Federated States of Micronesia—Assessment Letter for the Asian Development Bank

June 25, 2020

This note provides the IMF staff's assessment of the Federated States of Micronesia (FSM)'s macroeconomic conditions, prospects, and policies, based on available information as of June 22, 2020. The assessment has been requested in relation to the COVID-19 Pandemic Response Option program to the FSM to be considered by the Asian Development Bank in July 2020.

I. RECENT DEVELOPMENTS, OUTLOOK AND RISKS

1. **The FSM economy had performed well in recent years but the COVID-19 pandemic and related containment policies are putting strains on the economy.** Growth picked up to 1.2 percent in FY2019 (October 1, 2018-September 30, 2019), owing to a strong rebound of construction activity particularly public infrastructure investment. At the onset of the COVID-19 pandemic, the authorities preemptively declared a public health emergency in late January 2020 and later extended it through end-July 2020. The national and state governments have enacted strong containment measures to limit the risk of a local outbreak, including travel bans on all international flights and entry of non-citizens, strict mandatory quarantine for all returning passengers, and school closures. The FSM has no confirmed COVID-19 cases as of June 22, 2020. Nevertheless, domestic services activity including trade, restaurant and hotel services, transportation, real estate, and other business activities have contracted sharply. Planned large investment projects have been delayed, caused by restrictions on the movement of personnel and materials.

2. **The near-term growth outlook has significantly deteriorated.** Real GDP is expected to contract by 3.8 percent in FY2020, reflecting the negative impact of domestic containment measures, falling remittances, and to a lesser extent a contraction in tourism. Growth is expected to gradually recover in FY2021 as the pandemic subsides and economic activity resumes.

3. **The impact of COVID-19 crisis on the balance of payments is expected to be relatively muted.** The FSM's external position in 2019 is assessed to remain broadly consistent with the level implied by fundamentals and desirable policies. The current account surplus is projected to narrow significantly to 2.4 percent of GDP in FY2020, although the contraction of current account surplus is broadly in line with the pre-COVID projections. While corporate tax payments from foreign companies domiciled in the FSM, tourism receipts, and remittances are expected to decline, these shortfalls will be mitigated by falling oil prices, declining imports due to domestic demand contraction, and expected support from bilateral and multilateral partners.

4. **Risks are skewed to the downside.** Longer containment and uncertainties about the intensity and the duration of the COVID-19 outbreak could have a stronger-than-expected impact on both domestic and external demand. Extended travel restrictions could further delay the planned infrastructure projects. Activity would suffer even more if the FSM experiences a domestic COVID-19 outbreak. Heightened volatility in global financial markets may weigh down the expected return on

investment of foreign financial assets held by the Compact Trust Fund and the FSM Trust Fund, hindering the buildup of these funds and putting pressures on fiscal resources over the medium term. Looking further ahead, the substantial uncertainty surrounding the post-2023 relationship with the United States, including the FSM's capacity to cope with the fiscal cliff, disaster rehabilitation, and financial sector supervision, could discourage private investment and cause emigration, dampening growth. Given the country's geographic dispersion and isolation, weather-related natural disasters remain a major downside risk to the economy.

II. POLICY RESPONSE AND SETTINGS

5. The government has taken strong actions to counter the effects of the pandemic. To address the health emergency, the national government has prepared a US$20 million (about 5 percent of GDP) COVID-19 Response Framework, in order to develop quarantine and isolation facilities across the nation, provide mandatory infection control training for all first responders, and increase testing capacity and ventilators for each island state in the FSM. In addition, the government approved an economic stimulus package of US$15 million (about 3.8 percent of GDP). The package includes wage subsidies, interest payments relief for affected businesses, as well as social security and tax rebates to help cushion the impact on economic activity and protect jobs.

6. The pandemic is expected to weaken the fiscal position in the near term. The fiscal balance is projected to turn into a deficit in FY2020, amid the one-off increase in health and stimulus expenditures, and declining revenues. The deficit will be financed by temporarily diverting funding from the fishing access fees and revenue from foreign companies domiciled in the FSM that would have otherwise been added to the FSM Trust Fund, as well as additional grants from development partners. The fiscal balance is expected to return to a surplus from FY2021 onward, as foreign grants and fishing license fees remain abundant. Nevertheless, under the current arrangement, the FSM will face a fiscal cliff after FY2023 when the annual U.S. Compact grants amounting to 20 percent of GDP are set to expire.

7. Preliminary analysis suggests that the FSM's public debt is sustainable, but the overall risk of debt distress remains high. As the widening fiscal deficit in 2020 is expected to be financed by non-debt creating flows, the public debt-to-GDP ratio would rise only moderately with the deteriorating near-term growth outlook. However, under the baseline scenario without adjustment, the fiscal cliff would put the public debt-to-GDP ratio on an upward trajectory starting in FY2024, reaching about 45 percent in FY2029 and 70 percent in FY2039. As a result, the debt sustainability thresholds on the present value of external debt-to-GDP and public debt-to-GDP ratios are projected to be breached within a 20-year horizon.

8. A comprehensive approach to medium-term fiscal policy that copes with the expected fiscal cliff and safeguards debt sustainability is warranted. Given the uncertainty surrounding the evolution of the COVID-19 pandemic, health and other spending needs could further rise. Contingency measures to accommodate such additional spending could be prepared in advance, including possible reallocations of non-essential to crisis spending and plans to secure additional concessional financing. Once the fallout from the pandemic fades, significant fiscal adjustment would need to be phased in to address the fiscal cliff and stabilize the debt at a tolerable level. Growth-friendly tax measures—including introducing a broad-based VAT, selected excises, and tightening eligibility on concessional fishing license fees for the domestic fishing industry—and tax administration reforms, as well as rationalization of the public wage bill and non-essential expenditures would help achieve the necessary adjustment, while protecting spending on education, healthcare, and infrastructure. Public financial management (PFM) reforms are critical to underpin fiscal adjustment, including through upgrading PFM regulations and the information technology system. Continuing prudent policy to save revenue windfalls will enable a further buildup of the FSM Trust Fund, strengthening fiscal buffers. Given that the vulnerability to climate change and weather-related natural disasters constitutes a major risk, the FSM's resilience to climate change can be strengthened by speeding up adaptation and developing a disaster resilience strategy.

9. Banking sector supervision should be strengthened. While the FSM's banking system remains sound and is largely regulated by the United States' Federal Deposit Insurance Corporation, the economic fallout of the pandemic will affect borrowers' capacity to service loans and weigh on banks' earnings. The FSM Banking Board should enhance monitoring of commercial banks and upgrade the legal and regulatory framework for prudential supervision. Financial sector reforms should continue, including the development of a reform roadmap with actions needed to maintain financial sector stability and increasing capacity to respond effectively to risks to the financial system.

10. Comprehensive structural reforms would help shore up the FSM's medium-term economic prospects. Private sector development has been constrained by the FSM's remoteness, small size, and geographical dispersion. Improving the business and investment climate would therefore be crucial for private sector development and stronger governance. Reform priorities include lowering business startup costs, reducing time for settling disputes, digitalizing the land registry, and reducing undue regulatory burdens on foreign direct investment.

III. IMF RELATIONS

11. The 2019 Article IV consultation with the FSM was concluded by the IMF's Executive Board on September 6, 2019. The FSM is on a 24-month Article IV consultation cycle. The Fund provides technical assistance and training from headquarters, the Pacific Financial Technical Assistance Center (PFTAC), and the Singapore Training Institute.

Federated States of Micronesia: Selected Economic Indicators, FY2015-25 1/

Nominal GDP (FY2018): US$402 million
Population (FY2018): 102,321
GDP per capita (FY2018): US$3,928
IMF Quota: SDR 5.1 million

	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025
				Est.	Projections						
Real sector (annual percent change)											
Real GDP	4.6	0.9	2.7	0.2	1.2	-3.8	1.1	0.6	0.6	0.6	0.6
Consumer prices	-0.2	-0.6	0.1	1.5	1.9	-2.2	1.2	2.0	2.0	2.0	2.0
Employment	0.0	2.0	2.0	0.0	0.6	-3.2	0.5	0.0	0.0	0.0	0.0
Public (incl. public enterprises)	-1.1	1.0	1.0	...	...	...	...	...	...	...	...
Private	0.9	2.2	2.1	...	...	...	...	...	...	...	...
Nominal wages	1.7	-0.8	3.2	...	...	...	...	...	...	...	...
Public average wage/private average wage	2.5	2.5	2.4	...	...	...	...	...	...	...	...
Consolidated government finance (in percent of GDP)											
Revenue and grants	66.0	68.9	78.2	89.3	80.2	70.0	68.8	65.8	64.8	55.2	54.9
Revenue	36.9	35.8	41.3	53.9	44.5	30.8	32.7	32.7	32.2	43.1	42.8
Tax revenue	12.3	12.9	17.5	31.9	23.0	8.2	10.5	11.0	11.0	11.0	11.0
of which: corporate income tax	1.3	1.8	6.2	21.0	13.1	0.7	0.9	1.4	1.4	1.4	1.4
Non-tax revenue	24.6	23.0	23.9	22.0	21.5	22.6	22.2	21.7	21.3	32.2	31.9
of which: Fishing license fees	20.6	19.1	19.8	18.0	17.4	18.5	18.1	17.7	17.2	16.8	16.8
Grants 2/	29.1	33.1	36.9	35.4	35.7	39.3	36.1	33.1	32.6	12.0	12.0
Expenditure	55.7	61.7	64.0	64.4	63.8	71.5	63.6	61.1	60.1	60.0	60.0
Expense	48.5	49.2	47.8	47.8	46.3	53.8	46.6	46.6	45.6	46.1	46.1
Net acquisition of nonfinancial assets	7.2	12.5	16.2	16.5	17.5	17.7	17.0	14.6	14.5	13.9	13.9
Net lending/borrowing	10.3	7.3	14.2	25.0	16.4	-1.4	5.2	4.7	4.7	-4.8	-5.1
Net lending/borrowing (excl. grants)	-18.8	-25.8	-22.6	-10.4	-19.3	-40.7	-30.9	-28.5	-27.9	-16.9	-17.2
Balance of trust funds 3/	144.8	165.1	185.4	208.0	226.6	265.3	284.7	303.9	323.6	319.8	307.3
Commercial banks (in percentage of GDP; end of period)											
Loans	13.1	14.7	12.8	13.0	13.2	12.7	13.1	13.3	13.5	13.7	13.9
Deposits	79.9	77.7	87.2	87.3	87.4	86.9	87.2	87.3	87.4	87.5	87.6
Interest rates (in percent, average for FY)											
Consumer loans	15.7	15.7	15.7	...	...	...	...	...	...	...	...
Commercial loans	6.8	7.8	7.6	...	...	...	...	...	...	...	...
Balance of payments (in millions of U.S. dollars)											
Trade balance	-127.9	-110.3	-120.2	-128.5	-126.1	-109.4	-118.4	-119.7	-119.6	-128.0	-131.3
Net services and income	25.3	14.4	19.3	18.6	-1.2	-11.6	2.5	0.2	-0.7	47.8	48.8
Private and official transfers	116.7	119.6	138.5	194.5	193.4	130.4	133.8	140.8	143.0	61.7	63.6
Current account	14.1	23.8	37.7	84.6	66.1	9.4	17.9	21.3	22.6	-18.5	-18.9
(in percent of GDP)	4.5	7.2	10.3	21.0	16.0	2.4	4.5	5.2	5.4	-4.3	-4.3
External debt (in millions of U.S. dollars; end of period)											
Outstanding stock	81.1	80.4	80.4	75.4	70.4	65.2	61.4	57.5	53.7	70.0	86.6
(in percent of GDP)	25.6	24.2	21.9	18.8	17.0	16.7	15.4	14.1	12.8	16.2	19.6
Memorandum items:											
Exchange rate regime	U.S. dollar is the official currency										
Real effective exchange rate 4/	109.9	114.3	114.1	113.0	...	...	...	...	...	...	...
Nominal GDP (in millions of U.S. dollars)	316.5	332.3	366.7	401.9	414.3	389.9	398.9	409.3	420.0	431.0	442.2

Sources: FSM authorities and IMF staff estimates and calculations.
1/ Fiscal year ends on September 30.
2/ Excludes contributions to the Compact Trust Fund.
3/ Compact Trust Fund and FSM Trust Fund.
4/ Calendar year. 2010=100.