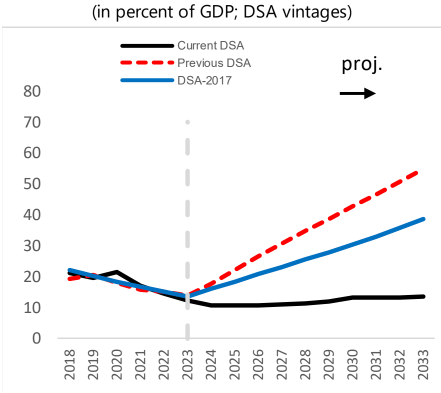
(past 5 years, percent of GDP)



Public Debt

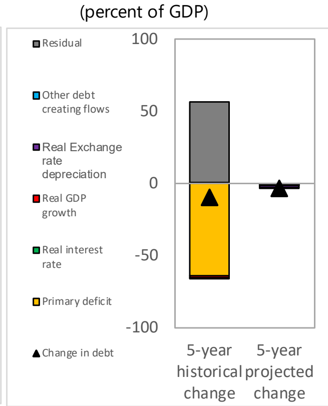
Gross Nominal Public Debt

(in percent of GDP; DSA vintages)



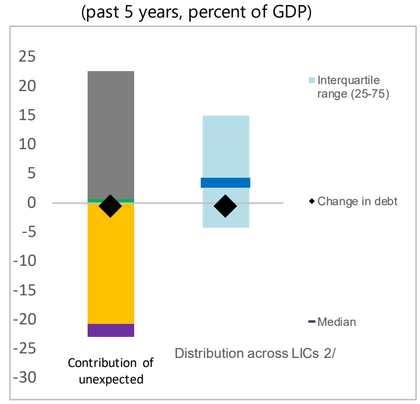
Debt-creating flows

(percent of GDP)



Unexpected Changes in Debt 1/

(past 5 years, percent of GDP)



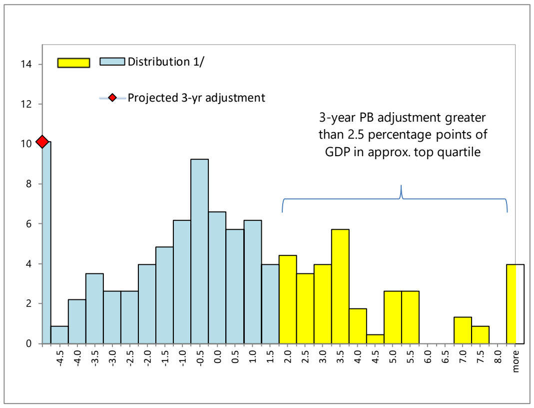
1/ Difference between anticipated and actual contributions on debt ratios.

2/ Distribution across LICs for which LIC DSAs were produced.

3/ Given the relatively low private external debt for average low-income countries, a ppt change in PPG external debt should be largely explained by the drivers of the external debt dynamics equation.

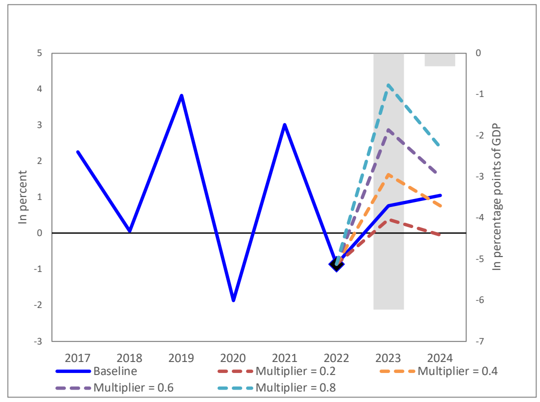
Figure 4. Federated States of Micronesia: Realism Tools 1/

3-Year Adjustment in Primary Balance
(Percentage points of GDP)



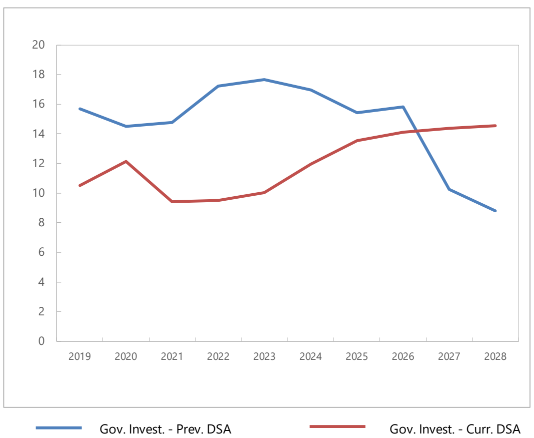
1/ Data cover Fund-supported programs for LICs (excluding emergency financing) approved since 1990. The size of 3-year adjustment from program inception is found on the horizontal axis; the percent of sample is found on the vertical axis.

Fiscal Adjustment and Possible Growth Paths 1/



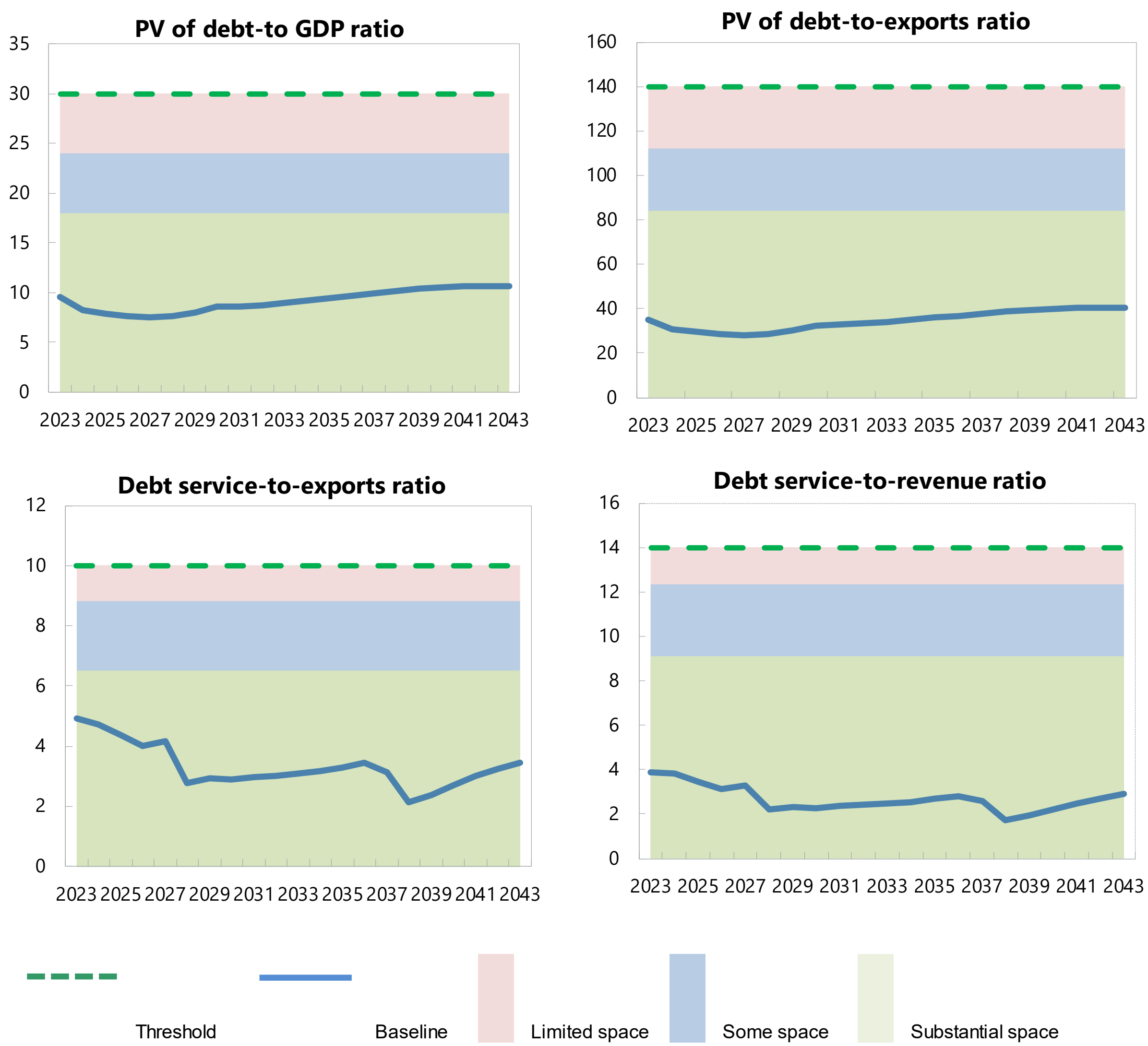
1/ Bars refer to annual projected fiscal adjustment (right-hand side scale) and lines show possible real GDP growth paths under different fiscal multipliers (left-hand side scale).

Public and Private Investment Rates
(percent of GDP)



1/ The private investment data needed to conduct the investment growth tool is not available for the DSA exercise.

Figure 5. Federated States of Micronesia: Qualification of the Moderate Category, 2023-2043 1/



Sources: Country authorities; and staff estimates and projections.

1/ For the PV debt/GDP and PV debt/exports thresholds, x is 20 percent and y is 40 percent. For debt service/Exports and debt service/revenue thresholds, x is 12 percent and y is 35 percent.

**Statement by Robert Bruce Nicholl, Executive Director of Federated States of Micronesia and Philip Arubilake, Advisor to the Executive Director
February 23, 2024**

On behalf of our Federated States of Micronesia (FSM) authorities, we thank Mr. Paulo Medas and his team for the constructive and candid policy discussions during the Article IV consultation mission. The FSM authorities agree with the staff assessment of the economic outlook and risks, and welcome the policy recommendations and advice that are presented in the report.

Introduction

FSM is an island state in the western Pacific Ocean, situated about 2,900 km northeast of Australia and about 3,400 km southeast of Japan. FSM has around 607 islands, including low lying atolls and volcanic islands, with a total land area of about 270 square miles. The islands are grouped into four states: Yap, Chuuk, Pohnpei and Kosrae. Each has its own government and constitution under the federation system. Like many small island states in the pacific, the economy of FSM is dominated by subsistence agriculture and fishery activity; it is also highly vulnerable to the effects of climate change. FSM issues fishing rights to foreign commercial vessels to operate in its 200-mile exclusive economic zone (EEZ), which covers around 1.2 million square miles of the Pacific Ocean - one of the largest EEZs in the world. However, financial assistance from the United States, including assistance under the terms of the Compact of Free Association Agreement (COFA) and foreign grants, make up the bulk of its budget revenues. FSM's population of around 114,000 is in decline due largely to emigration to the United States, enabled under the COFA. The geographical dispersion of the islands makes economic development challenging and public services costly to deliver.

The impact of the COVID-19 pandemic on the economy was severe. The containment measures significantly reduced activity in key sectors: hospitality, transportation, and construction. Major investment projects were also severely impacted due to limited movement of key personnel and materials during the border closure. On the positive side, the impact on education was limited as schools remained opened. Financial support from key donor and development partners enabled the national government to implement assistance programs for households and businesses and mitigated the impact of lockdown measures on the economy. The economy is recovering with significant scarring, record high inflation, and a skilled labor shortage due to emigration.

Economic Outlook and Risks

FSM's economy rebounded during 2023 and GDP growth is expected to increase further in 2024, supported by an expected increase in government spending, including through higher wages for civil servants and re-starting major infrastructure projects. The authorities are commencing a backlog of major projects that were delayed from the previous compact (Compact 2) that ended in 2023. Some of the investment projects are at their implementation stage while, most are at the design stage with the actual construction expected to begin in 2024.

FSM is experiencing high inflation imported through rising prices for food, fuel, and transportation. The authorities expect inflation to largely track the US inflation path.

FSM faces substantial challenges and downside risks. First, the remoteness of FSM and the geographical dispersion between the islands and states, as well as limited domestic transportation options, make them inherently costly to provide. Only one international airline has been operating into FSM, which makes it highly vulnerable to international connections and schedules (especially given this provides the mainstay of connection between states). Second, deteriorating labor shortages, and a lack of construction materials may further delay implementation of key investment projects, despite solid planning and appropriate aspirations. Third, FSM is vulnerable to the effects of climate change, mostly on the adaptation front. The authorities are mindful of these challenges and are willing to undertake reforms to address the key structural issues that are facing the economy.

Fiscal Policy

The FSM authorities have a track record of prudent fiscal management, with successive positive fiscal outcomes in past years due to improved fishing revenues and strong expenditure management. The authorities expect to maintain a strong fiscal outcome in 2024.

The authorities have been maintaining a prudent level of external debts. The pandemic's impact on the fiscal position and debt level was limited. Inflows of donor financial assistance and grants have enabled the authorities to provide the required stimulus and assistance to citizens without having to commit substantial domestic financial resources. However, while it is expected that the approval of the COFA by US congress will boost the government's financial position, the authorities are skeptical that risk of debt distress will significantly improve from high risk to moderate risk. The authorities do not expect debt dynamics to improve significantly given substantial financing needs to address climate vulnerabilities, the need to improve critical infrastructures, and urgency to address the bottlenecks delaying development and growth. Nevertheless, the authorities remain committed to maintain fiscal sustainability and emphasized the need to preserve financial resources in the trust fund for the future.

Financial Sector

FSM's financial sector comprises two commercial banks, a development bank (FSM Development Bank), insurance agencies and credit unions. Commercial banks are regulated by the FSM Banking Board (FSMBB) and insurance companies are regulated by the FSM Insurance Board. The US Federal Deposit Insurance Corporation (FDIC) also provides supervisory oversights on the commercial banks, enhancing the soundness of the banking sector. The authorities agree that the banking sector is sound, liquid and well capitalized. They also acknowledged that financial deepening is insufficient, though the banks have a large deposit base, partly boosted by inflows of remittances and resident deposits. The bank loan to deposit ratio is below 20 percent, and lending is low partly due to lack of availability of good collateral.

There were discussions to put the FSM Development Bank (FSMDB) under FSMBB's supervision. To effectively carryout an expanded mandate, the FSMBB will need further TA and relevant CD to improve its capacity to supervise the DB and Credit Unions if they are brought under its oversight in the future. The authorities have requested IMF TA to upgrade FSMBB's legal and regulatory framework.

Structural Reforms

The authorities concur with the importance of promoting private sector development to support sustainable economic growth and job creation. They noted that emigration to the US is largely due to a shortage of well-paying jobs in FSM. The authorities acknowledge the need for reforms, including land reforms, which would facilitate foreign direct investment. However, they note that the issue is complex and requires consensus among key stakeholders, including the states and domestic business sector. They also note that financial resources would be required to support the reforms through consensus building.

Climate Change

Climate change poses significant and building risks to the economy and food security. FSM, like other pacific island countries, is on the frontline of the effects of climate change and rising sea level. As most of the population is dependent on agriculture (mainly subsistence) and fishing, climate change is affecting households' food security. The authorities are prioritizing climate adaptation measures. Research efforts are ongoing with support from donors to identify climate resilient crops like taro, Kumala etc. to introduce in the low-lying islands and atolls affected by saltwater intrusion.

The authorities acknowledged the importance of climate adaptation investment. However, they stressed that integrating climate adaptation in infrastructure projects is costly. While they are aware of the availability of climate finance, accessing this financing is proving to be a challenge. Though FSM's contribution to carbon emission is negligible, the authorities have made a commitment to reduce carbon emission. During November 2022, the authorities launched their updated National Determined Contribution (NDC), including adaptation and mitigation.