DEBT SUSTAINABILTY ANALYSIS

1. **Pre-COVID-19 economic outlook.** The Federated States of Micronesia (FSM) had a solid pre-coronavirus disease (COVID-19) record of sound fiscal management, with annual fiscal surpluses achieved since FY2009, except for a small deficit incurred in FY2011. With higher revenues—mainly from fishing license fees and corporate income tax from offshore companies—and restraint on recurrent expenditure, including on the public sector wage bill, annual fiscal surpluses rose sharply in FY2014–FY2018, averaging the equivalent of 13.5% of gross domestic product (GDP). These fiscal surpluses were used mainly to build up the FSM Trust Fund, which increased almost tenfold from $22 million in FY2014 to $214 million by FY2018.[1] Further, FSM's debt management has also been prudent.

2. Economic growth during FY2015–FY2019, averaged around 1.9%, with growth supported by public sector investment in construction activity in FY2019. However, with the inception of COVID-19 and subsequent containment measures, domestic services and other business activities have contracted sharply. ADB's projections show that the average economic growth during FY2020–FY2021 is now expected to contract by 3.6%, and growth is expected to gradually recover only in FY2022. Reduced domestic activities combined with lower than expected remittances inflows and decline in tourism receipts carries adverse implications both for internal and external balances. As a result, fiscal position is expected to deteriorate while current account surplus is projected to narrow significantly. It is now anticipated that prolonged containment measures and uncertainties about the intensity and duration of the COVID-19 outbreak has the potential to further reduce the domestic and external demand.

3. **Declining debt–GDP ratio.** The ratio of external debt-to-GDP of FSM has declined from 28.1% in FY2014 to 20.2% in FY2019. In nominal terms, total external debt fell to $71.1 million in FY2019 from $89.7 million in FY2014. This was mainly due to continuous principal repayments and no new borrowing since FY2009. Total debt service averaged $7.1 million annually from FY2014 to FY2019, around 6.8% of exports of goods and services. Around 40% of the total debt were taken by state-owned enterprises, while the rest were by the national government. The debt is mostly concessional with about 70% from ADB and 27% from the United States Department of Agriculture.

4. **Pre–COVID19 debt sustainability analysis.** The International Monetary Fund (IMF) assessed the FSM to be at high risk of external and overall debt distress in 2019, prior to the COVID-19 pandemic.[2] This is mainly due to the possibility of a reduction in revenues in FY2024 unless economic provisions of the Compact Agreement are renewed. Compact grants (which amount to around 20% of GDP) are projected to be replaced by investment returns from the Compact Trust Fund which are expected to be around 11% of GDP, a substantial reduction in revenues. Under the baseline scenario, the IMF projects that post-FY2023 fiscal deficits would push debt on an upward trajectory, with the external debt-to-GDP ratio rising to 57% in FY2039 from 12% in FY2023. The debt sustainability analysis suggests that thresholds on the present value of external debt-to-GDP and public debt-to-GDP will be breached within a 20-year horizon, which is more appropriate for the FSM because the standard 10-year horizon would mask the consequence of the potential FY2024 fiscal cliff on debt dynamics. Similarly, stress tests also

[1] Graduate School USA Pacific Island Training Initiative. 2019. Federated States of Micronesia FY2018 Statistical Appendices.

[2] IMF. 2019. *Federated States of Micronesia: 2019 Article IV Consultation-Press Release; Staff Report; Staff Statement; and Statement by the Executive Director for the Federated States of Micronesia.* Country Report No. 19/288. Washington, DC.

confirmed vulnerability of FSM's external and public debt paths to fiscal and external shocks and underscores the importance of fiscal adjustment and improving capacity for debt payment.

5. **Post–COVID19 IMF debt sustainability analysis.** Since the IMF's 2019 analysis, the growth forecasts for FY2020 has been revised substantially downward in the aftermath of the COVID-19 pandemic. In an assessment letter provided to ADB, the IMF projects FSM's economy to contract by 3.8% in FY2020 with a gradual recovery backed by 1.1% expansion in FY2021.[3] The pandemic is also expected to weaken the fiscal position of the government. The projected fiscal surplus at 6.7% of GDP in FY2020 stated in the 2019 Article IV Report was revised to a deficit equivalent to 1.5% of GDP. Likewise, the projected surplus in the Article IV at 6.4% of GDP in FY2021 was revised downward to 5.2% in the assessment letter. Although fiscal balance is expected to return to a surplus from FY2021 onward due mainly to availability of foreign grants and fishing license fees, however, with the expiry of US Compact grants after FY2023, the fiscal position is expected to deteriorate.

6. With GDP contracting in FY2020, the public debt-to-GDP ratio is expected to rise moderately. Although FSM's public debt remain sustainable, the overall risk of debt distress is still high. It noted that while the debt is expected to be financed by non-debt creating flows (such as grants), the risk of a fiscal cliff after FY2023 remain. More specifically, under the baseline scenario without adjustment and deteriorating fiscal position, the public debt-to-GDP ratio is expected to rise from FY 2024 onward and reaching to around 45% in FY2029 and 70% in FY2039.

7. **Public financial management.** The latest IMF assessment point to lingering weaknesses in public financial management, including inadequate procurement procedures and deficiencies in screening of capital projects. In response, the FSM Public Financial Management Roadmap 2017–2020 prioritizes: (i) implementation of a new financial management information system (currently supported by a World Bank project); (ii) review and update of the FSM's financial management regulations; (iii) improving reporting standards, including through a new Department of Finance and Administration website; and (iv) sustaining capacity development efforts, particularly in accounting, auditing, and financial management.[4]

8. Although the IMF rates the country's risk of debt distress as "high", it is important to reiterate here that risks stem primarily from fiscal pressures attributable to the impending expiration of the economic provisions of the Compact in the medium-term, as well as the potential impacts of disasters over the longer-term, and not from any unsustainable borrowing practices. The COVID-19 crisis is projected to result in large financing needs in FY2020 and FY2021. However, as the government has no plans of borrowing and is instead seeking grant assistance from the country's development partners to fill near-term financing needs, the public debt-to-GDP ratio is seen to maintain its steady decline.

9. **ADB assessment.** ADB's own assessment confirms that FSM will remain at high risk of external debt distress, but that debt will be sustainable over the long term. Although economic contraction is expected to be more severe than IMF's assessment post-COVID-19 (–5.4% in FY2020 and –1.8% in FY2021), the revenue shortfall is expected to be covered by grants from development partners and realignment of domestic revenues and expenditures. Prior to the fiscal cliff, nominal debt is expected to decline to 10.9% of GDP in FY2024. Grant assistance through the proposed HEALS program will help the FSM forego higher-cost (even if concessional) borrowing and will help in maintaining debt sustainability. To illustrate, if the FSM must resort to

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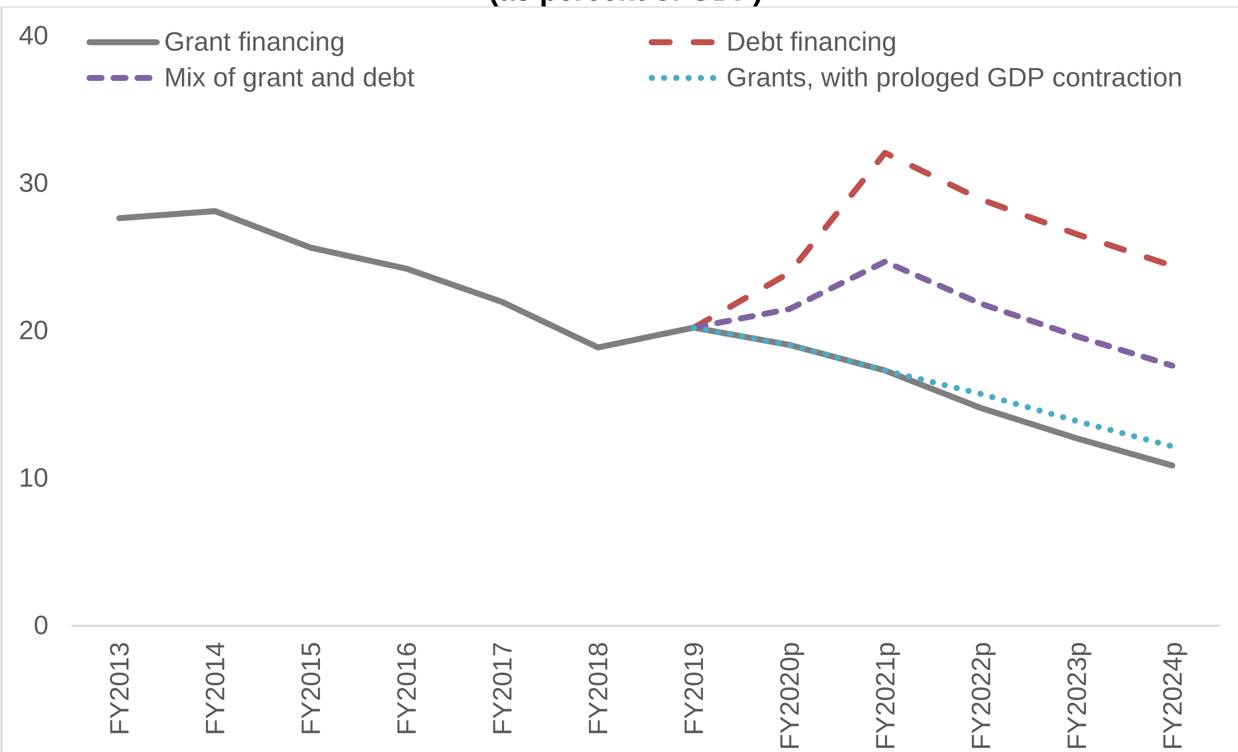
[3] IMF. 2020. *Federated States of Micronesia: Assessment letter for the Asian Development Bank*.
[4] FSM. 2017. Federated States of Micronesia. Public Financial Management Roadmap 2017–2020.

borrowing to fill near-term financing needs due to the COVID-19 crisis, the public debt-to-GDP ratio can rise to up to 32.0% by end-FY2021 until it gradually declines to 24.4% by FY2024. However, if the FSM can continue to rely on grant financing, the public debt-to-GDP trajectory will remain on a downward path, reaching as low as 10.9% by FY2024 (Figure).

Nominal Public and Publicly Guaranteed External Debt (as percent of GDP)



FY = fiscal year, GDP = gross domestic product, p = projections.
Source: Asian Development Bank estimates.

10. Additionally, the analysis has also considered the possibility of prolonged economic recovery and if the financing gap is financed through a mix of grants and debt. Both these alternate scenarios suggest that the debt-to-GDP ratio will remain lower than the ‘debt financing’ scenario while higher than ‘grant financing’ scenario. The analysis, therefore, corroborates that the projected debt-to-GDP ratio will remain under tolerable limits and sustainable in the medium to long-run. However, the analysis based on the figure above also points out that with prolonged measures, the debt-to-GDP ratio may elevate further. Hence, longer containment policies and further decline in domestic and external demand can potentially destabilize the macroeconomic stability and underscores the need to improve fiscal buffers.