Federated States of Micronesia

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ECONOMIC BRIEF

FSM
FY 2018

Graduate School USA

EconMAP
ECONOMIC MONITORING & ANALYSIS PROGRAM

1. Recent Economic Performance FY2018

Economic Performance

Economic growth in the FSM has displayed significant volatility during the amended Compact. After experiencing strong growth in FY2015 of 4.6 percent, economic growth weakened in FY2016 recording 0.9 percent, improved in FY2017 to 2.7 percent, and has slipped during the last period to just 0.4 percent. The component of FSM GDP resulting from domestic purse seine fishing operations adds considerably to the volatility of year-to-year growth rates. Excluding those domestic purse seine fishing operations, and despite continuing issues with the use of the Compact infrastructure grant, the FSM's domestic economy grew by a respectable 2.3 percent in FY2015, 2.7 percent in FY2016 and 3.5 percent in FY2017, but weakened in FY2018 with modest growth of 0.8 percent.

During the first six years of the amended Compact, economic performance was weak in the FSM due to difficulties adjusting to the new Compact terms. However, the following four years saw improvement, in large part resulting from the strong demand for infrastructure. The poor results in the following period (FY2012-FY2014), reflect management issues with the use of the Compact infrastructure grant. With agreement on construction management and procurement procedures settled in mid-2017, it was hoped that the large backlog of infrastructure funds remaining under the amended Compact would spur investment spending and would underpin a sustained higher growth trajectory. However, despite a large number of approvals of infrastructure projects by JEMCO, groundbreaking of the new projects has been slow to take place.

Employment

After a period of declining and stagnant employment conditions reflecting the weak economy in FY2011-FY2014, conditions improved in the domestic economy and led to employment growth of 2.0 and 2.0 percent in FY2016 and FY2017, with a reduced rate of 1.2 percent in FY2018. Private sector employment was the driving force, which grew by 7.3 percent over the 3-year period—although jobs in the public sector also improved by 2.5 percent, reflecting growth in the size of the national government public service. Since the start of the amended Compact private sector employment has remained largely flat while public sector employment has declined by 14 percent. FSM governments have downsized to adjust to reductions in the real value of Compact funding. Overall, jobs have fallen by 5 percent since FY2003.

Inflation

With the prior decline in world oil prices coming to a halt and with oil prices rising modestly in FY2018, inflation rose by 1.7 percent. The main contributing factor to inflation continued to be declining food prices, which fell by 1.5 percent offsetting rises in fuel, alcohol, tobacco and other prices.

Wages

Wages have grown modestly in the FSM by 1.4 and 1.9 percent per annum in the private and public sectors, respectively, since FY2003. However, once inflation has been taken into account real wages have fallen in both sectors by 1.7 and 1.1 percent, indicating declining standards of living.

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2. The Financial Sector

Banking

The deposit base in the FSM banking system ($320 million in FY2018) has grown significantly reflecting a sound financial system. However, lending performance to the commercial private sector has been weak and represents only 12 percent of the deposit base, one of the lowest in the region. The resulting surplus liquidity, now over $264 million, is invested offshore in low-yielding assets. The low rate of domestic lending reflects the perceived high risk of lending in the FSM and "lack of bankable projects." Overall, the inability of businesses to prepare credible business plans and financial statements, lack of collateral, the limited ability to use land as security, and inadequate provisions to secure transactions have inhibited development of the financial sector. With limited opportunities, commercial banks have preferred to invest their assets offshore in less risky and more secure markets.

External Debt

The FSM's external debt, at 22 percent of GDP and 16 percent net of offsetting assets (sinking fund), is one of the lowest in the region. Debt service of 4 percent of national government domestic revenues remains well within the capacity of the national government to service and does not present any threat of debt stress. A recent review by the FSM public auditor revealed many weaknesses in the FSM's external debt management. As a result, a debt management bill has been drafted but has yet to be acted upon by the FSM Congress.

While this analysis indicates that the FSM is not at risk of debt stress, the standard World Bank / IMF Debt Sustainability Analysis (DSA) places the FSM in an at-risk category. The DSA analysis assumes that large fiscal shortfalls projected post-FY2023 would be financed through (hypothetical) concessionary external borrowing. However, the FSM does not have access to the assumed persistent borrowing from donors, especially to maintain operational expenditures. While the World Bank / IMF's assumptions may differ from what would transpire if the FSM experiences a severe post FY-2023 fiscal shock, the consequence of the DSA is that the FSM has been accorded "grant only" status for access to resources. Under the current round of World Bank IDA 18 funding, the FSM is thus not eligible for loan finance, but does qualify for up to $25-$30 million of grants annually. In addition, with increased grant allocations from the Asian Development Bank and other major donors, the FSM is currently benefiting from a large increase in external aid compared with historical levels.

Social Security Sustainability

As of January 2017, an actuarial assessment of the FSM Social Security Fund indicated an unfunded liability of $286 million compared with assets of $51 million, a funded ratio of 18 percent similar to the RMI. However, unlike the RMI, the fund is not under imminent threat of collapse. Contributions to the fund in FY2018 were 89 percent of benefit payments. The fund was drawn upon in the amount of $3.0 million to meet payment needs and suffered a market loss of $3.1 million. Thus, the annual $1 million in support from the national government only provided a modest buffer against the $5.5 million decline in value of the SSA fund from $55.2 million at the end of FY2017 to $49.7 million at the end of FY2018.

The investment rate of return on the portfolio was reported in the audit as -6.21 percent; a puzzling result for FY2018 given positive equity returns in virtually all asset classes and an index return of -1.22 percent on the Barclays aggregate fixed income index during FY2018. Long-run projections indicate benefits rising faster than contributions, and further reforms to the system will likely be needed. While the contribution from the national government is welcome, in the long-run the fund should achieve self-sufficiency without the need for government intervention.

FSM Domicile for Japanese Companies

In 2005 the FSM passed corporate tax legislation that enabled the creation of an overseas domicile which has primarily been targeted at Japanese Companies. The law provides for a corporate tax rate of 21 percent, and through differential tax rates, the FSM host environment provides an attractive domicile for Japanese captive insurance companies and other corporations. The benefit of these arrangements has been a steadily growing stream of revenues to the National government now averaging $6 million in recent years from captive insurance companies, and occasional capital gains -elated tax revenues from overseas investment companies. In FY2014 there was an unusually large receipt of $28 million, reflecting a large declaration of capital gains by one company. In FY2017 there was a further large receipt of $23 million by that same parent corporation. In FY2018 there was a receipt of $77 million from a different Japanese organization and in early FY2019 there was a receipt of $50 million. Although large payments can be expected periodically, FY2018 and FY2019 were exceptional.

A particular area of concern has been compliance with the Global Forum on Transparency and Exchange of Information for Tax Purposes. The Global forum is a group of 146 members that are working under guidance of the OECD to create a transparent environment among nations to share information in the tax area; the FSM is not currently a member. As a result of phase 1 first round of peer reviews in 2015 the FSM was deemed non-compliant. In June 2016, there was a front-page article in the Nikkei Shimbum reporting that Panama, Micronesia and Indonesia would be blacklisted by the Global Forum. The implications of being placed in the same group as Panama would have been damaging to the FSM's reputation, and any inclusion on this list could have catastrophic impact the FSM domicile and Captive Insurance Industry.

As a result of Global forum non-compliance, the FSM enhanced its efforts and passed legislation on transparency and exchange of tax information. In 2016 the Global Forum undertook a fast track process and countries were designated either compliant, largely compliant, partially compliant, or non-compliant. Following the review, the FSM was designated as largely compliant, thus alleviating the fears arising from the Nikkei Shimbum article.

A further second-round peer review has also been undertaken and the FSM was rated as largely compliant. Earlier concerns have thus been largely addressed and the FSM has even stated that it intends to join the Global Forum as a member to maintain its good standing into the future.

Additional risks to the industry have resulted from changes in Japanese Corporate law concerning tax haven status. In addition to requiring foreign jurisdictions to have an income tax burden in excess of 20 percent, foreign domiciled companies are required to display substantial business activity rather than paper or cash box type functions. The exact nature of displaying substantial business activity is not yet known, but it will require a physical office and an administrator for each Japanese subsidiary in the FSM.

At present the industry resides in Pohnpei although corporate taxes generated from the FSM domicile are not treated as subject to FSM revenue sharing, and thus only generate direct revenue to the national government. However, should the current arrangements be contested by the state governments, and the issue taken to court, it could lead to a loss of confidence among Japanese companies and a loss of revenue for the FSM. Business performs well in an environment of stability and predictability; forces that jeopardize or undermine the current status quo should be strongly discouraged.

3. Fiscal Performance and Policy

The Fiscal Outturn

The overall fiscal balance recorded a record surplus in FY2018 of $102 million, or 29.3 percent of GDP. This was a significant increase from the large surpluses attained in FY2015 through FY2017 of 10.5, 7.4 and 14.9 percent of GDP, respectively. Revenues during the FY2015-FY2018 period were up in a series of different categories from an additional $80 million in corporate taxes from the offshore FSM domicile for Japanese companies (an exceptional year), an additional $17 million in foreign grants (including initiation of receipts from the World Bank) and an increase of $7 million in fishing fees. While expenditures grew, reflecting the large fiscal space, they did not keep pace with revenues. Major increases in expenditures were on use of goods and services ($27 million), and non-financial assets or infrastructure funded through FSM Congressional district public projects (additional $16 million).

However, the fiscal outturn differed significantly between the FSM national and state governments. The national government ran a surplus of $97.9 million, while the states recorded a surplus of $3.9 million, the largest recorded and only second time for the states to achieve a surplus during the amended Compact period. The FSM state governments, where service delivery occurs, have been constrained by the declining real value of Compact grants, while the national government has benefited from a boom in revenues from fishing fees and the offshore domicile for Japanese corporations.

Tax Reform

In the mid-2000s the FSM embarked on a lengthy process of tax reforms, which after many years of donor support and hard work has not yet led to adoption. With a tax/GDP ratio of 12 percent (ignoring FSM-domicile corporate taxes), FSM revenue effort has been low and presents an opportunity to adjust to future fiscal shocks and to create an efficient tax environment that supports private sector development. Two of the four FSM states (Chuuk and Kosrae) supported the tax reform initiative. Yap State, while expressing no objection to the reforms indicated that the proposal was unconstitutional with respect to Yap's constitution, and thus declined to participate. There was some renewed recent interest from Pohnpei State, where a disproportionate benefit from tax reform would accrue, but this now appears to have waned. While there is clearly little incentive for additional revenue effort at the national government, the need at the state level to achieve greater autonomy over fiscal policy going into to the post amended Compact period is strong.

Structural surplus and contributions to the FSM Trust Fund

The boom in national government revenues derived principally from fishing fees but also large periodic gains from corporate taxes from FSM-domiciled Japanese companies has led to the generation of large fiscal surpluses at the national government. In FY2015 national government domestic revenues were close to $90 million, a level sustained in FY2016, and rose rapidly in FY2017 and in FY2018 to $180 million (reflecting a large cyclical receipt of corporate tax). In FY2015 the national government ran a fiscal surplus of $35 million or 11 percent of GDP which had risen to $98 million or 28 percent of GDP in FY2018.

While revenues have grown rapidly the increase in fiscal space afforded by the increase has also enabled a large increase in expenditures on use of goods and services and Congressional district public projects. From an average of $19 million in FY2009-FY2013, the use of goods and services has risen to $46 million, and outlays on public projects has risen from an average of $3.3 million during the first 9 years of the amended Compact to $24 million in FY2018. Taking these rapid increases into account a measure of the structural fiscal surplus at the national government can be estimated: rising from $5 million or 1.7 percent of GDP in FY2011 to $121 million or 37 percent of GDP by FY2018.

The national government has been allocating a significant part of the fiscal surplus to the FSM Trust Fund (FSMTF), and the corpus stood at $214 million at the end of FY2018. Under a series of public laws and in particular PL18-107 and 20-134, the national government has specified annual commitments to the fund. Under PL18-107 the national government allocated 20 percent of its share of domestic taxes in favor of the states (approximately $6 million). Under PL 20-134 it allocated 50 percent of the earnings of corporate taxes from the captive insurance and large corporations' sector to the FSMTF (approximately $6 million in normal years). It further allocated 20 percent of fishing fee revenue to the fund (approximately $12 million). In total the national government has legislated to contribute on a conservative basis $24 million annually to the FSMTF. That number will rise substantially in years with large receipts from FSM-domiciled companies.

Clearly, the contributions to the FSM Trust Fund to provide a pool of resources for future generations are highly desirable. However, there is considerable scope to increase the level of contribution in normal years to the order of between $40 million (the average structural surplus in FY2015 and FY2016 ignoring corporate taxes) and $60 million (average FY2017-FY2018). Such saving would materially reduce the risks arising from projected fiscal shortfalls for the state governments of the FSM as early as FY2024 and thereafter.

Long-Term Planning

In 2012, the FSM initiated an exercise to plan for transition to the post amended Compact era after FY2023, known as the 2023 Action Plan. The Plan, while focusing on the post-2023 era, also addressed the use of the emerging national government structural fiscal surplus. However, since 2015, the 2023 planning effort and issue of sovereign wealth management has not been active on the policy agenda. While the FSM Congress has acted responsibly in legislating a process of formulaic contributions to the FSMTF, there remains a lack of a cohesive and rational approach to planning and in the allocation of the remainder of the structural surplus, especially the allocation of large periodic windfall gains from the FSM domicile for Japanese companies.

Clearly, there is a need for a rational approach to economic management and allocation of significant sovereign resources. The former 2023 Plan established a useful framework for resource allocation and a renewed focus on private sector development and selective policy reforms. As the FSM embarks with a new administration, the government would be well-advised to revisit the current approach, if not the precise content, to ensure the best use of readily available funds to address the FSM's future needs. Put simply, the FSM's fiscal situation begs for a profound and long-term restructuring of national and state fiscal operations, a task that has been understandably difficult to even discuss—much less achieve—in the presence of post-FY2023 uncertainty.

4. Public Financial Management

Public Expenditure and Financial Accountability (PEFA)

In 2010 the FSM conducted a PEFA self-assessment, a scored system of PFM established by the World Bank. After little action in the subsequent years, a renewed self-assessment was conducted in 2016 with the support of PFTAC, which led to development of a "Road Map". The Road Map provides a list of targets for reform against which progress can be monitored. Progress in this area is a standard condition of eligibility for budgetary support from some donors such as the European Union and the World Bank. Since preparation of the Roadmap, the FSM has focused on a set of key areas, including implementation of a new Financial Management Information System and Financial Management Procedures. To be of value FSM-wide, the PEFA exercise needs be rolled out to each of the FSM States, where most of the public expenditures take place. To this end the EU is providing TA support to develop PEFAs for each of the four governments.

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Financial Management Information Systems (FMIS)

The FMIS in the FSM is nearing the end of its effective life as the responsible software company is ceasing to support a declining user base. With donor grant support from the World Bank, a replacement system is being pursued. A project manager has been hired, and consultants have been selected to guide the FSM through needs assessment, development of an RFP, and selection of suitable software. However, implementation is likely to take place over a period of years. Enhanced reporting and a well-formulated chart of accounts should enable improved information for fiscal management and performance budgeting.

In addition to procuring a new FMIS the FSM requested support from the World Bank to implement a new Revenue Management System to interface with the FMIS. The initial phase of the RMS will be establishment of a tax register of business and issue of Tax Identification Numbers. A project manager has been hired and an IT expert will be recruited shortly. The intention is to issue an RFP by year end and for implementation to follow shortly thereafter and before the FMIS. The new RMS will greatly assist in the provision of statistics for GDP by industry, a topic that is discussed below.

Public Sector Payroll

With public payroll representing a high proportion of GDP, 18 percent in FY2018, careful monitoring of trends is warranted with anticipation of an uncertain level of resources post-FY2023. The proportion of public sector payroll has been slowly declining since the start of the amended Compact from 21 percent of GDP in FY2004. This reflects the substantial reductions in force in Chuuk and Kosrae and recent growth in the economy at a rate greater than the increase in public sector payroll. Since the start of the amended Compact in FY2003 through FY2018 the number of public servants has declined by 6 percent. However, the wage bill increased by 20 percent during this period, reflecting a 1.6 percent annual average increase in nominal wage rates. It is unclear if the FSM (at least at the state level) can sustain this rate of increase in the wage bill without further fiscal adjustment given the relatively stagnant economy and the static nature of nominal Compact sector grants.

5. SOE Performance and Reforms

The Power Sector

The FSM has managed to operate the SOE sector without the need for large subsidies. However, weak pricing policies in the utility area have led to inefficient operations and lack of replacement of capital. While the supply of electricity in Chuuk is now 24 hours with an improved sewer and water treatment system, Pohnpei has suffered from load sharing, while central components of its sewer system need rehabilitation. In Yap, the utility charges the government twice the normal price to maintain a positive cash flow. Moves are underway at Pohnpei Utility Corporation to reform the ailing utilities along the lines of the Chuuk initiative through a jointly financed reform program with World Bank, Asian Development Bank, and U.S. (Compact) funding. Current indications are that the key parties in Pohnpei state are prepared to endorse and fully implement the comprehensive reforms and practices that resulted in success in Chuuk state.

Telecom and ICT Reforms

The World Bank is supporting ICT reform through a series of reforms and grants. The initial phase of the project has been to lay a fiber connection ($47.5 million) to Yap and Chuuk. The reforms have required a new law permitting competition in the ICT market, the establishment of a Telecom Regulatory Authority, and creation of an Open Access Entity (OAE) to own and operate the new fiber asset. All three components have now been operationalized and the TRA has issued draft regulations for comment. The ICT reform process envisages open access to the fiber network to all potential service providers enabling the onset of a competitive market.

While the conditions have now been met, the project has been fraught with issues and resistance to reform. An initial lack of agreement on the terms of access to the existing HANTRU cable (providing access between Pohnpei and Guam) was eventually resolved through the issue of an Indefensible Right of Use, guaranteeing the OAE access to the new cable at no cost. Clearly, the most efficient and effective solution is ownership of all submarine cables by one entity. At present the fiber connections are owned and managed by two separate entities: FSM Telecom and the OAE. The new cable connections to Yap and Chuuk are now operational.

A second World Bank regional project agreed by the Bank's Board is to connect Kiribati, Nauru and Kosrae to the Pohnpei HANTRU spur. A third phase currently under design and known as Digital FSM is designed to enhance internet use in education and health and will provide fiber connectivity to target locations and homes. In all, the FSM will have been the beneficiary of a total of over $100 million for enhanced ICT connectivity. The envisaged connectivity to the home, operationalized by the OAE, coupled with a requirement that FSM Telecom must provide access to third parties to its cell tower network, lays the foundation for new entrants to enter the market. While the ICT law requires that new entrants must provide services to all four states if they wish to operate in Pohnpei or Chuuk, the provision of low-cost infrastructure financed through World Bank grants, should, even in a small market place, provide a commercial environment attractive to foreign investors.

FSM PetroCorp and Coconut Products for Export

The FSM PetroCorp was created in 2007 to take over the operations of the departing supplier, Mobil. The transfer proceeded well and the PetroCorp has achieved an annual return on capital of 10 percent since its commencement and has now opened operations in Guam and Nauru. It is one of the rare cases of a well-run SOE.

However, recent plans to open a coconut processing facility in Tonoas, Chuuk threaten to blemish the good record. While the project has been well designed and researched, investment costs are likely to escalate. Clearly this activity falls under the domain of venture capital and it must be questioned whether high risk projects are an appropriate use of public funds. For an industry that in the Pacific has been in decline for many years, with labor in short supply in similar low wage activities, and a declining raw material supply (due to aging coconut trees), the odds of success are not favorable. While technology has changed in the copra sector with potential for processing the whole product and production of virgin oil, the market is dominated by the Philippines, which provides 70 percent of world supply at low cost.

In the interests of transparency and accountability it is important that information about each PetroCorp project be isolated in the financial accounts as separate cost centers: specifically, to allow for identification of cross-subsidization, and more generally to allow for careful monitoring.

6. Private Sector Development

Fisheries and the Domestic Fleet

After a period in the early 1990s when the FSM invested heavily in the fishing industry, nearly all commercial ventures have either failed or are now under private management. There are two companies with government ownership (partial or full) that operate 8 vessels under private management. There are a further 3 major companies that operate 16 vessels and 3 other vessels individually owned that have been flagged in the FSM. Overall 27 vessels have been flagged by the FSM. Fishing in the region now effectively comes under the Parties to the Nauru Agreement (PNA)--a cartel of 9 Pacific island states including PNG, which has led to a remarkable and sustained increase in member country revenues from the sale of vessel days. The PNA has led to a fivefold increase for the FSM since the start of the amended Compact period. Daily fishing rates average close to $12,000 per vessel day and the FSM received $72 million of revenues or 21 percent of GDP in FY2018.

The "domestic" fishing fleet comes under a regional arrangement amongst Pacific nations known as the FSM arrangement (FSMa), whereby the owners pay a reduced daily rate negotiated between the host nation and the respective operators. The FSMa was established to encourage the development of the local fishing industry. However, it is debatable whether the 27 domestically flagged vessels make substantially greater contributions to the economy than 3rd country fishing vessels operating without a discount.

An on-going study of the fisheries sector by the Graduate School USA suggests the additional benefits to the FSM from domestic vessels compared with bilateral vessels is about $700 per day. This means discounts to domestic vessels should not exceed $700 per day. Defining what is a full price is complicated by transfer fees that the domestic vessels need to pay to other countries when fishing in their territories.

Irrespective of the definition, the FSM has been selling days at a discount greater than the benefits derived from the domestic vessels. At minimum this means the net loss to the FSM economy was $9 million per year or 2.6 percent of GDP due to discounts between FY2015 and FY2018. This is a matter that requires careful evaluation of the benefits of domestic flagging of vessels, where the private owners make substantial gains, perhaps at the expense of the local economy and the national treasury.

The World Bank's "Doing Business" Survey

The World Bank's "Doing Business" survey paints a discouraging view of the environment for private sector growth in the FSM. Out of 190 countries the FSM currently scores 160, 84% down the list indicating much room for improvement. The FSM fares worse than Palau and the RMI, which are ranked 133th and 150th, and the FSM is substantially below most of the South Pacific nations. Samoa is ranked 90th, Tonga 91st, , Vanuatu 94th, Fiji 101th, and Papua New Guinea 108th. Overall, the FSM's scores are generally weak. Registering property, protecting investors, and enforcing contracts all score between 184-187 some of the worst scores of all countries surveyed by the World Bank. Slightly higher up the list the FSM registers its best score with 61 for trading across borders and 90 for obtaining credit.

Foreign Direct Investment

The existing Foreign Direct Investment (FDI) regime in the FSM, established as part of a set of reforms sponsored by the ADB in the late 90s, provides for a two-part system that provides jurisdiction for investments that are of a national character to the national government and all others to the state governments. However, the system is cumbersome and results in a complex licensing process. In 2016 further reforms were introduced in the FSM Congress to modify the 1997 FDI Act bringing all foreign investment under the jurisdiction of the national government. The reforms effectively claim that all foreign investment is, by its very nature, of national character. While the reforms would streamline the FDI process, and should be supported, they have so far failed to pass through Congressional committee review to be considered for enactment. Overcoming reluctance to conceded jurisdiction in an area formerly under state control will take considerable effort.

7. Compact Issues

The FSM Compact Trust Fund

The FSM CTF experienced market gains during FY2018 of 6.8 percent; together with a scheduled contribution from the U.S. of $30.8 million at the outset of the fiscal year, those gains enabled the fund to grow in size by $71.1 million to an end of FY2018 balance of $636 million. During the period of investment since the outset of FY2007, the annualized rate of return has been 6.9 percent. The fund would need to grow at 16.7 percent annually from FY2019-2023 to achieve a level sufficient to provide a smooth transition to CTF distributions from FY2024 onward at the real value of FY2023 sector grants ($81.39 million). Such an unlikely result is all the more concerning as this "simple" sustainability estimate relies upon performance during the distribution period at a 5.0 percent real rate of return and does not allow for market volatility. In the presence of market volatility, the Graduate School USA has modelled outcomes under the CTF distribution rules. The model results for the FSM indicate a high probability of periodic fiscal shocks, including years in which zero dollars are legally available for distribution. Notably, over the period from FY2024-FY2063, fully 89 percent of cases show one or more years of zero distribution.

No distribution rules would simultaneously allow for (i) protecting the real value of the CTF corpus, (ii) ensuring distributions at or near the real value of the FY2023 grants, and (iii) avoiding year-to-year volatility of distributions. However, recent independent studies have shown that technical improvements to the existing rules could provide objectively better results at no extra cost. A key empirical finding is that once market volatility is accounted for, the size of the CTF would need to be approximately 1.67 times larger than estimate using a simple fixed rate of return with no market volatility. For the FSM, achieving this "SAFER" sustainability estimate implies a CTF value at the end of FY2023 of $2.76 billion. The median expected value of the FSM CTF at the end of FY2023 is $1.049 billion.

Making substantial improvements to the terms of the CTF Agreement would require mutual agreement by the original parties, which for the U.S. entails both executive and congressional approval.

Infrastructure and the Economy

Use of the infrastructure grants was slow in implementation at the start of the amended Compact due to capacity constraints to implement the projects. However, by FY2012 implementation issues had been overcome and expenditures exceeded that year's grant allocation of $22 million by $5 million. Improved performance was short-lived, and a series of issues plagued implementation with utilization falling to $7 million in FY2017. Out of a total estimated allocation of $350 million since the start of the amended Compact, the FSM has only been able to use approximately $150 million, leaving approximately $200 million or 58 percent of GDP of unspent resources.

Project management issues, lack of clear priorities, disputes between and national and state governments, the JEMCO requirement to prepare an updated Infrastructure Development Plan (IDP), inability or unwillingness to provide professional engineers and contract management staff to the level required, and a perception within the FSM national government that requirements to proceed apace were either unclear or changing over time resulted in further delays. By 2016 an Infrastructure Development Plan (IDP) was prepared to set priorities, but project management issues remained. After further delays, in June of 2017 a resolution between the U.S. and the FSM was reached to remove the suspension of the grant, while the contractor managing the PMU was terminated and replaced for an interim period by the U.S. Army Corps of Engineers.

The failure to implement the infrastructure grant has been very costly to the FSM in lost opportunities and in growth. GDP shrunk in the three years FY2012-FY2014, with the economy contracting by 8 percent. While much of the loss was due to the decline in the use of infrastructure grant funding, the earlier completion of large FAA airport improvement projects also resulted in a subsequent decline in economic activity. The large reservoir of unspent resources presents an opportunity to re-invigorate the FSM economy in the remaining years of the amended Compact period. However, care should be taken to ensure that resources are spent evenly, perhaps even well into the FSM trust fund period, to prevent the boom and bust cycle that has afflicted the FSM recently.

Post Amended Compact Uncertainties

Annual Compact sector grants, Compact infrastructure grants, and disaster assistance are set to expire in FY2024. The loss of approximately $81.4 million annually is targeted to be replaced through funding provided from distributions from the Compact Trust Fund; however, there is considerable uncertainty over the continuation of many other special and Federal programs and services the FSM receives from the US. In particular, the FSM benefits from the Special Education Grant (SEG), which was cashed out from former Federal programs provided in the original Compact. Funding is provided through annual Congressional appropriations whose continuation post-FY2023 will end under current law. There are many further US Federal programs such Postal Services, FDIC, NOAA, Pell grants, FAA, health programs, etc., which are subject to Congressional authorization.

While the shortfall in fully sustainable distributions from the Compact Trust Fund is estimated to be $50 million after FY2023, the range of possible values in the loss of Federal programs may, in a truly severe case, be a further $33 million or more (the sum in FY2018 of SEG, Federal Programs and Pell grants). Combining the reductions in sustainable drawdowns from the CTF and potential loss of Federal programs and services indicates a truly severe case outcome of a reduction in grants of $83 million or 24 percent of GDP. While such a result is deemed highly unlikely by informed observers in the U.S. government, the scale of U.S. assistance to the FSM in relation to its economy begs for sensitive and sound policy pronouncements. In the remaining years of the amended Compact period through FY2023, clarity is required on the status of these programs and services so that the FSM can effectively plan for the arrival of the Compact Trust Fund distribution period.

8. Other Issues

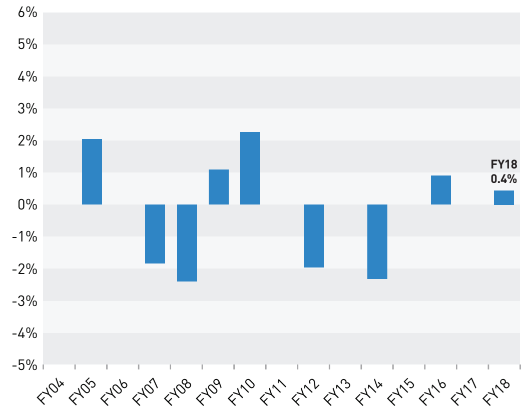
Statistical Issues

In former Gradual School USA reviews of the FSM, statistical availability has been accorded a high score. Since the start of the amended Compact the FSM has developed a full range of statistics on which to monitor economic performance. However, in a 2017 IMF Article IV staff review, the Fund indicated that "data provision has serious shortcomings that significantly hamper surveillance". While the ranking of statistical adequacy in the IMF reviews is not transparent, it appears timing and frequency are the major areas of concern. The FSM set of economic statistics is prepared 11 months after the end of the fiscal year. No quarterly estimates are prepared, which are now becoming standard. Coverage does not seem to be an issue. The annual statistical update in the FSM is timed to coincide with the release of the government audits and in time for the annual JEMCO meeting. More frequent estimates, such as quarterly, would not seem essential in an economy such as the FSM where trends are slow moving. However, availability of provisional estimates earlier in the year to coincide with budget preparation would be a priority.

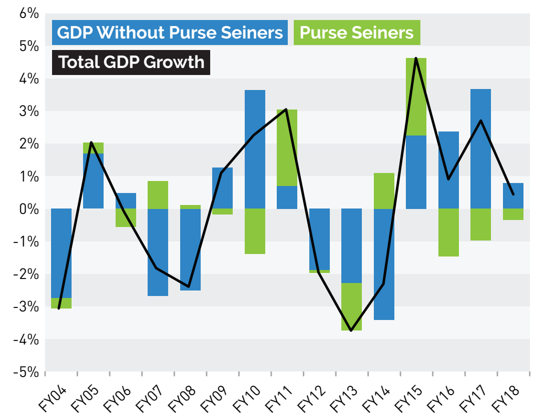
Of more concern has been the recent action by the FSM Department of Finance to cease sharing tax information with the National Statistics Office (NSO) purportedly due to the need for compliance with Global Forum requirements. Given these new constraints on sharing of tax information, key data relating to business gross receipts, which formed the basis of the GDP by industry estimates, has been unavailable to the NSO from FY2016 through FY2018. To address this matter FSM Finance committed to assisting in the provision of data required to maintain the GDP series by way of a new process requiring a complex back and forth flow of information between the respective departments. The suggested new process has not led to a resolution of the issue, and the FSM remains without the ability to adequately compile GDP by industry. The new Revenue Management Model discussed above will provide an enhanced source of information with improved data integrity. Until then, and even thereafter, a basis for exchange of information within the national government needs to be re-established as allowed for in law to meet Global Forum requirements between the FSM and foreign jurisdictions.

> In the remaining years of the amended Compact period, clarity is required on the status of U.S. funded programs and services so that the FSM can effectively plan for the Compact Trust Fund distribution period.

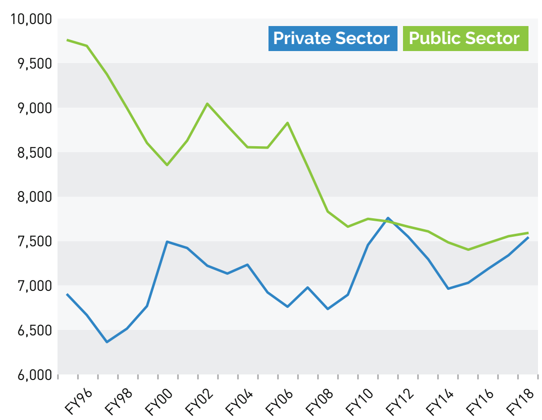
FSM has experienced **volatile GDP growth** during amended Compact



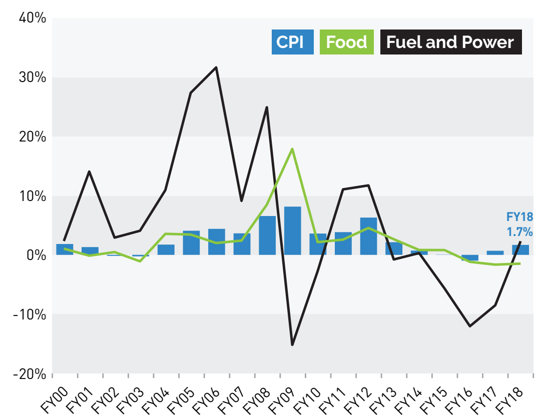
Contribution to GDP of **purse seine fisheries adds** significantly to **volatility** in economic performance



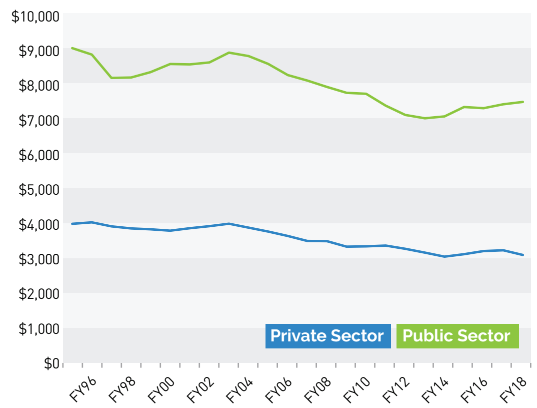
Large decline in **Public Sector Employment**



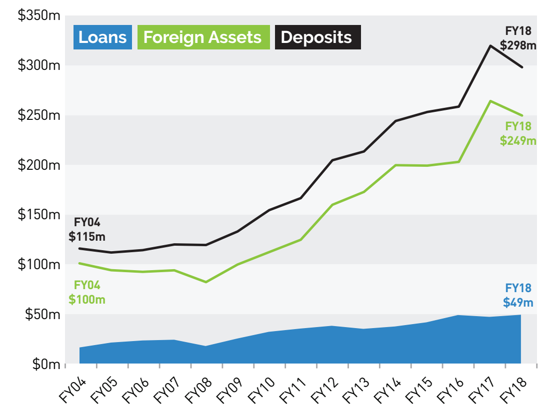
Inflation turned negative in FY15 and FY16, and grew modestly in FY17 and FY18



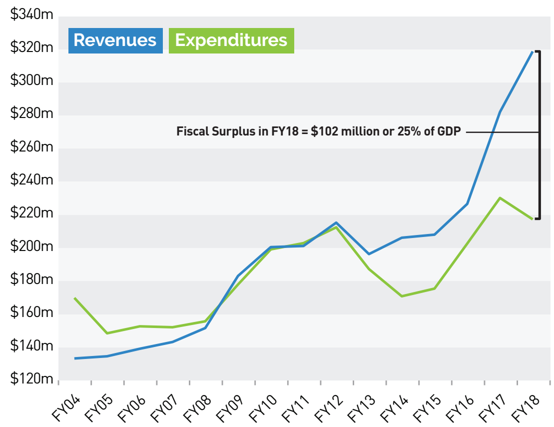
Real Wages decline: public/private sector wage differential remains large



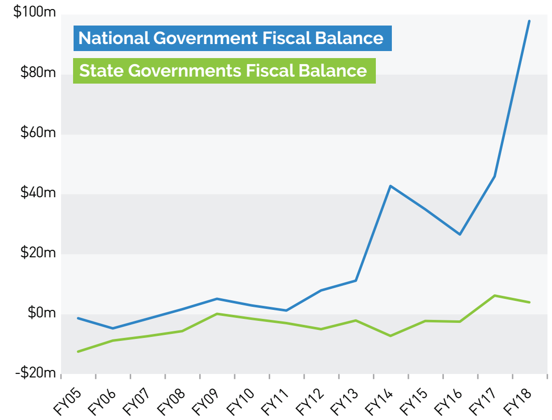
Commercial bank lending remains weak; funds invested offshore



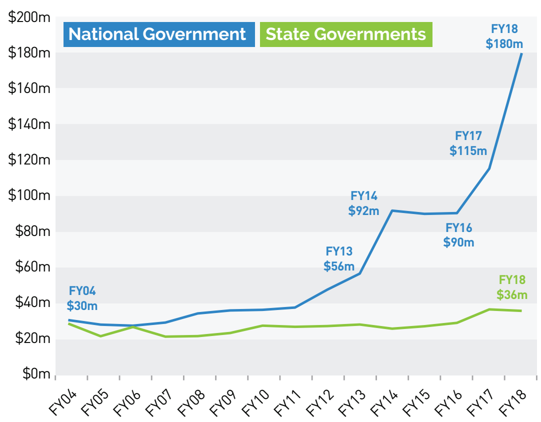
FSM generates large fiscal surpluses after FY13 with rising fishing fee and corporate tax revenues



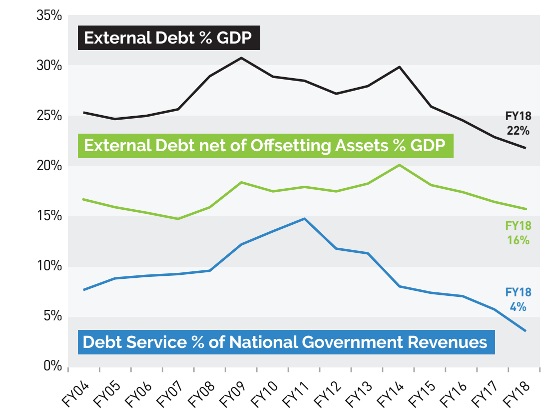
National achieves large fiscal surplus as **State governments attain balance**



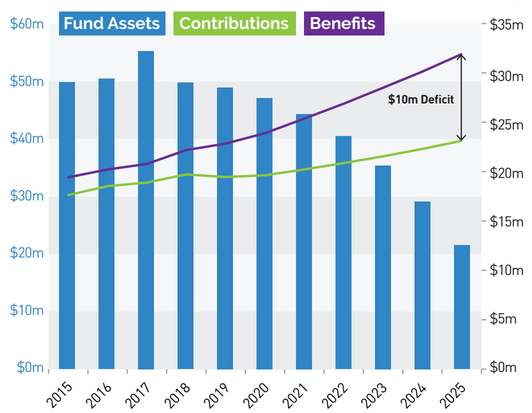
State government doemestic revenues stagnate as **National Revenues Boom**



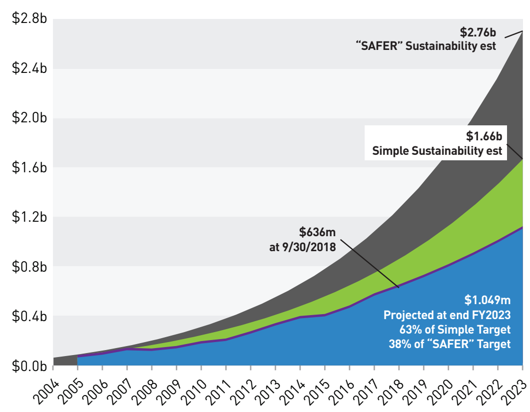
External debt low as a % of GDP and remains sustainable



FSM Social Sectury funds have been sustainable but benefits projected to outstrip contributions in long-term



CTF likely to fall short of both Simple Sustainability estimate and SAFER estimate



FSM summary economic indicators, FY2010-FY2018

	FY2017		Population	GDP per capita
GDP current prices, $ million	362.6	Chuuk	46,503	2,087
Population	102,622	Kosrae	6,181	3,537
GDP per capita $	3,533	Pohnpei	38,236	4,995
GNI per capita $	3,994	Yap	11,701	4,764
GNDI per capita $	5,337			

FY2016 GDP estimates are "Interim" until administrative data on business gross revenues becomes available.

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18
National accounts									
GDP, at constant prices $ million, FY2004 prices	**242.6**	**250.0**	**245.1**	**235.9**	**230.4**	**241.1**	**243.2**	**249.8**	**250.9**
GDP, % growth	**2.3**	**3.1**	**-2.0**	**-3.8**	**-2.3**	**4.6**	**0.9**	**2.7**	**0.4**
GDP, % growth (excluding purse seine fishing boats)	3.7	0.7	-1.9	-2.3	-3.4	2.3	2.4	3.7	0.8
FY2016 GDP estimates are "Interim" until administrative data on business gross revenues becomes available.									
Prices (annual percent change)									
Consumer price index	3.6	3.9	6.3	2.1	0.7	0.0	-0.9	0.1	1.4
CPI Domestic items	5.7	5.1	9.5	3.6	1.3	0.3	0.1	3.3	4.6
CPI Imported items	3.0	3.5	5.3	1.7	0.5	0.0	-1.3	-1.0	0.0
Employment and Wages									
Number of employees	**15,841**	**16,146**	**15,875**	**15,588**	**15,151**	**15,158**	**15,467**	**15,780**	**15,971**
% change	4.4	1.9	-1.7	-1.8	-2.8	0.0	2.0	2.0	1.2
Private sedctor	7,459	7,762	7,551	7,299	6,967	7,033	7,192	7,342	7,547
% change	8.1	4.1	-2.7	-3.3	-4.5	1.0	2.3	2.1	2.8
Public sector	8,315	8,284	8,220	8,169	8,039	7,962	8,048	8,191	8,239
% change	1.3	-0.4	-0.8	-0.6	-1.6	-1.0	1.1	1.8	0.6
Average annual wage	**7,654**	**7,663**	**7,905**	**7,965**	**8,056**	**8,288**	**8,218**	**8,389**	**8,485**
% change	2.3	0.1	3.1	0.8	1.1	2.9	-0.8	2.1	1.1
Private sector	4,867	5,054	5,222	5,170	5,047	5,165	5,241	5,329	5,229
% change	3.8	3.8	3.3	-1.0	-2.4	2.3	1.5	1.7	-1.9
Public sector	10,132	10,076	10,330	10,423	10,600	10,989	10,844	11,067	11,369
% change	3.2	-0.6	2.5	0.9	1.7	3.7	-1.3	2.1	2.7
Average annual real wage (less inflation)	**5,691**	**5,486**	**5,324**	**5,252**	**5,274**	**5,424**	**5,017**	**4,898**	**4,961**
% change	-1.3	-3.6	-3.0	-1.3	0.4	2.8	-7.5	-2.4	1.3
Government Finance Statistics, $ millions									
Revenue	**200.3**	**201.0**	**215.2**	**196.1**	**206.0**	**207.9**	**226.6**	**282.3**	**319.1**
Tax revenue	35.6	37.3	38.0	38.2	60.3	39.0	42.7	64.0	129.5
Grants	136.7	136.8	140.6	111.7	88.8	91.1	107.5	130.9	103.9
Other revenue	28.0	26.8	36.6	46.1	57.0	77.8	76.4	87.5	85.8
Expense	**-135.8**	**-135.7**	**-142.2**	**-141.7**	**-147.9**	**-153.4**	**-163.3**	**-175.1**	**-184.5**
Compensation of Employees	-68.0	-68.0	-67.7	-69.1	-69.8	-69.8	-69.8	-73.7	-74.5
Use of goods and services	-54.5	-52.4	-58.8	-53.7	-62.3	-67.8	-75.6	-86.6	-94.9
Other expense	-13.3	-15.4	-15.7	-18.9	-15.8	-15.8	-17.9	-14.8	-15.0
Net Worth and its Changes	**-62.4**	**-64.6**	**-71.9**	**-54.4**	**-58.1**	**-54.5**	**-63.2**	**-107.2**	**-134.6**
Nonfinancial assets	-63.2	-67.1	-70.1	-45.3	-22.6	-21.7	-39.1	-55.0	-32.8
Financial assets	2.3	-4.1	-8.8	-3.2	-30.7	-42.2	-31.5	-83.9	-86.8
Financial liabilities	-1.5	6.6	6.9	-5.9	-4.8	9.5	7.4	31.7	-15.1
Overall fiscal balance	**1.4**	**-1.8**	**2.9**	**9.1**	**35.5**	**32.7**	**24.1**	**52.2**	**101.9**
In percent of GDP (excl. MRA)									
Revenue	**67.6**	**64.9**	**66.2**	**62.5**	**68.6**	**66.4**	**69.2**	**80.4**	**91.9**
Taxes	12.0	12.1	11.7	12.2	20.1	12.4	13.0	18.2	37.3
Domestic revenues	46.1	44.2	43.3	35.6	29.5	29.1	32.8	37.3	29.9
Grants	9.4	8.7	11.3	14.7	19.0	24.9	23.3	24.9	24.7
Expense	**-45.8**	**-43.8**	**-43.8**	**-45.2**	**-49.2**	**-49.0**	**-49.9**	**-49.9**	**-53.1**
Compensation of Employees	-22.9	-21.9	-20.8	-22.0	-23.2	-22.3	-21.3	-21.0	-21.5
Use of goods and services	-18.4	-16.9	-18.1	-17.1	-20.7	-21.7	-23.1	-24.7	-27.3
Non Financial Assets	**-4.5**	**-5.0**	**-4.8**	**-6.0**	**-5.3**	**-5.0**	**-5.5**	**-4.2**	**-4.3**
Overall fiscal balance	**-21.0**	**-20.9**	**-22.1**	**-17.4**	**-19.3**	**-17.4**	**-19.3**	**-30.5**	**-38.8**

FSM summary economic indicators, FY2010-FY2018 cont'd

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18
Money and Banking ($ million)									
Assets	178.4	190.1	228.1	237.7	270.4	281.1	263.3	283.1	293.3
Foreign assets	111.8	124.3	159.5	172.4	199.3	198.9	173.6	192.2	204.8
Loans	55.7	55.2	56.8	54.0	60.9	68.9	78.4	77.8	75.8
Commercial loans	34.0	33.0	31.5	29.4	33.5	37.8	41.3	40.9	44.2
Consumer loans	21.7	22.2	25.3	24.6	27.4	31.1	37.2	36.9	31.6
Other assets	10.9	10.6	11.8	11.3	10.2	13.3	11.3	13.0	12.7
Liabilities	178.4	190.1	228.1	237.7	270.4	281.1	263.3	283.1	293.3
Deposits	154.1	166.2	204.3	213.2	243.9	253.0	234.2	253.3	263.9
Capital	24.3	23.8	23.7	24.5	26.5	28.1	29.1	29.8	29.4
Loans to deposit ratio, %	19.3	-0.9	2.9	-4.8	12.7	13.1	27.6	26.6	19.9
Balance of Payments $ million									
Trade balance	-128.4	-134.0	-125.4	-128.8	-117.5	-127.9	-110.3	-120.2	
Service balance	-45.7	-46.5	-45.4	-40.7	-36.0	-36.8	-41.2	-37.5	
Primary Income balance	10.6	9.6	15.4	25.5	25.4	59.4	54.8	48.4	
Secondary Income balance	110.8	108.6	107.7	107.4	125.2	110.3	109.6	136.7	
Current Account, balance	-52.7	-62.2	-47.8	-36.6	-2.9	4.9	12.9	27.3	
Capital Account, balance	64.2	62.0	68.3	42.2	21.2	30.9	32.4	23.1	
Financial account balance	11.5	-0.3	20.6	5.6	18.3	35.8	45.3	50.4	
International Investment position (IIP), $ million									
Total stocks, net	182.6	185.1	225.3	263.8	302.7	338.5	383.8	466.5	
Direct investment, net	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	
Portfolio investment, net	153.7	146.3	151.3	174.3	192.1	213.0	228.0	269.7	
Other investment, net	26.7	36.6	71.9	85.7	106.8	120.0	150.0	192.4	
memo: COFA Trust Fund	177.2	198.5	257.3	323.1	380.9	397.3	467.1	564.3	
External Debt, $ million									
Gross External Debt Total	85.6	88.2	88.4	87.7	89.7	81.1	80.4	80.4	
External Debt Net of Offsetting Assets	51.9	55.6	56.9	57.3	60.5	56.7	57.1	57.8	
Gross External debt as % of GDP (excl. MRA)	28.9	28.5	27.2	28.0	29.9	25.9	24.5	22.9	
Net External debt as % of GDP (excl. MRA)	17.5	17.9	17.5	18.3	20.1	18.1	17.4	16.5	
Debt Service	4.9	5.5	5.6	6.4	7.4	6.7	6.4	6.6	
Debt service as % of national goverenment revenues	13.5	14.8	11.8	11.3	8.1	7.4	7.1	5.8	

August 2019

ECONOMIC BRIEF

FSM FY 2018

The FSM Economic Brief is produced annually to provide an independent assessment of the Federated States of Micronesia's economic performance and policy environment, as well as independently verified economic statistics. The FSM Economic Brief summarizes the full FSM Economic Review, which is developed to assist the government of the FSM and the U.S. Department of the Interior's Office of Insular Affairs to fulfill their respective reporting requirements under the FSM Compact of Free Association with the United States.

The FSM Economic Brief has been prepared by the Economic Monitoring and Analysis Program (EconMAP) of the Graduate School USA, with funding assistance from the United States Department of the Interior's Office of Insular Affairs. Additional information is available online at **www.econmap.org**

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