March 2007
IMF Country Report No. 07/106

Federated States of Micronesia: 2006 Article IV Consultation—Staff Report; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with the Federated States of Micronesia, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on October 20, 2006, with the officials of the Federated States of Micronesia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 29, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF; and

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 28, 2007 discussion of the staff report that concluded the Article IV consultation.

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

Selected Issues Paper and Statistical Appendix

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

FEDERATED STATES OF MICRONESIA

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Consultation
with the Federated States of Micronesia

Approved by Wanda Tseng and Scott Brown

December 29, 2006

- **This report is based on discussions held by the team in Pohnpei and Chuuk** during October 10–20, 2006. The team comprised Messrs. Kang (Head), Faulkner-MacDonagh, Xu (all APD), and Mr. Andrew Blazey (OED).
- **Counterparts:** The team met with Vice President Killion, Secretary of Finance and Administration Andon, other senior officials, and representatives of the Chuuk and Pohnpei state governments.
- **Outreach:** The mission's outreach included meetings with representatives of the Chuuk and Pohnpei state legislatures, business leaders, and a local research institute, as well as interviews with the local press.
- **Context of past surveillance:** In the 2004 Article IV consultation, the authorities and the Fund agreed on the broad policy priorities—fiscal adjustment through expenditure cuts and tax reforms, to achieve self-sufficiency when the Compact ends in 2023, and structural reforms to support private sector development. However, the pace of reforms has been slow, partly due to capacity limitations and the loose federation of government which has made it difficult to forge a consensus for reform and coordinate policies.
- **Exchange rate:** The U.S. dollar is the official currency. The government of the Federated States of Micronesia (FSM) has accepted the obligations of Article VIII, sections 2, 3 and 4 and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions and security reasons.
- **Statistical issues:** Limited domestic capacity to produce economic data hampers surveillance and policy analysis. FSM continues to receive assistance from the Pacific Financial Technical Assistance Centre (PFTAC) to improve the quality of national accounts and CPI data.

Contents Page

EXECUTIVE SUMMARY

Background

- **The Federated States of Micronesia (FSM) has relied heavily on grants under the Compact of Free Association with the United States since gaining independence in 1986.** These grants have been primarily used to sustain a large public sector which dominates the economy.

- **Economic activity should pick up in FY2007 with the release of delayed Compact grants, but the risks are mainly on the downside.** Fiscal policy at the state level is unsustainably loose while structural problems continue to hold back the private sector.

- **Without stronger reform efforts, medium-term growth prospects are limited, given pending cuts in Compact Funds.** With Compact support declining starting in 2007, the authorities face the challenge of adjusting, a task made more difficult without sustained private sector growth. Meanwhile, continued deficits have raised the medium-term surpluses needed to achieve self-sufficiency when the Compact expires in 2023.

Key Policy Issues

- **Given the magnitude of the necessary fiscal adjustment, it would be desirable to phase in spending cuts and comprehensive tax reform measures over the next two years.** Further efforts are needed to reduce the large wage bill, particularly by the states, pass tax reforms, and strengthen tax administration. These steps could create room to preserve spending on infrastructure and development needs, while improving governance of the Trust Fund would help boost long-term investment returns.

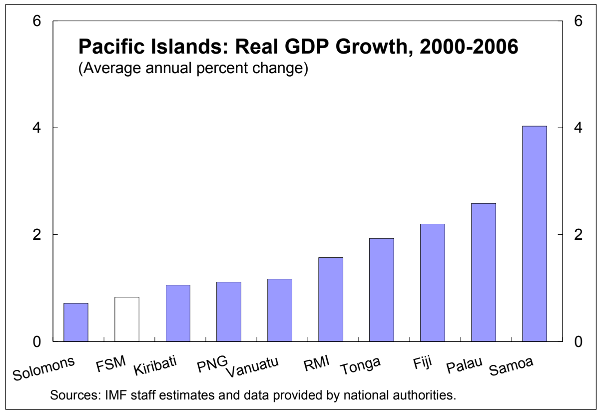
- **At the same time, reforms to improve the business environment are crucial to help catalyze growth and create jobs.** To ease the cost of doing business, the priorities should be to reduce the large public-private wage gap, strengthen the enforcement of contracts, and lower the barriers to foreign investment.

- **The financial system also needs to play a stronger role in supporting private sector growth.** Privatizing the Bank of FSM while reducing the scope of the FSM Development Bank in competing with commercial banks would help develop further the financial system. Supervision should be strengthened to safeguard against potential risks.

- **Given the dominant role of state governments in the federal system, a key challenge will be to achieve broad agreement at all levels to enact these reforms.**

I. INTRODUCTION

1. **The Federated States of Micronesia (FSM), a small Pacific Island country, has relied heavily on external grants since gaining independence in 1986.**[1] The most important aid source has been U.S. financing—provided under the Compact of Free Association—to help foster sustainable economic development. However, the national and state governments have relied on these grants primarily to sustain a large public sector, which—at 40 percent of GDP—dominates the economy. The private sector mainly serves the government and in recent years, growth has languished, even compared to other countries in the region with similar per capita incomes (e.g. the Marshall Islands and Samoa). A renewed Compact (Compact II) took effect in FY2004[2] that steadily lowers direct budget support through FY2023 (Box 1) and features stricter rules on reporting and auditing. These have proved difficult for the national and state governments to meet, causing the United States to withhold funds every year to date.



2. **With Compact grants projected to decline, the authorities face the urgent task of moving forward with fiscal consolidation and needed reforms.** The 2006 Article IV discussions focused on ways to achieve fiscal sustainability and improve growth prospects. To achieve self-sufficiency when the Compact ends in 2023, faster progress is needed to reduce the large wage bill, raise revenue collection—including by adopting a VAT— and boost investment returns of the Trust Fund. At the same time, structural reforms to promote the private sector will help support fiscal consolidation and improve growth prospects.

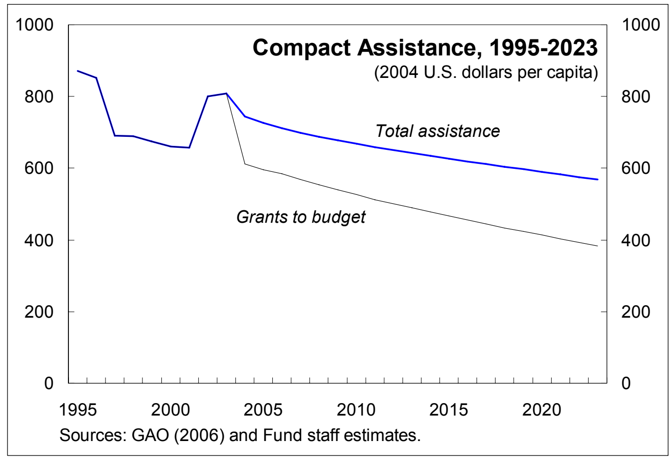
3. **Given the dominant role of the state governments, the key challenge will be to achieve broad agreement to enact these reforms.** The FSM's loose federal structure—where each state formulates its own budget, levies taxes, and has its own administration and legislature—has made it difficult for the national government to coordinate economic policies. With both national and state elections scheduled in 2007, the task for advancing reforms will prove challenging.

[1] The FSM, with a population of around 108,000, has four states—Chuuk, Kosrae, Pohnpei, and Yap. Authority is highly decentralized, with state governments significantly larger than the national authority.

[2] The fiscal year runs from October to September (e.g., FY2004 covers October 2003 to September 2004).

Box 1. Slow Implementation under Compact II

In 2004, the FSM and United States agreed on an amended Compact II to promote FSM's budgetary self-reliance and economic advancement. Compact II requires that grant aid be spent in one of six sectors: education, health, infrastructure, public sector capacity building, private sector development, and the environment. To receive these funds, FSM is required to meet numerous reporting and accountability requirements. A U.S.-FSM Joint Economic Management Committee (JEMCO) was set up to approve grant allocations and review performance and audits under the compact. The Compact phases-in gradual cuts to direct budget support, as a way to encourage self-sufficiency. A trust fund was also created to provide income after the annual compact grants expire in 2023 (Box 3).



Progress in implementing the compact has been slow, resulting in delays in sizable grant disbursements. As a result, the FSM still has yet to spend a large portion of its FY2004–06 infrastructure aid, close to $59 million. The U.S. Government Accountability Office in its June 2006 report to the U.S. Congress noted the following reasons for the slow implementation:

- *Lack of government consensus.* Under the FSM's loose federal structure, each state has its own constitution and formulates its own budget. With the central government managing less than 10 percent of compact grants, it has been difficult to secure agreement from the states on spending priorities and development goals.

- *Lack of administrative capacity.* Insufficient resources, combined with difficulties in harmonizing reports across states, have led to delays in meeting the extensive reporting and monitoring requirements, which include quarterly financial reports. As a result, little consideration has been given to how the funding would best be allocated across sectors and states to maximize their effectiveness.

These problems highlight the need for a more effective centralized mechanism for overseeing implementation. The FSM Congress has taken steps to improve coordination by establishing a Compact Management Board comprising the President and representatives from the four states and a supporting office to oversee communications with JEMCO and the United States. Over time, the focus will need to shift away from grant approval to a more centralized long-term approach that better integrates national and state priorities in meeting their development goals.

II. Economic Background

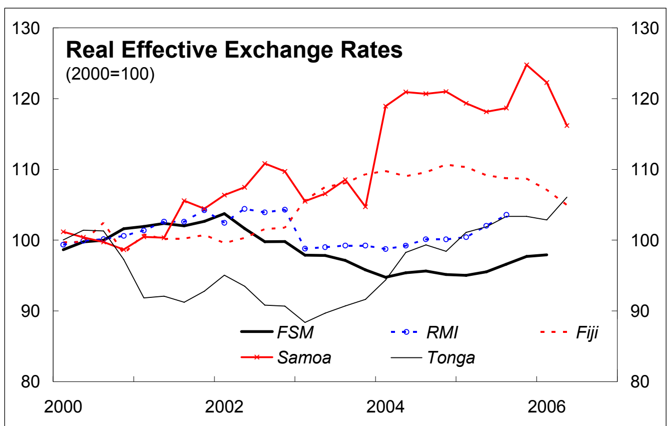
4. **Since the last Article IV consultation, economic growth has been weak.** Real GDP grew by only 1½ percent in FY2005 and declined by nearly 1 percent in FY2006. Sharp reductions in Compact-related capital spending, higher oil prices, and the closure of two textile mills in Yap following the expiration of textile quotas have held back growth. Employment rose slightly during FY2005–06, as government hiring largely offset job losses in the private sector, but poor job prospects continue to spur emigration to the United States, which is relatively easy for FSM citizens. Despite higher oil prices, the CPI has risen an average of only 4 percent (y/y) in the past two years (2¼ percent excluding fuel and transportation charges). The U.S. dollar is the official currency and has provided a strong anchor for inflation expectations.

Selected Economic Indicators

	FY2005	FY2006	FY2007
	(year-on-year changes)		
Real GDP	1.5	-0.7	1.8
CPI	4.1	3.9	3.0
Employment	0.3	0.6	0.2
	(in percent of GDP)		
Current account balance	-15.3	-12.7	-6.0

Sources: Staff estimates and FSM authorities.

5. **Structural problems, rather than exchange rate competitiveness, continue to hold back exports.** Goods exports are around 10 percent lower than the average for the decade, due mainly to the loss of textile trade preferences, while the real effective exchange rate remains depreciated relative to other Pacific island currencies since FY2000. Tourism has been held back by weak infrastructure and fewer overseas flights compared to other Pacific islands. Anecdotal evidence from surveys and the increase in Western Union branches suggest that remittance inflows have increased. However, given the low skills of the emigrants, the amounts are likely modest. The current account deficit fell slightly to just under 13 percent of GDP in FY2006, with aid now covering only half of the import bill—down from two-thirds a decade ago. External debt fell remains low, with about two-thirds on concessional terms; debt service was around 6 percent of exports in FY2006.



Sources: IFS, INS, and Fund staff estimates.

6. **The underlying fiscal situation has deteriorated, despite a decline in the overall deficit.** The general government deficit is estimated to have fallen to 1½ percent of GDP in FY2006, from 5½ percent of GDP the previous year, largely due to a sharp fall in capital spending. Although the national government ran a slight surplus, the four states ran deficits

with Pohnpei drawing down its cash reserves while Chuuk and Kosrae incurred arrears. As a result, unencumbered government reserves have fallen to low levels (1½ percent of GDP) and under current trends, will be depleted soon.

III. Policies to Promote Sustainable Growth

The mission and the authorities agreed that fiscal adjustment and advancing structural reforms are crucial for improving medium-term growth prospects. On the fiscal front, faster progress is needed to streamline the wage bill and raise revenue collection, including by adopting a VAT and strengthening tax administration. Reforms to improve the business environment would help the private sector to support growth during fiscal consolidation.

A. Economic Outlook and Risks

7. **Over the near-term, economic activity could pick up with an increase in capital spending under the Compact, but downside risks loom.** As the FSM adapts to the requirements under the amended Compact, grant disbursements and capital spending should recover, helping to lift growth to 2 percent in FY2007. With oil prices falling, inflation should moderate. The current account deficit is projected to improve to 6 percent of GDP, as higher aid inflows would be partly offset by stronger import demand and high energy costs. However, the risks to the outlook are mainly on the downside, as fiscal policy at the state level is unsustainably loose and structural problems continue to weigh on the private sector. The authorities agreed that next year's outlook appears to be positive while sharing the view that without a vibrant private sector, the pickup would likely be short-lived.

8. **The authorities and the mission also agreed that comprehensive fiscal and structural reforms are needed to accommodate the pending cuts in Compact funds.** Starting in FY2007, Compact support will begin to decline, and states will need to end the practice of using Compact grants to fund ongoing operations. Without fiscal and structural reforms, capital spending will remain weak, while per capita incomes will be flat. To avoid an unmanageable adjustment when the Compact expires in FY2023, fiscal reforms are needed to build up sufficient government assets. Structural reforms to promote the private sector would help raise growth significantly and support fiscal adjustment.

Medium-term Outlook: Current Policies vs. Reform Scenario
(Average outturns over FY2008-2023, in percent of GDP)

	Baseline 1/	Reform 2/
Fiscal balance	0.0	3.6
Capital spending	4.6	8.2
Outcomes in FY2023:		
Non-Trust Fund usable assets	12	66
Per capita GDP (2005 U.S. dollars)	2,428	3,239

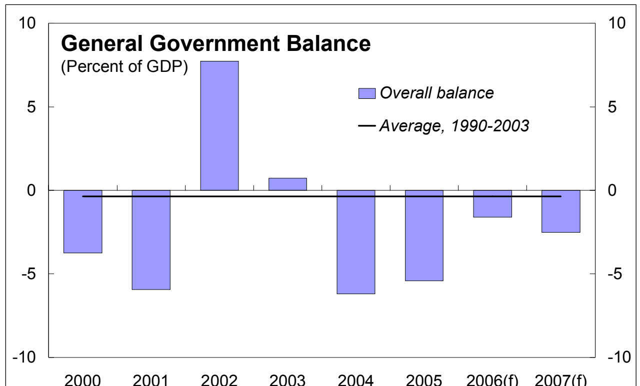
Source: Staff estimates.

1/ Assumes a constant tax ratio (12 percent of GDP) and a decline in capital spending (from 5½ percent of GDP in FY2006), because aid is not fully utilized. A lack of reform lowers real GDP growth to ¾ percent per year.

2/ Assumes an improvement in the revenue ratio, owing to: implementation of a VAT (adding 3 percent of GDP) and stronger enforcement (2½ percent of GDP). Fiscal and structural reforms lift capital spending to 8¼ percent of GDP and real GDP growth to 2¾ percent per year.

B. Need for Fiscal Consolidation

9. **The mission stressed that continued deficits have raised the size of the fiscal adjustment needed to achieve self-sufficiency.** The general government is projected to run a deficit for the fourth consecutive year and has been financing the shortfall by drawing down cash reserves. Staff now projects that annual surpluses of 3½ percent of GDP—around ½ percentage point higher than at the time of the last consultation—would be needed to generate sufficient income, along with the Trust Fund, to offset the end of Compact grants and build a cushion against unforeseen shocks. The mission noted that under the FY2007 budget, the general government deficit was projected to widen to 2½ percent of GDP, largely due to higher spending and urged the authorities to begin submitting budgets that targeted a surplus over the medium-term.



Sources: FSM authorities and Fund staff estimates.

10. **The authorities recognized the need for moving to surpluses but were hampered by political pressures and difficulties in coordinating states fiscal policy.** The authorities explained that political pressures to spend during an election year had made it difficult to submit a more ambitious budget. In addition, with the fiscal imbalances mainly at the state level, the national government has limited leverage in influencing fiscal policies. In particular, they were very concerned about the situation in the largest state, Chuuk, where the buildup in arrears threatens to destabilize the local economy (Box 2).

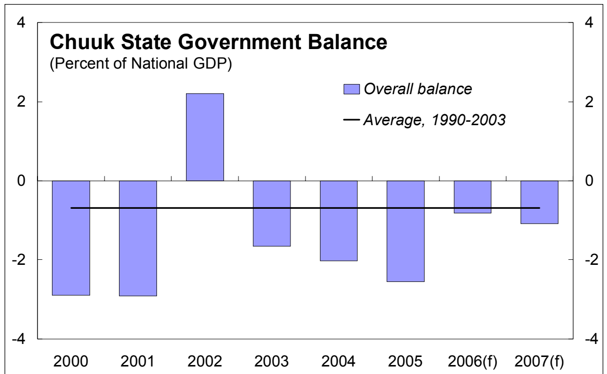
11. **Given the size of the adjustment, the mission suggested a strategy that phased in spending cuts combined with revenue measures over a two year period,** possibly by:

- *Reducing the wage bill at the state level.* State wages and salaries account for 50 percent of total spending and have risen well beyond what can be sustained through domestic revenue. Reducing state employment to the level in FY2000–03 could save around 2 percent of GDP annually and bring the budget back into balance.

- *Adopting a VAT and strengthening tax administration.* The authorities have devised a package that includes a VAT and creates a Unified Revenue Authority (URA) to centralize tax collection. According to staff estimates, the VAT could raise revenue by around 3 percent of GDP within 2 years while measures to strengthen tax administration may yield an additional 1 percent of GDP. These steps, combined with spending cuts, would enable the FSM to reach the needed medium-term surpluses.

Box 2. The Fiscal Problems in the State of Chuuk

Continued deficits have contributed to the buildup of payment arrears in Chuuk. The mission visited Chuuk whose fiscal position is the worst among the 4 states, with arrears reaching around 40 percent of state GDP. Around one-third are to suppliers, with the rest in the form of late land-lease payments and outstanding legal claims. Weak expenditure control and poor revenue collection have contributed to deficits averaging 1½ percent of GDP since 2000. Late payments are making it difficult for the Chuuk government to sign new land-lease contracts which could delay further disbursements under the Compact while the arrears to suppliers are threatening to undermine tax compliance.



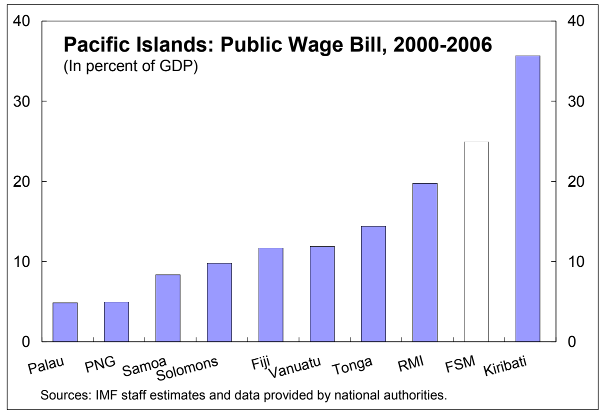
Sources: FSM authorities and Fund staff estimates.

The authorities have taken some steps to address the arrears, but the impact has been minimal. State officials have begun rescheduling debt owned to legal claimants (who are earning 9 percent annually) and have taken steps to raise revenue by increasing tax audits. To improve expenditure control, the National Public Auditor is looking to open a branch in Chuuk. However, despite these measures, arrears continue to grow with the deficit in FY2007 projected to rise to 1¼ percent of GDP.

The mission called for a more ambitious plan to stop new arrears and reduce existing arrears. As a first step, the mission recommended an audit of the arrears to determine the priority for repayment. To minimize the impact on the local economy and facilitate the release of needed Compact grants, priority should be given to repaying regular contractors and those with links to the Compact. To secure the funds, the Chuuk government should begin targeting a surplus in the budget, financed mainly by cuts to the large wage bill (which accounts for 60 percent of total expenditures) and other current spending. Additional financing could come from privatizing the five state-owned enterprises.

The state officials agreed with the strategy but noted that given the lack of political consensus on the course of action, progress would likely be slow. While it was clear that action is needed, officials and the legislature could not agree on where to cut spending and how to share the burden. The mission and the authorities agreed that the proposal by some state legislators to issue an international bond or apply for soft loans had little chance of succeeding and should not divert attention away from needed reforms. Although the size of the arrears is daunting, it was agreed that Chuuk had little choice but to move forward now, as its adjustment needs are even greater than the FSM as a whole.

12. **The authorities shared the view that a graduated approach would be needed, beginning with cuts to the wage bill for the states.** On possible cuts, the authorities noted that states had reversed much of the progress made in streamlining the civil service under the 1997 ADB Public Sector Reform Program. Although states have frozen wages and reduced work hours, they have resisted further cuts due to concerns over its economic impact. The mission noted that the wage bill in the FSM was still large by regional standards and that the local economy had largely withstood the earlier public job losses. Retraining programs for displaced workers could be introduced to help ease the adjustment, perhaps funded by a modest wage reduction.



13. **At the same time, the authorities placed importance on preserving spending on health care, infrastructure, and education for fostering sustainable development.** When cutting expenditures, the authorities saw a crucial need to maintain social and infrastructure spending for their development goals. To this end, the authorities have plans to expand the use of performance-based budgeting, which will help to better integrate national and state priorities. States are currently putting the framework in place and are expected to use the new system by FY2008.

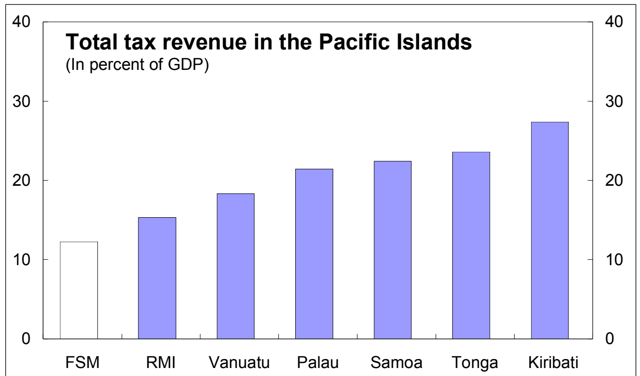
14. **The mission urged the authorities to complete plans to implement a VAT.** Although the national and state governments broadly support the proposal, business groups have raised concerns over the higher tax burden and the prospects that the revenue will merely support a larger government. The mission suggested that greater education on the benefits of the reforms in terms of reducing distortions, streamlining payments, and promoting investment could help shore up public support. The authorities broadly agreed and have requested help in analyzing the economic impact of the reforms as part of their outreach.

15. **Since implementing the tax reform will take several years, discussions focused on measures to broaden the tax base and strengthen administration.** Given the low tax collection in the FSM, the mission suggested:

- *Additional tax auditors*. The national government currently has only two auditors, compared to four for Pohnpei and Chuuk each. The cost of new hires could be more than offset by higher revenue, particularly if performance incentives were introduced.

- *Higher penalties for tax delinquents.* Penalties are too low at 25 percent, contributing to annual tax arrears of around ½ percent of GDP, and should be raised closer to international standards (100 percent of tax).

- *Better information sharing with state governments*. The national government could boost revenue by improving monitoring of incomes of the large number of self-employed state contractors, many of whom pay little or no income taxes.



Sources: IMF Staff Reports. Totals may not sum up due to rounding. Data are latest available: FSM (FY2005), RMI (FY2005), Palau (2004/05), Vanuatu (2005), Kiribati (2003), Samoa (2003/04), Tonga (2004/05).

16. **The authorities supported these proposals and are already taking measures to strengthen administration prior to creating the URA.** The authorities noted their plans to increase training in auditing, collection, and accounting to help with the transition to the URA. They also announced in November 2006 a tax waiver on penalties and interest through 2007 in an effort to recover arrears. The mission cautioned that frequent tax waivers could undermine tax compliance.

17. **Reforms of the public enterprises will reduce their burden on the budget, but may prove difficult to enact.** Some state governments, such as Pohnpei, have made progress recently in privatizing state-owned enterprises. The mission encouraged the authorities to continue efforts to privatize or shut down loss-making firms and to level the competitive playing field with the private sector by bringing state-owned enterprises into the tax system and eliminating their subsidy support. The authorities saw merit in the proposal but noted that state-owned enterprises, which account for nearly 5 percent of employment, would resist strongly since many would unlikely survive without such support.

18. **The authorities have taken steps to address the substantial unfunded liabilities of the Social Security Administration (SSA) and recognize that further changes are needed.** The large unfunded liabilities, estimated to be around 100 percent of GDP, reflect payouts that are 3–4 times greater than contributions in net present value terms. In 2006, the authorities took measures to raise contributions and reduce retiree payouts that will eliminate operating deficits through 2013. The mission welcomed these steps and urged the SSA to consider additional measures, such as raising the retirement age (now at 60 years of age) to secure its long-term solvency.

19. **The mission suggested improving the governance of the Trust Fund to help boost returns and ensure compliance with its overall mandate**.[3] As part of the Compact, a Trust Fund was created to provide a source of revenue after grants expires in 2023 (Box 3). Since its inception in 2004, investment returns on the fund have been disappointing, averaging only 2¼ percent per year, largely because of delays in appointing an investment advisor and fund manager. The poor performance raises concerns on whether future earnings from the Trust Fund will be enough to replace Compact grants. To strengthen the fund, the mission recommended to:

- *Delink the Trust Fund Committee (TFC) from the committee implementing the Compact.* Trust Fund operations are different from the rest of the Compact, and effective oversight requires that the TFC be staffed with professionals with financial expertise.

- *Elevate the status of the Trust Fund Committee by including the Secretary of Finance and Administration.* The appointment of the Secretary would help highlight the Trust Fund's importance for the FSM's future. Since the committee does not have a budget, the Secretary could also draw upon his or her staff to oversee the fund more effectively.

- *Aim for greater transparency in the fund's reports.* Experience elsewhere has shown that transparency can help protect against outside influence. To identify the need for corrective action, the reports should also include medium-term vulnerability analyses.

- *Adopt a simple and clear investment objective.* The fund's stated purpose is difficult to implement in practice.[4] Instead, the TFC could consider a simple mandate similar to other funds, such as to maximize total returns while preserving the fund's capital.

20. **The authorities stated that they were committed to sound governance of the Trust Fund.** They noted that after considerable delay, an investment advisor has been appointed to begin a diversified portfolio strategy. They supported the proposed appointment of the Secretary of Finance and Administration to the TFC, which would allow the committee to tap the government's considerable experience in managing their own reserve funds. They also agreed that greater transparency in the fund's regular reporting would help raise public awareness and oversight.

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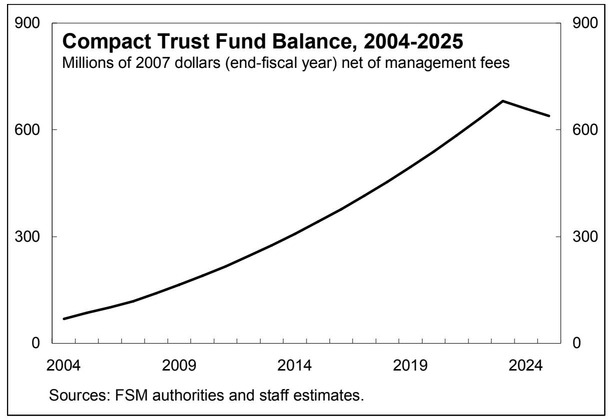
[3] A background paper accompanying the report will examine ways to strengthen the operations of the Trust Fund.

[4] According to the Agreement, "the purpose of the Fund is to contribute to the economic advancement and long-term budgetary self-reliance of the Federated States of Micronesia by providing an annual source of revenue, after FY2023…" (Article 2 of the FSM/US Trust Fund Agreement, November 2002).

Box 3. Activities and Management of the Compact Trust Fund

As part of the Compact of Free Association, a Trust Fund was established in 2004 to help promote FSM's economic advancement and self-reliance. The Trust Fund would support the FSM by providing a steady source of revenue after the Compact expires in FY2023. Under the agreement, the United States has pledged to contribute a set amount annually—reaching $29.6 million by FY2023, conditional on the FSM contributing $30 million as an initial investment (which was done in 2004). The Trust Fund cannot be used to finance spending or serve as collateral before 2024.



The Trust Fund is administered by a Joint Trust Fund Committee (TFC) consisting of 3 voting members appointed by the United States and 2 voting members by the FSM. The committee is responsible for managing the Trust Fund's investment and distribution of its resources. It is also authorized to select money managers and an investment advisor to manage a diversified portfolio. The fund can invest in U.S. stocks and bonds and other instruments as approved by the committee.

The first independent audit in 2006 found that the fund has severely underperformed during its early years, largely on account of weak oversight. The lack of clear procedures and firm deadlines contributed to delays in selecting an investment advisor and money manager. As a result, initial returns averaged only 2¼ percent, as all contributions were held in low-yielding bank deposits. In addition, the committee failed to perform various administrative functions, such as issuing annual reports on a timely basis and establishing clear rules for oversight.

These shortcomings have raised additional doubts on whether future earnings from the Trust Fund will be sufficient to replace Compact grants after 2023. Under conservative assumptions, staff estimates that future returns on the Trust Fund and other assets would be sufficient to replace expiring Compact grants for only a few years and that the stock of assets would decline relative to GDP over time, leaving only a small cushion against future shocks. Accumulating fiscal surpluses along with generating higher returns, net of management fees, will be vital to achieve the required growth of the fund.

Experience from other reserve management funds highlights the need for an effective public governance structure to achieve their mandates. New Zealand's Superannuation Fund or Norway's Petroleum Fund (now the Government Pension Fund) both feature a high degree of transparency through regular reporting and strong public oversight to enhance accountability. Stronger oversight has also helped the Trust Fund for the Marshall Islands, which has a similar setup with the FSM, to earn higher returns.

C. Improving the Business Environment

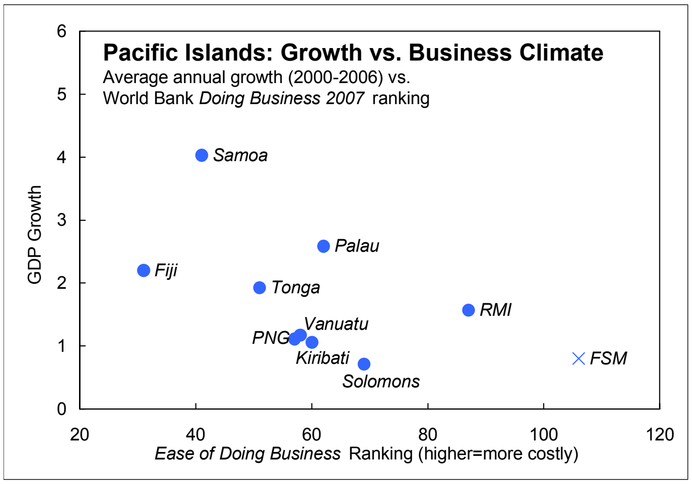
21. **The difficult business environment in the FSM has deterred investment and held back growth.** According to the World Bank's *Doing Business* report, the FSM ranks 106th in the world (last among the Pacific Islands) in terms of the ease of doing business.[5] In particular, the time to enforce commercial contracts and shut down a business is nearly twice as high as other Pacific Island countries. The restrictive foreign investment regime in some states, the large public-private wage gap, and problems in land titling have also impeded the private sector.

Selected Indicators of the Business Environment

	FSM	PICs	East Asia & Pacific
Cost of starting a business			
In percent of income per capita	135.9	44.9	42.8
Cost of enforcing commercial contracts			
In percent of debt	77.0	57.6	52.7
In number of days	775.0	517.6	477.3
Time to resolve bankruptcies			
In years	5.3	2.4	2.4

Source: World Bank, *Doing Business 2007.*

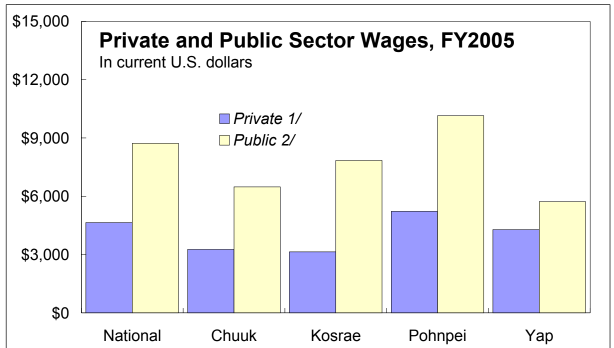
22. **The authorities saw promoting private-sector growth as crucial, not least to create new jobs during fiscal adjustment.** Tourism and fisheries had potential to develop further, but given the many significant obstacles, including high transport costs and poor infrastructure, the prospects for developing these sectors is limited without reforms to improve the business environment and attract foreign investment. While recognizing the difficulties, the mission noted that other countries in the region with lower business costs had managed to achieve higher growth rates and per capita incomes.



[5] A background paper to the consultation examines in more detail the factors behind the high cost of doing business and ways to improve the business environment.

23. **The mission and the authorities agreed that strengthening the capacity of the courts would help to facilitate contract enforcement.** The court's limited capacity has led to significant delays in enforcing contracts and resolving bankruptcies. For example, Chuuk, Pohnpei, and the national government each have only four judges with a long backlog of cases ranging from the criminal to corporate. Enhancing the capacity of the courts, combined with firm deadlines, would help facilitate and shorten the time for enforcing contracts. The authorities recognized the difficulties with the courts and have plans to hire additional judges at the national level.

24. **In the mission's view, reducing the large public-private sector wage gap would reduce competition with the public sector for skilled workers.** Public sector wages are on average almost double those in the private sector, although the gap varies across states. The large gap has contributed to crowding out the private sector in the market for skilled labor. The authorities recognized that the gap causes problems but stressed that past steps to reform the public sector would make further wage cuts difficult.



1/ Includes financial institutions.
2/ Data for the states excludes public enterprises and national government employment.

25. **The mission suggested replacing states' Foreign Investment Boards (FIB) with a transparent, criteria-based permit system.** The foreign investment regime is restrictive in most states—except for Yap—which has a streamlined licensing system.[6] Recently, the Pohnpei FIB has taken a more restrictive view towards FDI, despite contributing to jobs and tax revenue. The mission suggested that states move to a "negative-list" to help streamline the permit process (as done in Chuuk) and limit the possibility of FIBs being captured by narrow interest groups. The authorities recognized its potential benefit, but saw the chances of enacting reform as low since foreign investment policy is done mainly by the states, where concerns are widespread about the impact on local businesses.

26. **Restrictions on land use represent a major obstacle to expanding the private sector.** Registering titles is time-consuming and cumbersome, while sales are restricted at the state level. For example, the Pohnpei State Constitution outright bans land sales and foreign ownership of land. As a result, businesses face difficulties in securing property and growing. The states have taken steps to facilitate land use by lengthening leases from 25 years to 55 years and expanding titling, but resistance remains strong to allowing the sale of land.

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[6] Only Kosrae and Yap have amended their foreign investment laws to meet the ADP Private Sector Development Loan Program conditions for streamlined procedures and transparency.

27. **The mission and the authorities agreed that opening the land market on a small scale may help build support for further reforms.** Given the sensitivities, the mission proposed a pilot project allowing land sales in a specially designated zone, such as in a commercial district where titles and leases are already in place. Success there could build support for its expansion. The authorities saw merit in a pilot case and noted that they would complement financial initiatives underway to expand secured lending (next section).

D. Strengthening the Financial Sector to Support Private Sector Growth

28. **The banking sector is well regulated but does little domestic lending.** The banking system consists of the government-owned FSM Development Bank and two commercial banks. The largest is the Bank of FSM, which is 80 percent owned by the national and state governments. The U.S. Federal Deposit Insurance Corporation (FDIC) insures deposits for the two commercial banks and plays an important role in supervision, along with the FSM Banking Board.[7] However, banks hold around three-quarters of their assets overseas, mainly in long-term U.S. bonds. Following the pullout by the Bank of Hawaii in 2002, bank credit has staged a modest recovery but still remains one-half below the levels during 1995–2000.

29. **The new secured transaction law will help expand lending.** The law, which went into effect in October 2006, makes it easier for businesses to borrow against moveable assets, such as machinery, inventory, and cash flow. It will also create a national registry for identifying secured claims. By some estimates, these reforms could lower the lending rate for equipment loans by as much as 1 percentage point.

30. **The mission and the authorities agreed that these reforms should be complemented by measures to strengthen the role of private banks in the financial system.** Government-owned or controlled banks issue nearly 90 percent of loans in the FSM. The government's large presence in the banking system has helped to maintain confidence, but has also limited its development. To expand the role of private banks, the mission suggested, as a start, selling shares of the Bank of FSM to a strategic outside investor with banking experience who could upgrade the bank's services and extend into new areas.[8] The authorities noted that they have already begun selling shares on a limited basis to local investors with an aim of partial privatization. With the bank now profitable, they considered that this may be an opportune time to seek a strategic outside investor. To better serve the outer regions, the authorities plan to expand credit unions.

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[7] No outside agency supervises the FSM Development Bank.

[8] Selling only 10 percent of the bank's shares to an outside investor would still allow the bank to be insured by FDIC which requires that at least 75 percent of its shareholders be local investors.

31. **At the same time, the mission suggested reforms to reduce the scope of the FSM Development Bank in competing with commercial banks.** With its broad mandate "to assist in the economic advancement of the nation," the Development Bank has overlapped with commercial banks. For example, although the bank was originally established to help new companies, around half of its borrowers are already well-established firms, some for as long as 10 years. To limit the scope of the Development Bank to those not being served by commercial banks, the mission recommended to:

- *"Graduate" established firms after a fixed time.* This would not only provide more business opportunities for commercial banks but also free up resources for the Development Bank to lend to those groups who lack access to credit, such as subsistence farmers, commercial fishermen, and residential builders where the Development Bank's ability to foreclose on property provide an important advantage over other banks.

- *Give flexibility in setting lending rates.* Currently, the bank is required to charge a fixed interest rate of 9 percent on all loans. Allowing the bank to adjust rates based on risk would strengthen its commercial orientation and help eliminate its reliance on government support.

- *Put the Development Bank under the supervision of the Banking Board.* Given its size and close links to the economy, the Banking Commissioner should supervise the Development Bank to help safeguard the overall soundness of the financial system.

32. **The authorities stressed that strengthening the Development Bank's commercial orientation or tightening supervision should not compromise its mission of lending to high-risk borrowers who are not being served by commercial banks.** The mission pointed out that greater flexibility in setting rates, improved risk analysis, and closer supervision would help ensure that the bank remains sound in meeting its development goals.

33. **It was agreed that the new insurance law will require a sound regulatory and supervisory framework.** In 2006, the Congress passed a law allowing for the regulating and licensing of insurers. Since the law calls for the Banking Board to also supervise insurers, it will be important to ensure that the regulator has the training and capacity to cover both industries. The authorities recognized the need to enhance supervisory capacity and have submitted a budget to increase staff and training.

34. **The mission saw little economic benefit from initiatives to develop the FSM as an offshore financial center and a tax haven for foreign corporations.** Congress passed legislation to provide a tax haven for foreign corporations (2004) and to register captive insurers (2006) as a way to secure additional revenue. The mission underscored that the tax haven measures could be considered harmful by other countries and are unlikely to develop the local economy. Moreover, the lack of capacity to supervise captive insurers runs the risk

of possible misuse and greater scrutiny under AML/CFT monitoring. The authorities emphasized that the initiative to become an offshore financial center and tax haven originated from the legislature and was not widely endorsed. However, reversing these steps would be difficult, since Congress approved these bills over the President's veto.

IV. Other Issues

35. **The FSM has taken steps to strengthen the AML/CFT framework.** The government amended the money laundering law to allow for the identification of an account holder's real name and to require reporting of suspicious transactions and has proposed modifying the law to allow for the creation of a financial intelligence unit (FIU). The mission stressed the need for adequate training and resources and encouraged the authorities to seek out donor assistance in this area.

36. **The FSM has signed the Pacific Island Countries Trade Agreement (PICTA), but Congress has yet to ratify it.** Discussions between the Pacific Island countries and the EU on an Economic Partnership Agreement in which the FSM is participating remain in the early stages.

37. **The limited domestic capacity to produce economic data hampers surveillance and policy analysis.** Data on the national accounts and fiscal outcomes are compiled by outside experts with a lag of just under 1 year. The FSM continues to receive assistance from PFTAC and STA to improve data quality and collection.

V. Staff Appraisal

38. **Without stronger reform efforts, the FSM faces limited medium-term growth prospects.** Since 1986, the FSM has relied heavily on Compact of Free Association support to advance its economic development and sustain a large public sector. With support under the amended Compact projected to decline and expire by 2023, the authorities face the challenge of adjusting, a task made more difficult without sustained private sector growth.

39. **Continued fiscal deficits have raised the size of the adjustment needed to achieve self-sufficiency.** Without an accumulation of fiscal surpluses needed to offset the decline in Compact grants and build a cushion against shocks, capital spending will fall and the government's financial position will become increasingly fragile. Fiscal consolidation that frees up resources for capital spending, combined with structural reforms, could raise medium-term growth prospects significantly.

40. **Securing fiscal sustainability will require a strategy that phases in spending cuts and comprehensive tax reform.** Consolidation should begin with cuts to the large wage bill, particularly by the states. On the revenue side, priority should be given to passing tax

reforms, including the VAT, and strengthening tax administration. Improving the governance of the Trust Fund will boost long-term investment returns.

41. **At the same time, reforms to improve the business environment could catalyze growth and create jobs.** Easing the high cost of doing business would help promote growth, create new employment, and generate higher revenue. The priority should be to reduce the large public-private wage gap, improve the capacity of the courts to enforce contracts, and shift to a "negative list" for foreign investment at the state level.

42. **The financial system also needs to do more to support private sector development.** Privatizing the Bank of FSM and reducing the scope of the FSM Development Bank to compete with commercial banks would help develop further the financial system. At the same time, supervision should be strengthened.

43. **Given the dominant role of the state governments, the key challenge will be to achieve broad agreement at all levels to enact these reforms.** National and state elections scheduled for 2007 further complicate the task of advancing reforms, but further delays raise the risk of an even more difficult adjustment down the road. Greater efforts to inform the public will therefore be crucial for forging a broad consensus for these reforms.

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

45. **It is recommended that the next Article IV consultation take place on the 24-month cycle.** The authorities welcomed a proposed interim staff visit during 2007.

Table 1. Micronesia: Basic Data, FY2002–2007 1/

Nominal GDP (FY2005): US$237 million
Population (FY2005): 108,276
GDP per capita (FY2005): US$2,189
Quota: SDR5.1 million

	FY2002	FY2003	FY2004 Est.	FY2005 Est.	FY2006 Proj.	FY2007 Forecast
Real sector (average annual percent change)						
Real GDP	1.4	3.3	-4.4	1.5	-0.7	1.8
Consumer prices	-0.1	-0.2	1.8	4.1	3.9	3.0
Employment	0.7	-1.6	-1.0	0.3	0.6	0.2
Public (inc. public enterprises)	4.6	-2.6	-2.9	2.5	2.9	1.9
Private	-4.1	0.1	1.4	-2.0	-1.9	-1.9
Nominal wages	3.2	0.9	-0.4	1.1	2.2	2.6
Public-private wage ratio	1.9	1.9	2.0	2.0	2.0	2.1
Consolidated government finance (in percent of GDP)						
Revenue and grants	71.7	68.6	59.4	56.6	53.1	56.7
Revenue	21.0	19.1	24.0	20.9	19.8	19.2
Grants	50.6	49.5	35.4	35.7	33.4	37.5
Expenditure	63.9	67.9	65.6	62.0	54.7	59.2
Current	53.5	55.7	53.6	56.3	51.4	48.0
Capital	10.4	12.2	12.0	5.7	3.3	11.2
Overall balance	7.7	0.7	-6.2	-5.4	-1.6	-2.5
Usable financial assets 2/	-2.5	-3.5	-1.3	2.5	1.6	-0.2
excluding Yap and Pohnpei	-9.9	-11.4	-11.0	-11.4	-11.7	-12.4
Compact Trust Fund (millions of U.S. dollars, end-period)			0.0	62.4	84.3	105.9
Commercial banks (in millions of U.S. dollars; end of period, through June 2006)						
Foreign assets	87.2	110.0	105.2	99.2	104.8	…
Loans	39.1	23.7	21.3	25.7	29.0	…
Total deposits	112.0	119.8	115.4	111.4	117.7	…
Interest rates (in percent, average for FY)						
Consumer loans	15.3	15.1	15.1	16.4	19.2	…
Commercial loans	6.2	6.9	6.9	7.8	10.4	…
Balance of payments (in millions of U.S. dollars)						
Trade balance	-84.6	-91.8	-119.3	-121.2	-111.7	-111.4
Net services and income	-25.3	-24.1	-21.0	-21.4	-22.1	-20.3
Private and official transfers	104.2	118.1	99.6	106.2	102.7	116.4
Current account including official transfers	-5.7	2.2	-40.7	-36.4	-31.1	-15.4
(in percent of GDP)	-2.5	0.9	-18.1	-15.3	-12.7	-6.0
Current account excluding official transfers	-107.6	-113.6	-137.8	-139.3	-128.5	-124.4
(in percent of GDP)	-48.1	-49.3	-61.4	-58.8	-52.5	-48.5
Overall balance 3/	32.1	18.3	-55.5	-20.8	-14.1	-3.6
(in percent of GDP)	14.3	7.9	-24.7	-8.8	-5.8	-1.4
Gross reserves (in months of imports)	4.7	6.3	3.5	3.1	3.0	…
External debt (in millions of U.S. dollars; end of period) 4/						
Stock	57.9	59.2	59.4	59.9	60.4	59.5
(in percent of GDP)	25.9	25.7	26.5	25.3	24.7	23.2
Debt service	2.4	2.4	2.6	2.5	2.5	2.5
(in pct. of exports of goods and services)	5.2	5.2	7.2	6.5	6.2	5.9
Exchange rate regime			U.S. dollar is the official currency			

Sources: Data provided by the FSM authorities and Fund staff estimates.
1/ Fiscal year ending September 30.
2/ Cash and other liquid investments not reserved for specific uses.
3/ Includes changes in reserves, valuation changes and errors and omissions.
4/ Government and public enterprise debt only.

Table 2. Micronesia: General Government Operations, FY2002–2007 1/

	FY2002	FY2003 Estimated	FY2004 Estimated	FY2005 Estimated	FY2006 Projected	FY2007 Forecast
	(In millions of U.S. dollars)					
Overall balance	17.3	1.7	-13.9	-12.8	-3.9	-6.5
Current Balance	8.8	2.3	12.4	0.7	-0.7	-4.1
Capital Balance	8.5	-0.7	-26.3	-13.5	-3.2	-2.4
Total revenue and grants	160.3	158.1	133.3	134.1	130.0	145.4
Revenue	47.0	44.1	53.9	49.6	48.3	49.2
Tax revenue	26.3	23.9	27.2	29.1	29.8	30.6
Wage and salary tax	7.5	6.4	8.0	6.5	6.7	6.9
Gross revenue tax	6.2	5.2	6.0	6.8	6.9	7.1
Import taxes	6.7	6.0	6.7	8.8	9.0	9.3
Fuel	0.8	0.6	0.6	0.6	0.6	0.6
All others	5.9	5.4	6.1	8.2	8.4	8.6
Other national taxes	0.9	0.1	0.0	0.3	0.3	0.3
State tax revenue	4.9	6.2	6.5	6.7	6.8	7.0
Non-tax revenue	20.7	20.1	26.7	20.5	18.6	18.6
Fishing access revenue	10.6	11.8	12.1	13.1	12.5	12.5
Dividend and interest income	2.3	0.9	2.5	1.5	0.1	0.1
Other nontax revenues	7.9	7.4	12.1	6.0	6.0	6.0
Grants (from abroad)	113.3	114.1	79.4	84.5	81.7	96.3
Current	81.5	86.7	78.7	84.5	76.8	69.8
Compact General	47.7	43.9	0.0	0.0	0.0	0.0
Compact Special	18.2	22.7	53.2	55.5	55.4	55.6
Other:Current	15.5	20.1	25.5	29.1	21.3	14.1
Capital	31.8	27.4	0.7	0.0	4.9	26.5
Compact CIP	31.8	25.3	0.0	0.0	0.0	25.1
Other	0.0	2.1	0.7	0.0	4.9	1.3
Total expenditure	143.0	156.5	147.2	146.9	133.9	151.9
Current	119.7	128.4	120.2	133.4	125.8	123.1
Goods and services	113.1	121.6	115.4	129.1	122.6	120.5
Wages and salaries	58.1	60.2	57.1	59.1	57.5	59.3
Travel	7.8	8.4	7.4	8.5	8.4	8.3
Other	47.2	53.0	51.0	61.6	56.6	52.9
Interest payments	0.0	0.0	0.0	0.0	0.1	0.1
Subsidies	4.4	3.4	1.1	0.6	0.3	0.3
Transfers	2.2	3.4	3.8	3.7	2.8	2.2
Capital	23.3	28.0	27.0	13.5	8.2	28.8
Acquisition of fixed capital	4.6	13.6	5.1	9.9	8.2	28.8
Multi-purpose development projects	17.7	14.5	9.5	3.7	0.0	0.0
Capital Transfers	1.0	0.0	12.4	0.0	0.0	0.0
Memorandum items:	(In percent of GDP)					
Overall balance	7.7	0.7	-6.2	-5.4	-1.6	-2.5
Current	3.9	1.0	5.5	0.3	-0.3	-1.6
Revenue	21.0	19.1	24.0	20.9	19.8	19.2
Tax revenue	11.7	10.4	12.1	12.3	12.2	11.9
Non-tax revenue	9.3	8.7	11.9	8.7	7.6	7.2
Grants	50.6	49.5	35.4	35.7	33.4	37.5
Total expenditure	63.9	67.9	65.6	62.0	54.7	59.2
Current	53.5	55.7	53.6	56.3	51.4	48.0
Wages and salaries	26.0	26.1	25.4	24.9	23.5	23.1
Capital	10.4	12.2	12.0	5.7	3.3	11.2

Sources: Data provided by the FSM authorities and staff estimates.
1/ Fiscal year ending September. The consolidated fiscal accounts cover the national and four state governments.

Table 3. Micronesia: Balance of Payments, FY2002–2007

	FY2002	FY2003	FY2004	FY2005	FY2006 Projected	FY2007 Projected
	(In millions of U.S. dollars)					
Overall balance 1/	**32.1**	**18.3**	**-55.5**	**-20.8**	**-14.1**	**-3.6**
Current Account Balance	**-5.7**	**2.2**	**-40.7**	**-36.4**	**-31.1**	**-15.4**
Trade balance	-84.6	-91.8	-119.3	-121.2	-111.7	-111.4
Exports, f.o.b.	26.9	28.3	17.5	20.1	21.4	22.2
Imports, f.o.b.	-111.5	-120.1	-136.8	-141.3	-133.1	-133.6
Petroleum products	-14.9	-14.3	-16.7	-22.3	-23.5	-19.9
Services account	-36.0	-36.1	-37.4	-40.0	-39.8	-38.1
Receipts	18.9	18.6	18.2	18.6	19.2	19.8
Travel	16.8	16.7	16.5	17.1	17.5	17.9
Communications (net)	2.1	1.9	1.5	1.3	1.5	1.7
Other	0.1	0.1	0.3	0.1	0.1	0.1
Payments	-55.0	-54.8	-55.6	-58.6	-59.0	-57.9
Freight and insurance	-19.7	-21.2	-24.1	-26.6	-27.0	-25.8
Transportation	-12.2	-10.8	-11.4	-12.0	-12.0	-12.0
Travel	-5.3	-5.6	-5.3	-5.6	-5.6	-5.6
Other	-17.8	-17.2	-14.8	-14.4	-14.4	-14.4
Income, net	10.8	12.0	16.4	18.6	17.7	17.7
Receipts	16.4	18.7	22.7	24.6	23.7	23.7
Fishing rights fees	10.6	11.8	12.1	14.4	12.5	12.5
Interest dividend income	5.8	6.8	10.6	10.2	11.2	11.2
Payments	-5.6	-6.6	-6.2	-5.9	-6.0	-5.9
Foreign workers earnings	-2.6	-3.4	-3.1	-2.8	-2.8	-2.8
Interest payments	-1.7	-1.8	-1.8	-1.6	-1.6	-1.6
Dividends	-1.4	-1.4	-1.4	-1.5	-1.5	-1.5
Unrequited transfers	104.2	118.1	99.6	106.2	102.7	116.4
Private	2.3	2.3	2.5	3.3	5.3	7.3
Inflows	4.8	4.9	5.0	6.0	8.0	10.0
Outflows	-2.5	-2.6	-2.5	-2.7	-2.7	-2.7
Official	101.9	115.8	97.1	102.9	97.4	109.0
Compact funds	65.9	66.6	51.7	53.2	55.4	80.7
Other	36.0	49.1	45.4	49.7	42.0	28.3
Capital and financial account	**37.7**	**16.1**	**-14.8**	**15.6**	**17.0**	**11.8**
Capital Transfers	39.1	39.8	-22.5	8.1	17.5	9.4
Official	31.8	32.2	-28.6	1.1	4.9	1.3
In-kind	7.3	7.6	6.1	7.1	12.6	8.1
Financial account (borrowing)	-1.4	-23.6	7.7	7.4	-0.5	2.4
Short term, net	-0.8	-25.0	7.5	6.9	-0.5	-0.5
Medium term, net	-0.6	1.3	0.2	0.5	0.0	2.9
Memorandum items	(In percent of GDP)					
Current account balance	-2.5	0.9	-18.1	-15.3	-12.7	-6.0
Trade balance	-37.8	-39.9	-53.2	-51.1	-45.7	-43.4
Exports	12.0	12.3	7.8	8.5	8.7	8.6
Imports	-49.9	-52.1	-61.0	-59.6	-54.4	-52.1
Service	-16.1	-15.7	-16.7	-16.9	-16.3	-14.9
Income	4.8	5.2	7.3	7.9	7.2	6.9
Transfers	46.6	51.2	44.4	44.8	42.0	45.4
Private	1.0	1.0	1.1	1.4	2.2	2.9
Official	45.6	50.2	43.3	43.4	39.8	42.5
Current account, ex. transfers	-49.1	-50.3	-62.5	-60.2	-54.7	-51.4

Sources: Data provided by the FSM authorities and staff estimates.
1/ Includes changes in reserves, valuation changes and errors and omissions.

Table 4. Micronesia: Indicators of Financial and External Vulnerability, FY2002–2006

	FY2002	FY2003	FY2004	FY2005	FY2006
Commerical banks 1/					
		(Year-on-year percent change)			
Deposits	-7.9	6.9	-3.7	-3.4	-1.1
Private sector credit	-29.4	-38.6	-5.6	16.7	11.3
(in percent of GDP)	15.0	8.9	8.6	9.5	9.8
		(In percent of total assets)			
Foreign assets	67.9	80.4	80.2	77.2	77.4
Return on assets 2/	-0.2	0.3	0.8	…	…
Equity capital	10.5	9.0	9.6	10.1	9.7
Return on equity 2/	-1.1	2.2	5.8	…	…
		(In percent of total loans)			
Loss allowance	2.2	5.6	6.1	5.7	5.0
Non-performing loans 2/	7.7	2.5	3.1	…	…
FSM Development Bank 1/					
		(Year-on-year percent change)			
Loans	-2.8	3.2	-4.2	8.0	18.0
(in percent of GDP)	9.1	9.1	9.0	9.2	9.7
		(In percent of total assets)			
Foreign assets	24.7	22.6	22.7	7.3	7.0
Equity capital	74.3	71.5	71.5	84.3	76.8
		(In percent of total loans)			
Loss allowance	14.2	19.0	22.7	17.5	21.8
External indicators					
Exports (goods & services, y-on-y pct. chg.)	5.8	2.4	-23.9	8.2	4.9
Imports (goods & services, y-on-y pct. chg.)	-3.8	5.0	10.1	3.9	-3.9
Current account balance (percent of GDP)					
Including official transfers	-2.5	0.9	-18.1	-15.3	-12.7
Excluding official transfers	-48.1	-49.3	-61.4	-58.8	-52.5
Overall balance (percent of GDP) 3/	14.3	7.9	-24.7	-8.8	-5.8
Gross official reserves					
In millions of U.S. dollars	65.9	92.4	56.3	51.1	48.2
In months of imports of goods and services	4.7	6.3	3.5	3.1	3.0
In percent of GDP	29.4	40.1	25.1	21.6	19.7
Total external debt 3/					
In millions of U.S. dollars	57.9	59.2	59.4	59.9	60.4
In percent of exports of goods and services	126.4	126.3	166.5	155.1	149.0
In percent of GDP	25.9	25.7	26.5	25.3	24.7
Debt service					
In millions of U.S. dollars	2.4	2.4	2.6	2.5	2.5
In percent of exports of goods and services	5.2	5.2	7.2	6.5	6.2
In percent of GDP	1.1	1.0	1.2	1.1	1.0

1/ Data for 2006 as of June.
2/ For the Bank of FSM. Comparable data are not available for the Bank of Guam or FSM Development Bank.
3/ Includes changes in reserves, valuation changes and errors and omissions.
4/ Around ½ of the total is concessional debt to the Asian Development Bank.

Table 5. Micronesia: Social Indicators

	Micronesia	Same Region/Income Group	
		East Asia and Pacific	Lower-middle Income
Population			
Total population (millions)	0.11	1,885	2,475
Growth rate (percent annual)	0.3	0.9	1.0
Urban population (percent of population)	29.7	40.6	48.7
Total fertility rate (births per woman)	4.0	2.0	2.0
GNI per capita (in U.S. dollars)	2,300	1,627	1,918
Current public expenditure			
Health (in percent of GDP)	5.6	1.9	2.5
Education (in percent of GDP)	7.3	3.2	3.5
Gross primary enrollment			
(in percent of school age population)	142	115	108
Male	136	116	111
Female	149	114	105
Immunization rate (percent 12-23 months)			
Measles	85	82	86
Diphtheria/Pertussis/Tetanus (DPT)	78	87	88
Life expectancy at birth (years)			
Total	68	70	70
Male	67	68	68
Female	69	72	73
Mortality			
Infant (per thousand live births)	19.0	29.0	32.0
Under 5 (per thousand live births)	23.0	37.0	40.0

Sources: World Development Indicators 2006 and Millenium Development Goals, World Bank.

ANNEX I. MICRONESIA— MEDIUM-TERM FISCAL OUTLOOK

This annex updates previous staff work on the size of the needed fiscal adjustment to achieve self-sufficiency after the end of the Compact in 2023. The annex describes the result of medium-term simulation under a baseline and with reforms. The results indicate that both structural reforms and fiscal adjustment are required to free up room for capital spending, raise growth prospects, and ensure that the government has sufficient savings to weather the end of the Compact grant aid in FY2023.

Basic assumptions

- CPI inflation is 2½ percent annually, equal to long-term U.S. inflation estimates, since the U.S. dollar is the official currency. Gross nominal investment returns are assumed to be 7 percent (6 percent net returns plus 100 bps in fees)—2½ percentage points above U.S. nominal GDP growth over 2008–2023. During the draw-down phase of the Trust fund, assets are invested conservatively in instruments yielding only 5 percent (on a net basis).

- Current Compact grants are disbursed as scheduled between FY2008–2023. In the "baseline" scenario, difficulty in implementing the Compact persists and capital spending remains at a low level into the medium-term.

- No additional borrowing takes place.

Baseline scenario

Policy assumptions. Fiscal policy is assumed to remain in balance over the medium-term. Tax ratios are roughly constant (as a share of GDP), resulting in a compression of real per capita spending in capital and other current expenditures. Medium-term real GDP growth is assumed to be ¾ percent, reflecting weak infrastructure and low labor productivity growth.

Outcomes. With these assumptions, GDP, revenues and expenditures—particularly capital spending—are flat. Furthermore, the government's stock of financial assets would be around $700 million (in 2007 dollars), of which around $680 million is in the Compact Trust Fund and $20 million would be the balance in the General Fund. During the draw-down phase, investment income would only be around $35 million (in 2007 dollars). By contrast, FY2023 Compact grants are estimated to be $48 million (in 2007 dollars), leaving a shortfall of 7 percent of GDP, equal to the revenue loss from the step-down of grants in the mid-1990s.

Fiscal reform scenario

Policy assumptions. The staff's fiscal policy recommendations are implemented, but only gradually, with the fiscal balance reaching 3½ percent of GDP over the medium-term. This is accomplished through a combination of revenue and expenditure measures. Introducing a VAT could raise revenue by around 3 percent of GDP, while cutting the wage bill and improving administration could yield an additional 2½–3 percent of GDP. Although the impact would not take place immediately, these efforts (government streamlining, higher infrastructure spending, and a more efficient tax system) would raise growth over the medium-term by ½ percentage points per year.

Outcomes. Stronger growth and tighter fiscal policy help to boost overall incomes and revenue ratios, and capital spending would also improve over the baseline scenario. Even in the long-run, however, there are still insufficient resources to make up for lower Compact support. Infrastructure spending would be only marginally higher than the baseline scenario, as the need for fiscal consolidation and shrinking the government sector would crowd out public spending. At the same time, government assets would reach around $850 million, which would generate around $43 million in income, annually; around ten percent lower than the level of expiring Compact grants.

Comprehensive reform scenario

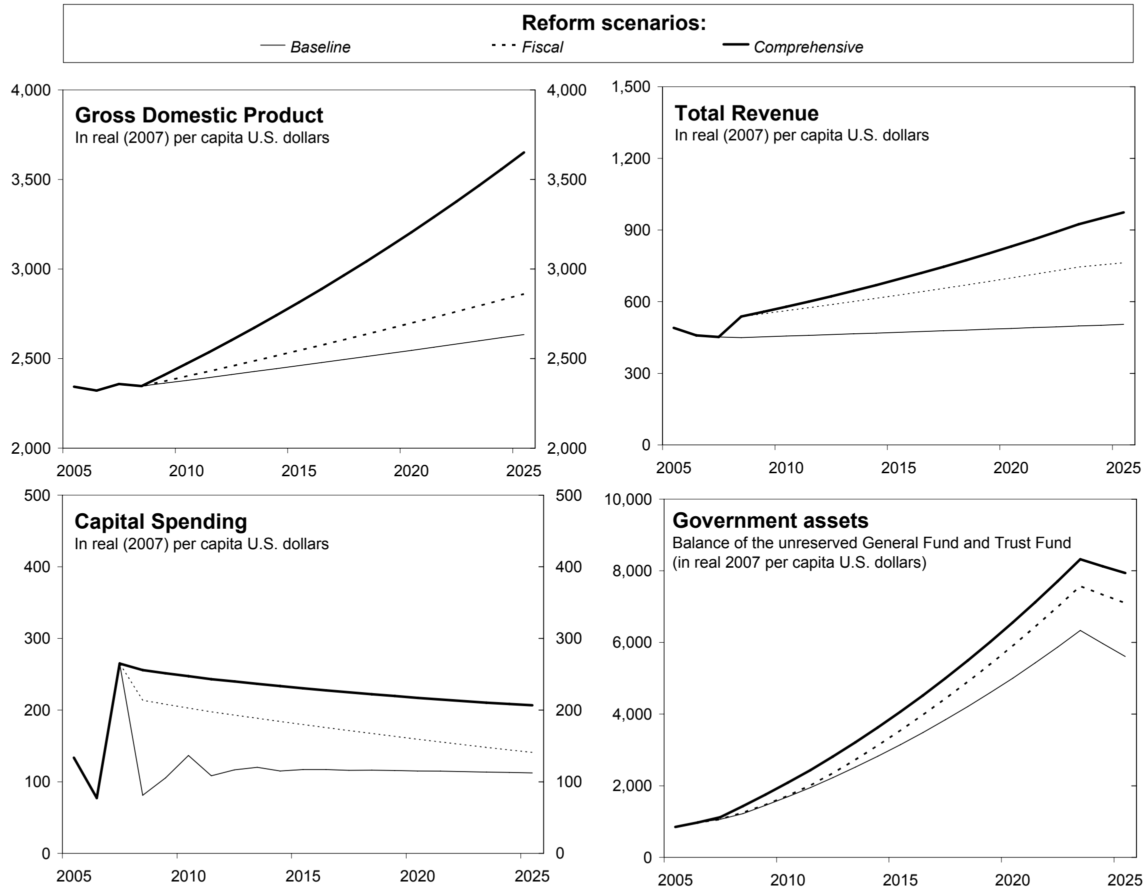
Policy assumptions. In this scenario, fiscal reforms are implemented expeditiously and, combined with structural reforms to promote the private sector, would help raise real GDP growth to 2¾ percent—in line with the growth rate of Yap during the first Compact period.

Outcomes. In this scenario, per capita incomes are almost 40 percent higher than baseline. Stronger growth would ensure more revenue (on a per capita basis) is raised, allowing capital spending to be nearly twice as high as the baseline scenario and higher spending on education and other development needs. At the end of the period, the stock of government assets would reach almost $1 billion—thanks to consistent pattern of saving—and generate sufficient income to replace expiring grants.

Impact of the FSM's federal nature on the simulations

Because of the federal nature of the FSM, each state would need to rebuild its General Fund independently of the actions of other states. For example, the state of Yap already has a stock of assets that is more than sufficient to help it replace any shortfall after FY2023. In all other states, recent deficits have resulted in a sharp deterioration in their General Fund balances. As a result, states must, individually, run large surpluses.

The swing in the fiscal balance is large and would likely take several years to fully implement. For example, in Chuuk, the swing in the fiscal balance is nearly $9 million, or nearly one-eighth of state GDP. The swing in the fiscal balances elsewhere are also large, except for the national government and the state of Yap, both of whom have substantial savings in the General Fund and a history of fiscal rectitude.



Medium-term Outlook for Public Finances (IMF Government Financial Statistics basis)

	FY2005	FY2006 (Est.)	FY2007 (Forecast)	Annual surpluses required (FY07-24) 1/
Fiscal balance (in millions of dollars)				
FSM	**-12.8**	**-3.9**	**-6.5**	**9.2**
National	-0.8	0.3	-0.2	0.5
Chuuk	-6.1	-2.0	-2.8	6.0
Kosrae	0.1	-0.2	-0.4	1.4
Pohnpei	-0.9	-1.0	-2.0	2.3
Yap	-5.1	-1.0	-1.1	-1.0
Unreserved general fund balance (freely available cash, in millions of dollars)				
FSM	**5.8**	**3.9**	**-0.5**	**180**
National	4.1	4.6	4.6	18
Chuuk	-26.7	-28.7	-31.5	68
Kosrae	-4.3	-4.5	-4.9	20
Pohnpei	3.2	2.2	0.2	45
Yap	29.6	30.4	31.1	28
Memorandum item (in percent of GDP):				
FSM Fiscal balance	-5.4	-1.6	-2.5	3.6

1/ This column is in millions of 2007 dollars. In FY2024, Trust Fund income in FY2024 will not be sufficient to replace Compact grants. To avoid a sharp adjustment, staff projections suggest that the unreserved accounts of the General Fund will need to reach $180 million to complement the Trust Fund. (Assumes a nominal net return of 6 percent.) While subject to uncertainty, the projections highlight the need to take steps now to build up savings for the future.

ANNEX II. MICRONESIA—FUND RELATIONS
(As of November 30, 2006)

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

II. **General Resources Account**:	SDR Million	Percent Quota
Quota	5.10	100.00
Fund holdings of currency	5.10	100.00
Reserve position in Fund	0.00	0.01

III. **SDR Department**:	SDR Million	Percent Allocation
Holdings	1.29	n.a.

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangement**:

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 international payments and transfers for current and capital transactions.

VIII. **Article IV Consultation**:

The FSM is on the 24-month consultation cycle. The 2004 Article IV consultation discussions were held during October 18–28, 2004. The Executive Board discussed the staff report and concluded the consultation on February 25, 2005.

IX. **Technical Assistance, 1999–2006**:

STA, MFD, LEG, and PFTAC have provided technical assistance on statistics, banking supervision, tax policy, and combating of financial crime and financial system abuse.

X. **Resident Representative**: None

ANNEX III. MICRONESIA—RELATIONS WITH THE PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTER (PFTAC)[9]

Since 2000, the Center's assistance to the FSM has included 30 advisory missions, mostly in the area of banking supervision and tax policy and administration. The FSM has also sent 21 officials to various regional seminars and workshops organized by PFTAC.

Public Financial Management

The mission in June 2006 mission focussed on re-establishing with the authorities a PFTAC PFM connection by undertaking a "quick scan" assessment, at both the national and state levels of developments in PFM and to identify any follow-on PFTAC TA.

Tax Administration and Policy

PFTAC has designed a comprehensive tax reform program to assist FSM improve the effectiveness of their tax regime. In 2005 the President approved the recommendations of the *Tax Reform Task Force* and established an Executive Steering Committee to manage the reform process. The Executive Steering Committee is currently considering the legislation drafts and tax policy prepared by IMF Legal and PFTAC respectively. PFTAC intends to provide further technical assistance in revenue estimation and project management of the reform implementation.

PFTAC has also participated in a major customs modernization program involving the development and implementation of the PC Trade computer software system and associated technical assistance designed to facilitate trade, speed up clearances and improve the accuracy of data. Recently PFTAC provided technical assistance to train Customs officers from all four States in Post Clearance Audits which utilizes the macro data available within the PC Trade system.

Financial Sector Regulation and Supervision

In May 2006, the advisor visited FSM to review draft insurance legislation. An aide memoire was provided to authorities on the supervision of insurance in FSM. The mission discussed and reviewed the proposed insurance legislation and followed up on aspects of issues

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[9] The Pacific Financial Technical Assistance Centre (PFTAC) in Suva, Fiji is a multi-donor technical assistance institution, financed by IMF, AsDB, AusAID and NZAID, with the IMF as Executing Agency. The Centre's aim is to build skills and institutional capacity for effective economic and financial management that can be sustained at the national level. Member countries are: Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tokelau, Tonga, Tuvalu, and Vanuatu. This annex is prepared on the basis of the input from the PFTAC staff.

identified in an IMF TA mission in March 2006. The Banking Commissioner was cognizant of the need to establish a legislative and supervisory framework for insurers, domestic and foreign, which are active in FSM. The advisor continues to liaise with authorities on issues related to recently enacted insurance legislation and proposals to establish a captive insurance sector.

Economic and Financial Statistics

A November 2005 mission discussed with the authorities their needs and options for TA over the next two years. It was agreed that 2006 be focused on building local capacity to compile the existing range of statistics, and from 2007 plan to improve existing statistics and to extend their range. At present the needs are limited to statistics included in the Annual Compact report to the United States: CPI, BOP and nominal and real GDP, by state and consolidated. A brief follow-up mission in June 2006 confirmed the needs; a request was made for an in-country national accounts course.

A workshop on National Accounts was conducted in October 2006 by the PFTAC Coordinator and Statistics Advisor. Wider macroeconomic statistics issues were covered, and an outreach program involving education of officials in the four state governments of the importance and uses of macroeconomic statistics was conducted.

ANNEX IV. MICRONESIA—RELATIONS WITH THE ASIAN DEVELOPMENT BANK[10]

Since becoming a member in 1990, the FSM has received substantial assistance from the AsDB. As of August 2006, cumulative AsDB assistance to the FSM consisted of eight loans and 40 technical assistance (TA) grants.[11]

The AsDB continues to support the FSM with three pillars of the country strategy: (i) good governance, (ii) inclusive social development, and (iii) pro-poor economic growth. Under AsDB's country strategy for 2006–07 special attention will be given to results-oriented implementation of ongoing projects, performance-based allocation of AsDB funds among the states, and continued support for capacity building.

Currently, five loans are active: one focused on basic social services, two on infrastructure and two on the development of the private sector. The AsDB approved a Private Sector Development Program (PSDP) at the end of 2001, with two loans totaling $13.0 million. The PSDP aims at promoting small and medium sized businesses, enhancing the regulatory and policy framework, and improving factor markets. Measures are also planned to mitigate any adverse social impact of these adjustment polices. The Basic Social Services Project is intended to improve the human resources of FSM in a sustainable manner to enable long-term social and economic development. Health and Education sectors are the specific focus with emphasis on improving service quality, raising community participation, and developing sustainable funding options. Implementation of this $8 million loan began in 2003. The Omnibus Infrastructure Development project loans (totaling $19m), approved in 2004, are designed to enhance public health, environmental quality, and surface water quality through improved wastewater infrastructure and management for Pohnpei and improved delivery of water services and expanded water supply systems for Yap and Kosrae; and improved management and provision of power in Chuuk.

The AsDB has been assisting the FSM to improve public sector efficiency and effectiveness since 1995 through TA in economic management and capacity building. The AsDB continues to support the government in increasing its institutional capacity in public sector management, administration and auditing through TA activities.

AsDB's non-lending program, AsDB's key modality of assistance to promote private sector

[10] Prepared on the basis of information from AsDB staff.

[11] The eight loans are for: (i) fisheries development; (ii) law, economic management and public policy; (iii) finance; (iv) water supply and sanitation; (v) basic social services; and (vi) private sector development.

development and development effectiveness in the FSM, currently includes technical assistance (TA) for public sector management and administration. Assistance is being provided to implement the Public Sector Capacity Building Roadmap (the roadmap was designed by an earlier TA) which focuses on three areas of the public sector recognized as most urgent critical to address the challenge of reduced funding under the Compact – financial management, economic planning and statistics.

Table 1. Loans to the Federated States of Micronesia by Sector
(In millions of dollars; as of end-August 2006)

Sector	No.	Amount
Agriculture and Natural Resources	1	6.5
Energy	0	0
Industry and Nonfuel Minerals	0	0
Transportation	0	0
Communications	0	0
Finance	1	18.0
Law, Economic Management and Public Policy	2	13.0
Water Supply, Sanitation & Waste Management	1	10.6
Multisector	3	27.0
Other	0	0
Total	8	75.10
Memorandum Item:		
Technical Assistance Provided	40	23.28

Table 2. Loan Approvals and Disbursements to the FSM, 1995–2005
(In millions of dollars)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Total
Loan Approvals	0.0	10.6	18.0	0.0	0.0	8.0	13.0	0.0	0.0	19.0	0.0	68.6
Loan Disbursements	0.3	0.1	11.3	6.2	4.9	4.4	2.5	1.4	2.7	1.1	1.7	36.6
Undisbursed balance at the end of the year	6.2	16.7	23.4	17.2	12.3	14.2	23.3	22.0	19.2	18.1	16.4	
Memorandum Item:												
TA approvals 1/	3.3	1.2	2.4	4.9	1.3	0.8	1.2	1.0	1.2	0.85	0.0	23.3

1/ Includes period 1990 to end-August 2006 in the Total column.

ANNEX V. MICRONESIA—RELATIONS WITH THE WORLD BANK GROUP

Total Commitments:	None
IFC Investments:	None
Recent Reports:	*Opportunities to Improve Social Services: Human Development in the Pacific Islands*, forthcoming.
	Doing Business 2007: How to Reform.
	At Home and Away: Expanding Job Opportunities for Pacific Islanders through Labour Mobility, 2006.
	Not If, But When: Adapting to Natural Hazards in the Pacific Islands Region, 2006.
	The Pacific Infrastructure Challenge, 2006.
	Pacific Regional Strategy FY2006–2009, May 2005.

The FSM joined the World Bank Group in June 1993. In 1995, the FSM received a grant of about $140,000 through the Institutional Development Fund to help improve the capacity for coordinating fisheries development policies across the four states and to improve the performance of fisheries parastatals, including through privatization. In 2002, the economic importance of fisheries to Pacific Islands was estimated and presented in a study jointly with the AsDB, the Forum Fisheries Agency, and the Secretariat of the Pacific Community.

Several regionally focused reports which cover the FSM have recently been published. In particular, the policy note, "*Not If, But When: Adapting to Natural Hazards in the Pacific Islands Region*" reviewed the disaster trends and lessons learned from pilot risk management of natural hazards initiatives, and recommends a strategy for risk mitigation.

More recently, the report, "*At Home and Away: Expanding Job Opportunities for Pacific Islanders through Labour Mobility*," studies in detail the development potential of labour movement schemes for the Pacific Islands and advocates greater mobility for Pacific unskilled workers to help overcome the challenges the region faces because of small economies, remoteness, growing youth populations and low jobs growth.

The *Doing Business 2007* is the fourth in a series of annual reports investigating the regulations that enhance business activity and those that constrain it. The report presents the ranking of FSM on key indicators that can be compared across 175 economies and over time.

FSM is an IBRD-eligible country.

ANNEX VI. MICRONESIA—STATISTICAL ISSUES

Limited domestic capacity to produce economic data hampers surveillance and policy analysis. Nevertheless, there have been a number of improvements in data compilation, reflecting substantial assistance provided by the AsDB- financed Economic Management Policy Advisory Team (EMPAT) and PFTAC. For example, the Statistics Unit (Division of Economic Planning and Statistics, Department of Economic Affairs) is responsible for the compilation of national statistics, and the first *Statistical Yearbook* was published in July 1999. However, major weaknesses remain, particularly in the area of national accounts. Furthermore, the EMPAT office is now closed, and the authorities are attempting to enhance local capacity to produce statistics. Funding remains a problem, as agencies lack the money to tabulate survey results (including the 2004 Household Income and Expenditure Survey).

Real Sector

Recent GDP estimates are calculated from tax and social security data; however, no unemployment or aggregate production indicators are available. The authorities have published a quarterly consumer price index for the nation as a whole and each state.

Government Finance

The national and the state governments and public sector enterprises publish annual audit reports detailing their fiscal operations; and consultants have put these data in GFS format. However, publication lags exist. Further improvements in the quality of the fiscal data are dependent on greater cooperation between the national and state governments. No data are reported to STA for publication in the *IFS* or the *GFSY*.

Monetary Accounts

An IFS country page was established in 2000. The Banking Commissioner reports updated data to STA on a monthly basis The data comprise interest rates, the accounts of the monetary authorities, commercial banks and the FSM Development Bank. However, the Commissioner has taken the view that a new banking law prevents the sharing of this information with the rest of the Government, hampering domestic surveillance.

Balance of Payments

The Statistics Unit publishes annual estimates of the balance of payments and external debt statistics. Questions remain regarding the accuracy of the trade data; for example, the authorities do not track the export of goods from ports. In addition, data on workers' remittances are inadequate, as current estimates are extrapolated from a 1998 survey.

MICRONESIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

AS OF DECEMBER 1, 2006

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	Nov. 2006	Nov. 2006	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Sep. 2006	Dec. 2006	M	M	M
Reserve/Base Money	Sep. 2006	Dec. 2006	M	M	NA
Broad Money	Sep. 2006	Dec. 2006	M	M	NA
Central Bank Balance Sheet	Sep. 2006	Dec. 2006	M	M	NA
Consolidated Balance Sheet of the Banking System	Sep. 2006	Dec. 2006			
Interest Rates[2]	Sep. 2006	Dec. 2006	M	M	M
Consumer Price Index	Mar. 2006	Aug. 2006	Q	Q	I
Revenue, Expenditure, Balance/Composition of Financing[3] General Government[4] and Central Government	FY2005	July 2006	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	N/A	N/A	N/A	N/A	N/A
External Current Account Balance	Sep. 2005	July 2006	A	A	I
Exports and Imports of Goods and Services	Sep. 2005	July 2006	A	A	I
GDP/GNP	Sep. 2005	Aug. 2006	A	A	I
Gross External Debt	Sep. 2005	July 2006	A	A	I

1 Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
2 Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
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 and maturity composition.
6 Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA)

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IMF Executive Board Concludes 2006 Article IV Consultation with the Federated States of Micronesia

On February, 28 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Federated States of Micronesia.[1]

Background

The Federated States of Micronesia (FSM) has relied heavily on U.S. grants under the Compact of Free Association since gaining independence in 1986. Sharp reductions in Compact-related capital spending, higher oil prices, and the closure of textile mills in Yap have weighed on economic activity. Real GDP grew by only 1½ percent in FY2005 and declined by nearly 1 percent in FY2006. Employment rose slightly, as government hiring largely offset job losses in the private sector. Despite higher oil prices, inflation remains low.

The current account deficit remained wide at 13 percent of GDP, with aid covering half of the import bill, down from two-thirds a decade ago. Goods exports are around 10 percent lower than the average for the decade, due mainly to the loss of textile trade preferences. With the U.S. dollar the official currency, the real effective exchange rate remains depreciated relative to other Pacific island currencies since 2000.

The underlying fiscal situation has deteriorated, despite a decline in the overall deficit. The general government deficit is estimated to have fallen to 1½ percent of GDP in FY2006, from 5½ percent of GDP the previous year, largely due to a sharp fall in capital spending. Although the national government ran a slight surplus, the four states ran deficits with Pohnpei drawing down its cash reserves while Chuuk and Kosrae incurred arrears.

[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. 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.

Executive Board Assessment

Executive Directors noted that since the last Article IV consultation, economic growth in the Federated States of Micronesia has been weak, partly reflecting delays in Compact aid disbursement. While Directors expected economic activity to pick up with the release of these funds, they stressed that fiscal consolidation and private sector development will be essential to sustain economic growth in the medium term as Compact aid declines.

Directors expressed concern that continued budget deficits have raised the size of the adjustment that will be needed to achieve fiscal sustainability when the Compact expires in 2023. They urged the authorities to begin targeting surpluses that would help generate sufficient income to offset the loss of Compact grants and serve as a cushion against unforeseen shocks. Directors underscored that, to ensure this outcome, fiscal policy at the state level will need to be tightened, coordinated, and harmonized with that at the national level.

Directors recommended that spending cuts and comprehensive tax reforms be phased in to secure fiscal sustainability. Priority should be given to reducing the public sector wage bill, which is large by regional standards, possibly in the context of a broad reform of the public sector. This would help to preserve essential spending on health care, infrastructure, and education. Directors attached high priority to the early introduction of the planned value added tax, and to measures to broaden the tax base and to strengthen tax administration. They welcomed the measures to address the projected social security administration shortfalls.

Directors highlighted the importance of the Trust Fund as a source of revenue after Compact grants expire, and urged the authorities to strengthen the Fund's operations and boost its returns by improving its governance and transparency. At the same time, they stressed that the Trust Fund is not designed to provide resources similar to the current levels of grant support or to supplant other revenue sources, but to assist in the transition to a more self-sufficient economy.

Directors underscored the urgency of improving the business environment to increase the size and efficiency of the private sector. They encouraged the authorities to vigorously implement reforms to ease the high cost of doing business in order to spur private investment. These should include steps to privatize public enterprises and close unprofitable ones, improve the enforcement of contracts, facilitate land use, and ease restrictions on foreign investment.

Directors encouraged the authorities to step up the pace of financial sector reform to support private sector development. In this regard, they welcomed the new secured transaction law, which will help to expand lending. Other important measures would be to privatize the Bank of the Federated States of Micronesia and to place the Development Bank under the supervision of the Banking Board. Directors commended the authorities for taking steps to combat money laundering and terrorism financing.

Directors emphasized the need to build institutional capacity with technical assistance from the IMF and the Pacific Financial Technical Assistance Centre. In particular, they encouraged the authorities to improve the quality and timeliness of economic statistics, especially the national and fiscal accounts.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Federated States of Micronesia: Selected Economic Indicators, FY2002–2006 1/

	FY2002	FY2003	FY2004	FY2005	FY2006
Real sector (average annual percent change)					
Real GDP	1.4	3.3	-4.4	1.5	-0.7
Consumer prices	-0.1	-0.2	1.8	4.1	3.9
Employment	0.7	-1.6	-1.0	0.3	0.6
Public (inc. public enterprises)	4.6	-2.6	-2.9	2.5	2.9
Private	-4.1	0.1	1.4	-2.0	-1.9
Nominal wages	3.2	0.9	-0.4	1.1	2.2
Public-private wage ratio	1.9	1.9	2.0	2.0	2.0
Consolidated government finance (in percent of GDP)					
Revenue and grants	71.7	68.6	59.4	56.6	53.1
Revenue	21.0	19.1	24.0	20.9	19.8
Grants	50.6	49.5	35.4	35.7	33.4
Expenditure	63.9	67.9	65.6	62.0	54.7
Current	53.5	55.7	53.6	56.3	51.4
Capital	10.4	12.2	12.0	5.7	3.3
Overall balance	7.7	0.7	-6.2	-5.4	-1.6
Usable financial assets 2/	-2.5	-3.5	-1.3	2.5	1.6
excluding Yap and Pohnpei	-9.9	-11.4	-11.0	-11.4	-11.7
Compact Trust Fund (millions of U.S. dollars, end-period)			0.0	62.4	84.3
Commercial banks (in millions of U.S. dollars; end of period, through June 2006)					
Foreign assets	87.2	110.0	105.2	99.2	104.8
Loans	39.1	23.7	21.3	25.7	29.0
Total deposits	112.0	119.8	115.4	111.4	117.7
Interest rates (in percent, average for FY)					
Consumer loans	15.3	15.1	15.1	16.4	19.2
Commercial loans	6.2	6.9	6.9	7.8	10.4
Balance of payments (in millions of U.S. dollars)					
Trade balance	-84.6	-91.8	-119.3	-121.2	-111.7
Net services and income	-25.3	-24.1	-21.0	-21.4	-22.1
Private and official transfers	104.2	118.1	99.6	106.2	102.7
Current account including official transfers	-5.7	2.2	-40.7	-36.4	-31.1
(in percent of GDP)	-2.5	0.9	-18.1	-15.3	-12.7
Current account excluding official transfers	-107.6	-113.6	-137.8	-139.3	-128.5
(in percent of GDP)	-48.1	-49.3	-61.4	-58.8	-52.5
Overall balance 3/	32.1	18.3	-55.5	-20.8	-14.1
(in percent of GDP)	14.3	7.9	-24.7	-8.8	-5.8
Gross reserves (in months of imports)	4.7	6.3	3.5	3.1	3.0
External debt (in millions of U.S. dollars; end of period) 4/					
Stock	57.9	59.2	59.4	59.9	60.4
(in percent of GDP)	25.9	25.7	26.5	25.3	24.7
Debt service	2.4	2.4	2.6	2.5	2.5
(in pct. of exports of goods and services)	5.2	5.2	7.2	6.5	6.2
Exchange rate regime	U.S. dollar is the official currency				

Sources: Data provided by the Federated States of Micronesia authorities and IMF staff estimates.
1/ Fiscal year ending September 30.
2/ Cash and other liquid investments not reserved for specific uses.
3/ Includes changes in reserves, valuation changes and errors and omissions.
4/ Government and public enterprise debt only.