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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/73-3

11:10 a.m., August 28, 2019

3. Federated States of Micronesia—2019 Article IV Consultation

Documents: SM/19/202 and Supplement 1; and Supplement 2; SM/19/203, and Correction 1

Staff: Nozaki, APD; Davies, ICD; Murgasova, SPR

Length: 35 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	Alternate Executive Directors
	A. Tivane (AE), Temporary
	E. Ondo Bile (AF), Temporary
	C. Moreno (AG), Temporary
N. Ray (AP)	
	P. Fachada (BR)
	P. Sun (CC)
	E. Cartagena Guardado (CE), Temporary
L. Levonian (CO)	
	A. Zaborovskiy (EC), Temporary
	P. Rozan (FF), Temporary
	K. Merk (GR)
	P. Dhillon (IN), Temporary
	L. Cerami (IT), Temporary
	K. Chikada (JA)
	K. Osei-Yeboah (MD), Temporary
	P. Al-Riffai (MI), Temporary
	V. Rashkovan (NE)
	N. Vaikla (NO), Temporary
	S. Potapov (RU), Temporary
	F. Rawah (SA), Temporary
	S. Chea (ST), Temporary
	P. Trabinski (SZ)
	O. Haydon (UK), Temporary
	P. Pollard (US), Temporary

G. Tsibouris, Acting Secretary
A. Bala, Summing Up Officer
E. Mannefred, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Asia and Pacific Department: Y. He, K. Kashiwase, C. Sandoz-dit-Bragard, H. Xu. European Department: O. Ftomova. Fiscal Affairs Department: D. Prihardini. Institute for Capacity Development: M. Davies. Legal Department: D. McDonnell. World Bank Group: A. Tully. Alternate Executive Director: A. McKiernan (CO). Senior Advisors to Executive Directors: Y. Danenov (SZ), L. Johnson (AP), Z.Mohammed (BR). Advisors to Executive Directors: E.

Boukpessi (AF), S. Buetzer (GR), D. Crane (US), S. Harutyunyan (NE), T. Nagase (JA), A. Park (AP).

3. FEDERATED STATES OF MICRONESIA—2019 ARTICLE IV CONSULTATION

Mr. Ray and Mr. David submitted the following statement:

The Federated States of Micronesia (FSM) is a small island country spread out over the western Pacific Ocean with more than 600 islands, covering an area roughly the width of Australia. It has a population of just over 100,000. Four autonomous states make up the FSM – Pohnpei, Kosrae, Chuuk and Yap – each with its own distinct language and ethnic identity.

A key challenge for the country is the forthcoming expiry of annual grants from the United States (US) – equivalent to more than 20 percent of GDP – made under the Compact of Free Association between the two countries. After 2023, most of these will be replaced by distributions from a Compact Trust Fund (CTF) being built up from US contributions. However, the current track for contributions, together with expected investment returns, means that these distributions are unlikely to compensate for the loss of grants while also maintaining the CTF's real value over time. The FSM also has its own, separate trust fund, the FSM Trust Fund (FSMTF) as an additional revenue source to enhance fiscal self-reliance.

A government committee has been established to plan for the expiry of the grants and of some support services currently received from the US. The FSM has an Action Plan 2023 to help prepare for these events, that includes increasing revenue mobilization, building fiscal buffers and developing the private sector. President David W. Panuelo was elected in May 2019 and aims to continue driving a reform agenda.

Other challenges include mitigating climate change effects and building resilience to natural disasters. The FSM is the first Pacific island country to have an IMF-World Bank Climate Change Policy Assessment (CCPA), conducted alongside the Article IV consultation.

The FSM authorities broadly agree with staff's recommendations and are grateful for the technical assistance and training they receive from the Fund.

Fiscal policy

The FSM will face a fiscal cliff after 2023, with the overall balance projected to turn from a surplus of around 5 percent of GDP in 2023 to a deficit of 4-5 percent of GDP in 2024. The authorities broadly agreed with staff's recommendation for a gradual fiscal adjustment leading up to 2023 to preserve budget space for priority areas of spending such as education and health. They will continue to enhance tax compliance and consider growth-friendly tax policy reforms, such as introducing a value added tax and selected excises on tobacco, alcohol and fuel. The authorities are also rationalizing tax expenditures and strengthening tax administration through the roll-out of a new IT system. Ongoing PFM reforms with the World Bank and European Union will help streamline and rationalize nonessential expenditure, as well as ensuring space for spending on climate change resilience.

The authorities are committed to continue building up the FSMTF by saving revenue windfalls into it. Funds in the FSMTF have grown from about $13 million in 2014 to around $230 million in 2019. New laws were also enacted this year that earmark 50 percent of corporate tax receipts and 20 percent of fishing license fees as contributions to the FSMTF. As things currently stand, the FSM will only be able to take investment returns out of the CTF, meaning there could be large revenue volatility after 2023. The authorities do not agree with staff's recommendation to use the FSMTF as a stabilizer, as they want to keep building up the FSMTF for the long term. Instead, the authorities are seeking a review of the rules around CTF distributions.

Fiscal deficits post-2023 would place external debt on an upward trajectory, leaving the FSM at a high risk of debt distress. The authorities support staff's consideration of the debt trajectory over a 20-year horizon in the DSA, as this reflects the risks facing the country. They intend to continue maximizing grant financing and not take on any new loans up to 2023.

Financial sector

Supervision of the FSM's financial sector would be significantly transformed by any reduction in US FDIC oversight after 2023. The authorities agree with staff's recommendation to strengthen the FSM Banking Board's capacity for banking supervision, update the banking laws, maintain correspondent banking relationships and develop prudential regulations. The authorities have been active in addressing international tax transparency issues given that a number of investment companies are based in the FSM. An assessment by the EU and OECD Global Forum on Transparency and Exchange of Information for Tax Purposes two years ago found the FSM to be largely compliant.

Private sector development

The authorities agreed that improving the business and investment climate, and facilitating access to credit, is critical for private sector development. The country's remoteness, limited natural resources and sparse population present challenges to private-sector growth. However, efforts are underway to implement reforms in sectors such as fisheries, information and communication technologies, maritime transportation, energy and niche tourism. These include judicial reforms for business dispute resolution and coordinating with the four State governments on land registries. A bill to amend the Foreign Investment Act is currently before Congress, aimed at streamlining FDI laws and creating a single national window for FDI.

Climate Change

The FSM has many low-lying islands at risk from natural disasters, compounded by rising sea levels and temperature change. The CCPA found there is generally good planning in place, and there may be available financing to address climate change impacts from the $200 million backlog of unspent compact infrastructure funds. However, some infrastructure gaps remain, largely as a result of the need to find suitable projects for donors as well as a lack of absorptive capacity in the FSM.

The CCPA recommended developing an overarching National Adaptation Plan that is fully integrated with sectoral and subnational strategies, as well as a comprehensive strategy for building resilience to natural disasters, particularly for early warning, disaster response and risk financing. The latter is important given the expected loss of access to direct funding from US federal agencies for natural disaster response and reconstruction after 2023.

The authorities will reflect on the findings and recommendations of the CCPA. Full implementation of the FSM's energy master plan should enable the country to meet its Naturally Determined Contributions under the Paris Agreement. The authorities agree that adaptation planning is lacking and will continue to seek sources of financing as well as technical assistance to support their planning. They would also like climate finance institutions to streamline their requirements for small states that have limited capacity to access funding.

Ms. Levonian, Mr. Merk, Mr. Buetzer and Mr. Rankin submitted the following joint statement:

> We thank staff for their informative reports on the Federated States of Micronesia (FSM) and Mr. Ray and Mr. David for their useful buff statement. We congratulate the authorities on their recent economic performance, but note that significant challenges remain related to the scheduled expiration of US Compact grants, climate change, and weak private sector activity. We agree with the thrust of the staff appraisal and offer the following comments for emphasis.
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> Fiscal consolidation is required to build buffers and preserve fiscal sustainability ahead of the 2023 expiration of US Compact grants. We welcome the authorities' prudent policy of saving recent revenue windfalls into the FSM Trust Fund and encourage further action to build buffers through revenue mobilization and expenditure rationalization. Recognizing that tax revenue lags regional peers, we encourage the authorities to follow staff advice on growth-friendly tax policy reforms, including introducing a VAT and raising fuel taxes. Nonessential expenditures should also be rationalized. We highlight staff findings that smaller increases to the public sector wage bill (which exceeds regional peers) would yield savings of 1.2 percent of GDP. Prudent fiscal adjustment measures should protect critical spending on education, healthcare, and climate-resilient infrastructure. Could staff comment on the state of negotiations to amend the Compact Trust Fund agreement to smooth distribution volatility?
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> The FSM faces intense challenges from climate change. Accordingly, we thank staff for the very useful Climate Change Policy Assessment and appreciate continued work on this macroeconomic challenge confronting small states. As the staff assessment highlights, rising sea levels, temperatures, and increasingly frequent natural disasters are resulting in significant macroeconomic costs. We welcome the progress that the authorities have made on climate change preparedness and encourage further work to develop a comprehensive disaster resilience strategy with Fund support. We also encourage the authorities to consider participation in regional parametric insurance pools. Many countries in the Caribbean have benefited from participation in the CCRIF parametric insurance pool. The DSA highlights that natural disaster shocks have a particularly adverse impact on debt sustainability. Could staff comment on the potential role climate resilient debt instruments (e.g., loans with "natural disaster clauses") could play in promoting debt sustainability?

Data shortcomings continue to hamper macroeconomic surveillance. We encourage the authorities to close data gaps with the support of Fund and PFTAC technical assistance.

Lastly, can staff provide an estimate of women's labor force participation and women's formal sector employment in the FSM?

Ms. Pollard and Ms. Crane submitted the following statement:

We thank staff for the papers and Mr. Ray and Mr. David for the helpful buff statement. Well-tailored policy advice and well-targeted technical assistance from the IMF can play a particularly important role in a capacity-constrained economy like Micronesia's. As Micronesia takes necessary steps to increase its economic self-reliance, we are hopeful that negotiations to extend certain provisions of the Compact of Free Association with the United States, announced by U.S. Secretary of State Pompeo during his recent visit, will result in smoothing of possible cliff effects and improvements in economic resilience. We appreciate that Compact renewal was factored in as an upside risk.

Fiscal and debt sustainability. We welcome the authorities' prudent steps to save windfall revenues to build fiscal buffers in the FSM Trust Fund, and encourage the gradual fiscal consolidation recommended by staff. Stronger self-financed buffers will increase the resilience of the economy to various outcomes with respect to future Compact grants and potential volatility of Compact Trust Fund proceeds, as well as to natural disaster risks. To take best advantage of the large amount of unused capital grants committed under the Compact, we underscore staff's recommendation to strengthen implementation capacity including through standardized project appraisal and selection across states. We also agree with staff that limiting wage bill growth and ongoing efforts to improve public financial management would also contribute to fiscal sustainability. The application of a 20-year time horizon in the Debt Sustainability Analysis is appropriate, helping highlight well ahead of time the elevated risk of debt distress in the outyears. Can staff comment on prospects to broaden available debt data?

Financial sector. Maintaining financial sector stability and correspondent banking relationships is a key challenge. We appreciate the IMF's technical assistance on upgrading the Banking Act and strengthening Micronesia's banking regulation and supervision capacity. We note that the U.S. FDIC's future role in the oversight of Micronesia's banking sector will depend on the outcome of Compact negotiations.

Climate and natural disaster resilience. Micronesia is one of the countries most exposed to climate risks and faces specific challenges of being spread so widely across the Pacific Ocean, increasing the cost of preparing for, mitigating, and responding to disasters. Harmonizing actions on climate and disaster at the national and state levels is immensely challenging and one of the major barriers to effective response and preparedness. In this context, we encourage the authorities to persist in their efforts to build fiscal and financial buffers, including through risk-pooling mechanisms like PCRAFI, and to invest in climate resilient infrastructure to make the economy resilient to climate and disaster risks. While IMF staff recommend a comprehensive Disaster Risk Strategy, we take note of Micronesia's capacity constraints (human and financial) and encourage a pragmatic approach to filling gaps in disaster risk planning, in collaboration with the World Bank and other donors.

Private sector growth. We welcome IMF staff's coordination with World Bank and Asian Development Bank staff, including around the "Pacific Possible" analysis of reforms to promote private sector growth in promising areas like fisheries and tourism. Steps to improve FDI environment, especially in key sectors, will boost growth and support the government's efforts to mobilize revenue.

Data. In the context of the serious data shortcomings noted in the staff report, we commend the authorities for implementing e-GDDS in 2017 and encourage further work on strengthening data provision. We took note in the Information Annex of the limited staff resources in the Statistics Office, which, in turn, limits the support that PFTAC can effectively provide. Staff comments would be welcome.

Mr. Tan and Mr. Chea submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Ray and Mr. David for their informative buff statement.

We commend the Federated States of Micronesia's authorities for fostering fiscal sustainability and strong economic development over recent years. Nonetheless, the economy is subjected to significant uncertainties stemming from the expiry of the U.S. Compact grants, and climate change vulnerability over the medium-term. In this context, further efforts are needed to enhance structural reforms as well as medium- and long-term fiscal and financial sustainability. This will help to strengthen private sector growth and climate change resilience. We concur with the broad thrust of the staff appraisal and offer the following comments for emphasis.

It will be prudent to strengthen fiscal buffers ahead of the potential expiration of the U.S. Compact grants. We are encouraged by the authorities' continuing efforts in raising annual budget contributions to the FSM Trust Fund. However, the FSM is expected to face significant fiscal deficit and upward-facing debt trajectory over the medium-term. In this regard, we agree with staff that a gradual fiscal adjustment of 4–5 percent of GDP over the medium term through FY2023 to balance the budget in FY2024 will help to preserve the long-term projected real value of the Compact Trust Fund (CTF) and the FSM Trust Fund. Accelerating reforms on public financial management (PFM) as well as enhancements on revenue mobilization and expenditure prioritization in line with the 2023 Action Plan will further safeguard priority spending such as education, healthcare, and infrastructure development. Could staff elaborate on the possible concessional financing sources to the FSM as an alternative to the U.S. Compact grant post 2023?

Enhancing climate change resilience is crucial in responding to the FSM's increasing frequency and intensity of natural disasters. We welcome the authorities' progress on natural disasters preparedness. To close the gaps in preparedness, further efforts are needed to strengthen the capacity to implement adaptation projects and develop contingent financing plans for natural disasters from diverse sources. To this end, we share the authorities' views on streamlining access requirements and mobilizing technical support by development partners to fill implementation capacity gaps. Could staff comment on the potential impact of climate change in relation to the FSM's revenue outlook from the fishing industry, as we note that a large portion of the revenue comes from fishing licenses?

Improving private-sector development and financial sector soundness will promote long-term economic growth. We welcome the authorities' interest in capacity building to improve tax administration, banking supervision, and macro statistics as well as their efforts to implement and enhance data adequacy. Given the possible reduction in the FDIC oversight in 2023, we agree with staff on the updating of the banking laws, the adoption of prudential banking regulations, and the development of a reform roadmap to strengthen banking supervision measures. Lastly, advancing on structural reforms and regulatory framework will be equally important to bolster private-sector development and promote a more favorable business and investment climate for potential foreign investors. Going forward, we encourage the authorities to continue to work closely with development partners and tap on further technical assistance to address FSM's challenges.

With these remarks, we wish the authorities every success in their future endeavors.

Mr. Sun and Ms. Lok submitted the following statement:

We thank staff for the comprehensive set of reports, and Mr. Ray and Mr. David for the informative buff statement. We welcome the positive economic performance of the Federated States of Micronesia (FSM) in recent years. In the face of the significant uncertainty associated with the Compact Agreement in the medium term and high vulnerability to natural disasters and climate change, steadfast actions are needed to strengthen resilience and achieve sustainable growth. In this regard, we take positive note of important efforts by the authorities in advancing reforms on various fronts. We broadly share staff's appraisal and would like to confine our comments to the following.

The FSM is expected to face a fiscal cliff in FY2024, with the fiscal balance turning from surplus to deficit. To tackle this challenge, we believe a gradual fiscal adjustment through growth-friendly measures would be warranted. In this regard, we support the authorities' efforts in strengthening tax administration and compliance. We also welcome the authorities' ongoing public financial management reforms, supported by the World Bank and the European Union, which would help enhance the efficiency and quality of public spending and investment, as well as identify potential areas for expenditure savings. In the process of fiscal adjustment, it is critical to ensure that essential social and infrastructure spending is preserved. Meanwhile, to further strengthen fiscal resilience, we encourage the authorities to continue to build up the FSM Trust Fund, and welcome the authorities' commitment in this regard.

The substantial risk posed by climate change calls for strong measures to bolster preparedness and resilience. As recognized by the Climate Change Policy Assessment (CCPA), the FSM has taken significant steps to counter the climate-related threat. That said, some gaps remain, and there is a need for further strengthening capacity and mobilizing adaptation investments. The CCPA has identified some priorities and recommendations for tackling the climate-change challenges faced by the FSM, and we encourage the Fund, together with the World Bank, to continue to work closely with the authorities and provide guidance as needed to strengthen the FSM's climate change resilience.

Going forward, with the possible reduction in FDIC oversight, efforts to enhance the FSM's own banking supervision would be warranted. We look forward to the upgrading of the Banking Act with the support of relevant technical assistance, which will contribute to a stronger and more modernized legal framework for prudential supervision. In what ways can the Fund provide further assistance to the authorities to develop prudential regulations and relevant technical capacity? In the meantime, we encourage the authorities to continue to promote private sector credit in a prudent and well-paced manner. To complement this work and allow the financial sector to fully play its role in facilitating private sector development and supporting the economy, we believe it would be helpful to also implement targeted structural reforms to improve the business and investment environment.

As the FSM continues to tackle various challenges, we encourage the Fund to maintain close engagement with the authorities to provide guidance and assistance where needed. With these remarks, we wish the authorities every success with their policy endeavors.

Mr. Villar and Mr. Cartagena Guardado submitted the following statement:

We thank staff for the comprehensive report and Mr. Ray and Mr. David for their informative buff statement. We welcome the recent economic developments and performance of the Federated States of Micronesia (FSM). The country's economy has grown above historical averages and the external position has improved. Despite significant trade imbalances, large transfers and grants led to both current account and fiscal surpluses since 2012, and inflation has been low. FSM is a sparsely populated and dispersed conglomerate of more than 600 islands, highly dependent on foreign aid, vulnerable to climate change, and with opportunities to increase financial deepening.

The Compact Agreement of Free Association with the United States (Compact) has helped FSM's current economic performance. As noted in the staff report, FSM has received grants and support under this Compact, being one of the drivers in recent developments. The agreement has also facilitated banking surveillance as it has been executed by the Federal Deposit Insurance Corporation. Further staff comments on the authorities' view of the potential renewal of the Compact and of the effectiveness of the government committee established to plan for the expiry of the grants are welcomed.

We note the progress achieved by FSM in implementing the reforms recommended during the 2017 Article IV consultation. We encourage the authorities to execute further actions in revenue mobilization and expenditure rationalization mainly given uncertainty of the renewal of the Compact. The public sector debt has decreased to 20 percent of GDP in FY2018 from a peak of 31 percent of GDP in FY2009. Total debt service reached 5.8 percent of exports in FY2018 and is expected to remain broadly stable over the medium term. We agree with the staff that fiscal consolidation should be gradual, with growth-friendly measures preserving essential social spending. We welcome the authorities' commitment to continue building up the FSM Trust Fund by saving revenue windfalls. Trust performance has led to an increase in more than $200 million between the 2014 and 2019. Further staff comments about the impact of the proposed fiscal consolidation (4-5 percent and 0.1-0.3 percent annually) given the low-growth outlook of around 0.6 percent (its potential) for the short and medium term will be welcomed.

Financial deepening and strengthening capacity for banking supervision remains a challenge. We welcome the authority's commitment to strengthen the FSM Banking Board's capacity for banking supervision, update the banking laws, maintain correspondent banking relationships and develop prudential regulations. As the staff reports, financial deepening is limited by the lack of collaterals, which was also noted in previous years. The use of land as collateral should be approached to promote financial deepening. FSM Development Bank and Credit Unions have helped expanding credit to private sector contributing to financial deepening. We agree with staff that they should be placed under the supervision of the Banking Board to ensure a sound financial system.

We welcome FSM's progress in capacity building with the technical assistance (TA) provided by the Pacific Financial Technical Assistance Centre. We note in the staff report that FSM has been a modest user of TA, and that it has important short-term capacity building needs in fiscal, financial and statistics fields. Use of TA for the new banking law, banking supervision and national accounts, as well as external sector statistics should be accelerated. And TA recommendations should be executed before the expiration of the Compact to be better prepared for the challenges and uncertainties that may arise afterwards. Further staff comments on the authorities' advances in strengthening banking supervision are welcomed.

FSM is vulnerable to climate change. We welcome the well-developed Climate Change Policy Assessment conducted by the staff as an integral part of the 2019 Article IV Consultation. We also welcome the progress in the implementation of the national climate change policy under the Compact and the adoption in four of the states of the Joint State Action Plan for climate change. We agree with staff on the importance of increasing capacity to address natural disaster risks following the likely expiration of Compact-related assistance in 2023.

Mr. Chikada and Mr. Nagase submitted the following statement:

We thank staff for the set of informative papers on the Federated States of Micronesia (FSM) and Mr. Ray and Mr. David for their helpful statement. We welcome that the economy and fiscal balance of the FSM have performed well in recent years. However, the FSM faces significant challenges and uncertainties related to the potential expiration of the Compact Agreement with the United States and climate change.

In light of the significant challenges the FSM faces, staff's various analysis and policy recommendations will provide a good basis for the authorities to take necessary actions to prepare for and mitigate the possible adverse effects. We would also like staff to continue carefully monitoring and assessing the progress of the discussions on the post-2023 relationship with the United States and give further policy advice as appropriate. As we broadly concur with the thrust of the staff appraisal, we would like to limit our comments to the following points:

Fiscal Policy

A sound fiscal adjustment is essential to address the anticipated fiscal cliff. We welcome the authorities' judicious decision to save most of the revenue windfalls into the FSM Trust Fund (FSMTF) and they achieved to strengthen their fiscal position. However, we take note of the staff's assessment that more needs to be done to cope with the potential cliff and strongly encourage the authorities to start implementing fiscal consolidation. On the expenditure side, as staff point out, the authorities should conduct public financial management (PFM) reform and rationalize nonessential expense, while preserving budget for important policy area like education, healthcare and infrastructure, including on climate change resilience. On the revenue side, for example, introducing new tax sources such as VAT and excise tax and enhancing tax compliance would be needed.

Financial Policy and Structural reform

Strengthening the own capacity for banking sector supervision is needed. To make preparation for the possible reduction in the oversight of the Federal Deposit Insurance Corporation (FDIC) after 2023, we encourage the authorities to improve the legal and regulatory framework for prudential supervision, strengthen monitoring of commercial banks, and develop a reform roadmap with actions needed to maintain financial sector stability and corresponding banking relationships. However, we understand that FSM is in a unique situation and has only one domestic commercial bank, thus we would welcome staff's views on how to promote private sector lending (please also see below) as well as how much resources FSM could put on to build its own banking supervision capacities, and if there is any scope for FSM to learn from other countries' experiences.

To vitalize the weak private sector, the business and investment climate should be improved. We note the fact that the long-time economic growth of the FSM has been lowest among Pacific Island countries, reflecting its stagnant private sector. On this point, we agree with the staff's view that the private sector credit and the foreign direct investment (FDI) should be promoted under the appropriate regulations and supervision.

Climate Change Resilience

The resilience to the climate change should be strengthened. We thank staff for their effort to conduct Climate Change Policy Assessment (CCPA) for the FSM, which is the first assessment in the Pacific, and their continued contribution to analyze and develop a policy response to the expected economic impact of the climate change and weather-related natural disasters for small states. Since there is a risk that the FSM would no longer be able to get the assistance from the United States Agency for International Development (USAID) and the Federal Emergency Management Agency (FEMA) after expiration of the Compact in 2023, the authorities should accelerate the pace of closing gaps in preparedness and adaptation.

Mr. Ostros and Mr. Vaikla submitted the following statement:

We thank staff for an informative report and Mr. Ray and Mr. David for their insightful buff statement. We welcome the solid economic growth and the authorities´ prudent fiscal policies, which have considerably strengthened the fiscal position. Given the considerable uncertainty related to the expiry of the grants and the fiscal cliff after 2023, we encourage the authorities to continue saving revenue windfalls and implement gradual fiscal consolidation. The Federated States of Micronesia (FSM) is highly exposed to climate risks, therefore further efforts are needed to increase resilience. We broadly agree with staff's appraisal and would like to make the following comments for emphasis.

The uncertanty related to the renewal of the Compact Agreement with the United States raises fiscal risks considerably. We welcome the Action Plan 2023 and an establishment of a government committee to prepare for the fiscal cliff. We also commend the authorities for saving revenue windfalls during FY2017-18 and for recently adopting the law to contribute 50 percent of corporate tax receipts and 20 percent of fishing license fees as contributions to the FSMTF. Going forwards, saving revenue windfalls to the FSM Trust Fund (FSMTF), which has considerably grown in past years, is essential to mitigate fiscal risks. While we understand that staff´s recommendation to enable larger drawdowns from the FSMTF makes sense from a short-term fiscal policy perspective, we support the authorities' long-term view to build the FSMTF for future generations and thereby avoid using it as a short-term stabilizer.

Gradual fiscal consolidation is needed to handle the fiscal cliff. We concur with staff that a gradual fiscal adjustment of 4-5 percent of GDP through FY2023 is needed to cope with the fiscal cliff. We note that, compared to peer countries, the tax revenues for FSM are relatively low, while the government wage bill is above average. Therefore, we encourage the implementation of growth-friendly tax policy reforms, such as introducing a VAT and selected excises on tobacco, alcohol, and fuel, as recommended by staff. Furthermore, strengthening the tax administration and scaling back nonessential expenditure, such as limiting wage bill growth, would strengthen the fiscal situation.

The FSM faces intense challenges from climate change. We welcome the fifth pilot of the Climate Change Policy Assessment (CCPA) for small states which notes that while the FSM's ability to respond to natural disasters is currently good, it is likely to suffer serious adverse environmental, social, and economic losses as a result of natural disasters and slower moving impacts of climate change. We support the CCPA´s recommendations and emphasize the importance of short-term priorities, including improving climate data collection and use, developing an overarching National Adaptation Plan and continuing to develop contingency financing options, and considering regional parametric insurance.

Mr. Psalidopoulos and Ms. Cerami submitted the following statement:

We appreciated the rich set of staff's papers, including the Climate Change Policy Assessment (CCPA), which is absolutely macrocritical in the case of the Federated States of Micronesia, one of the most geographically dispersed countries, highly vulnerable to climate change, and dependent on foreign grants. We also thank Mr. Ray and Mr. David for their candid buff statement and welcome the constructive dialogue between staff and the authorities. We share staff's appraisal and would like to make the following remarks.

The FSM economy has performed well, also on the back of sound economic policies, most notably on the fiscal side. We commend the authorities for the decision to save most of the revenue windfalls to the FSM Trust Fund. And we also welcome some key findings of the Public Investment Management Assessment conducted in the context of the CCPA, namely the 30 percent of GDP target for the general government debt, the balanced budget rule, the national strategy for public investment, and the Joint State Action Plans on climate change.

However, as the FSM Trust Fund combined with the Compact Trust Fund will not suffice to cover the loss of U.S. grants under the Compact Agreement expiring in 2023, more actions should be taken in the event of non-renewal of the Agreement. This will entail a gradual fiscal adjustment, comprising additional revenue mobilization and expenditure rationalization measures, while continuing to save revenue windfalls into the Trust Fund. Like staff, we are concerned about the current arrangement for Compact Trust Fund distributions, which would result in increased revenue volatility; however, we share the authorities' reservation about using the FSM Trust Fund to offset the income volatility. Instead, we support revising the arrangement of the Compact Trust Fund to smooth out distributions and allow for fiscal reforms to gradually build self-sufficiency.

In view of the possible termination of the Compact Agreement, it will also be critically important strengthening the national strategy on climate change, as the country would no longer be able to rely on the United States for disaster preparedness, response, and recovery assistance. To this end, the country needs to raise additional funding for mitigation and adaptation investments and to build capacity to address natural disaster risks. We fully support the CCPA recommendations and share the view that more resilient public infrastructure can raise returns to private investment, and hence support capital accumulation and growth. But we also consider important to promote the development of the sustainable finance market, not only to mobilize private capital for green projects but also to promote private sector credit to the economy, which is still very limited. In this respect, we support staff's recommendation to strengthen banking regulation and supervision, in preparation for the possible reduction of FDIC oversight

Lastly, we encourage the authorities to consent to the Fund's publication of all staff's papers, including the CCPA.

Mr. Fachada and Ms. Mohammed submitted the following statement:

We thank staff for the comprehensive reports and Messrs. Ray and David for their statement. The Federated States of Micronesia (FSM) is a small, widely dispersed Pacific country that is highly vulnerable to climate change and natural disasters. Nevertheless, FSM has achieved favorable economic performance in recent years, with relatively high growth and low inflation, together with large fiscal and current account surpluses reflecting the authorities' prudent decision to save windfall revenues. This notwithstanding, we agree with staff that in the medium-term, FSM risks are tilted to the downside due to substantial macroeconomic uncertainty, unless the Compact Agreement with the U.S. is renewed.

With the potential end of compact grants in FY 2023, fiscal adjustment has become essential to preserve fiscal space and social spending, especially in education and health. We commend the authorities for continuing to build the Compact Trust Fund (CTF) and the FSM Trust Fund to ensure economic self-sufficiency and less dependence on foreign financial assistance. Gradual fiscal consolidation in the medium-term seems to be plausible and attainable and we welcome the enhancement of tax administration and tax compliance, which should be complemented by tax policy reforms such as the introduction of a value added tax. The authorities should also step-up their efforts in achieving public finance management reforms to bolster fiscal adjustment and more efficient public investment management. In light of the visit of the U.S. Secretary of State to FSM in August (after the circulation of the report), could staff update their views on the likelihood of the U.S. Compact Grants being renewed beyond FY 2023?

Strengthening the financial sector supervision and regulation are vital to safeguard the sector. We see merit in improving prudential banking regulations while developing a reform roadmap to strengthen the Banking Board's supervision of commercial banks. Upgrading the Banking Act to modernize the legal framework would support prudential supervision and the maintenance of correspondent banking relationships. We agree with staff that expanding regulatory oversight of the Banking Board to include the FSM Development Bank and credit unions would help promote prudent lending and safe financial inclusion.

Improving the business environment would encourage private sector activity and shore-up potential growth. We encourage the authorities to facilitate private sector development, addressing long-standing weaknesses in the business environment and infrastructure, including through lowering business start-up costs, reducing time for settling disputes, digitalizing the land registry and reducing undue regulatory burdens on FDI. We welcome the authorities' effort to establish a one stop shop for FDI applications and fast-tracking processing in priority sectors.

We strongly welcome the IMF-World Bank Climate Change Policy Assessment (CCPA). The document underscores FSM's vulnerability to the impact of climate change. We take note that the authorities have made progress on climate change preparedness but more needs to be done to address remaining gaps. We encourage the authorities to develop and implement an overarching adaptation plan. However, given the country's limited implementation capacity, strengthen public investment management to prioritize projects and further mobilization of grant financing are necessary to accelerate climate change adaptation. We also take note of the authorities' call for the need for climate finance institutions to streamline access requirements to be in line with the capacity in small states, and we underscore that development partners need to mobilize technical support to fill the implementation gaps.

As in the last Debt Sustainability Analysis (DSA) in September 2017, we consider staff's assessment that FSM is at a high risk of debt distress to be somewhat exaggerated. While there are undoubtedly risks stemming from climate change and natural disasters and the reduction in grants after FY2023, these risks tend to be mitigated by the large balances in the two trust funds and the concessional nature of the current debt. We also believe that staff's recommendation to maintain the Article IV in the current 24-month cycle is inconsistent with their overall assessment of risks and support moving FSM to the regular surveillance cycle.

Ms. Riach and Ms. Freeman submitted the following statement:

We support staff's assessment of the Federated States of Micronesia and thank Mr. Ray and Mr. David for their informative buff statement. We agree with the broad thrust of staff recommendations, particularly the need for a gradual fiscal adjustment to manage future uncertainty over the Compact Agreement and the need to strengthen the banking sector. Given the particular vulnerability of Micronesia to climate change and that this is the penultimate of the six planned Climate Change Policy Assessments (CCPA) pilots, we wanted to focus comment on the climate recommendations and lessons for the region.

The Climate Change Policy Assessment and the Debt Sustainability Analysis (DSA) clearly demonstrate the macroeconomic risks of climate change to Micronesia, and to the wider pacific region. The DSA focuses on how natural disasters could increase the risk of distress and shock, while the CCPA allows us to explore the wider impediments to growth and allow investment in preparation and risk management. We find the CCPAs a useful tool and would like to see them continue. We are keen to work further with the Board on identifying future countries and honing the methodology. What plans are there to extend the roll out of CCPAs beyond the pilot phase, and particularly to other small island countries in the region? What lessons can we draw from this CCPA for the region; and how are we sharing them with other islands facing similar risks?

We welcome the collaboration with the World Bank and Green Climate Fund and agree with the joint view that there needs to be much greater focus on and investment in adaptation. Given vulnerabilities identified, we strongly support the recommendation to create a national adaptation plan. The CCPA highlights key adaptation delivery risks of project delivery capacity constraints within the Government and also a large development financing gap. What consideration has there been for technical assistance from donors and other MDBs to help build project capacity? On financing, Figure 12 highlights that adaptation investment now could decrease the economic impact of a natural disaster by 40 percent. Given this analysis and the financing gap for adaptation, what analysis has been done of further funding sources and, within the resources available, a prioritization of the pipeline for investment?

The CCPA also makes recommendations on insurance and disaster risk management. We think there could be consideration of raising financing in advance, including through the use of the World Bank’s CAT DDO. We also agree with the need to consider this as part of a wider Disaster Risk Strategy.

Lastly, we note within the Debt Sustainability Analysis that climate change could have a 10 percent impact on GDP. This largely focuses on risks of a natural disaster but it is also clear that changes in the blue economy will also affect Micronesia's economic growth and debt risks, particularly changes to fish patterns, sea levels and pollution. Does the sensitivity analysis include impacts of degraded blue biodiversity on Micronesia's GDP? Are there any key recommendations for the protection of the blue economy that should be considered to help manage risks to growth?

We thank staff for the detail that they have provided and look forward to reviewing lessons learned on the CCPA after the final pilot for Tonga later this year.

Mr. de Villeroché, Mr. Rozan and Mr. Sode submitted the following statement:

We thank staff for the quality of their documents and Mr Ray and Mr David for their informative buff statement. While the Federal States of Micronesia's economy has performed well in recent years, FSM faces several challenges stemming from its remote geographic location, its vulnerability to climate change and the possible expiry of annual grants from the United States that could occur in 2023. We broadly agree with the Fund analysis and recommendations. We also welcome the Fund's technical assistance. We would like to make the following comments for emphasis:

The planned expiration of the Compact Agreement with the US is the main downside risk for the country and the uncertainty concerning a potential renewal makes economic planning particularly difficult. Could staff comment on the chance of a renewed agreement and on the level of preparedness of the authorities in case of a definitive expiration. Could staff elaborate on its policy recommendations in case the Compact is renewed?

Given FSM high vulnerability to climate change and the potential loss of access to FEMA, we agree with staff that the authorities needs to invest in preparedness, speed up adaptation, and develop a disaster resilience strategy, notably by identifying disaster risk financing options. We thank staff for the Climate Change Policy Assessment (CCPA), which is proving to be a very useful tool, for instance the analysis in figure 12 describing possible scaling up scenarios for climate change adaptation spending and their macroeconomic implications. Could staff describe how many CCPA are planned in the coming years and which countries will be analyzed? Beyond, on paragraph 46, a discrepancy in the evaluation of amounts spent on adaptation across countries undergoing CCPAs is mentioned. Could staff explain if there is plan to harmonize this methodology, as comparability and data reliability is significant to support the CCPA's credibility? We strongly encourage cooperation between the Fund, the World Bank and other development partners such as the Asian Development Bank and the Green Climate Fund to support the authorities' efforts. We also encourage the authorities to consider participating in the Pacific Catastrophe Risk Insurance Facility, notably in the context of the US Compact expiration

On the fiscal front, we commend the authorities for saving the recent revenue windfall and we encourage them to implement the recommended gradual fiscal consolidation. Reaching a higher revenue to GDP ratio will be key and we strongly encourage initiatives aimed at mobilizing additional domestic resources. On the expenditures front, rationalization of the wage bill could help reduce spending.

Concerning structural reforms, we broadly agree with staff assessment on the need to strengthen transport infrastructures, improve the investment climate and improve access to financial services. We notably agree with staff that the authorities should try to develop the private sector through reform targeted on information and communication technologies, fishery, maritime, energy, and sustainable niche tourism.

Mr. Rashkovan and Ms. Harutyunyan submitted the following statement:

We thank staff for the comprehensive set of papers and Mr. Ray and Mr. David for their informative buff statement. We welcome the macroeconomic performance of the Federated States of Micronesia (FSM) over recent years, with economic growth above the historical average, low inflation, large external and fiscal surpluses. Nonetheless, the medium-term risks are skewed to the downside related to the expected expiration of the Compact Agreement with the U.S. in 2023, resulting in the loss of access to US grants and other macro-critical services. In this context, climate change and natural disaster related risks weigh heavily on macro-sustainability. Against this background, the implementation of fiscal consolidation and further strengthening of climate change resilience is paramount. We broadly agree with staff's assessment and would like to offer the following comments for emphasis.

We stress the importance of medium-term gradual fiscal consolidation while protecting social spending in priority areas. We note that in view of the expected fiscal cliff arising from the expiration of U.S. grants in FY2023, the FSM remains at high risk of debt distress. To this end, we share staff's view on the need of gradual fiscal adjustment of 4-5 percent of GDP by 2023 through growth-friendly tax policy reforms, as underlined in the report. In this context, accelerating tax administration reforms, rationalizing nonessential expenditures and enhancing public finance management (PFM) are essential. We welcome the authorities' substantial contributions to the FSMTF over the last years and the newly adopted saving mechanism. Notwithstanding this, the post-2023 distributional arrangement from the Compact Trust Fund (CTF), limited to the investment returns, poses additional fiscal risks along with large revenue volatility. In this regard, we are concerned about the lack of agreement between staff and authorities around the drawdowns from the FSMTF beyond 2023. Could staff comment on this, as well as update on the status of negotiations with the fund managers on the CTF distribution formula and legislation?

We fully support the joint IMF-WBG partnership in developing the Climate Change Policy Assessment for Small States (CCPA) and welcome the first CCPA report in the Pacific for FSM. The CCPA provides helpful guidance for disaster preparedness and presents mitigation, adaptation and risk management strategies aimed at helping vulnerable countries respond adequately to macroeconomic challenges while safeguarding long-run fiscal and external sustainability. In this sense, we welcome the fifth pilot report for FSM and look forward to further CCPAs for other small states. In the view of the scheduled expiration of the USAID and FEMA post-disaster assistance in 2023, strengthening the FSM's resilience against natural disasters shocks is macro critical. In this context, we urge the authorities to accelerate their efforts to develop an overarching National Adaptation Plan and comprehensive Disaster Resilience Strategy in cooperation with the IMF, WB and other development partners. Also, we encourage the authorities to make greater use of disaster risk transfer mechanisms, including the regional parametric schemes under the PCRAFI, which will help preserve medium-term fiscal sustainability. And finally, strengthening public investment management and mobilizing further grant financing is paramount.

Strengthening banking supervision is essential given the expected post-2023 reduction in the FDIC oversight. In this context, we encourage the authorities to step up their efforts aimed at upgrading legal and regulatory frameworks. We emphasize the importance of expanding the oversight authority of the FSM Banking Board to credit unions to ensure prudent lending. In this regard, we would appreciate staff's comments on the authorities' view of not placing the FSMDB under the supervision of the Banking Board at this stage?

Finally, while the participation in the e-DSSA is an important step forward, we emphasize the importance of continued efforts on further improvement and timely dissemination of macroeconomic data with the assistance of the IMF and PFTAC. In this context, we highlight the importance of solving data shortcoming in the public debt coverage, including the lack of data on loan guarantees and non-guaranteed debt by SOEs, to support Debt Sustainability Analysis and policymaking. Further capacity building is essential given the challenges lying ahead of the FSM.

With these remarks, we wish the authorities all the success in their future endeavors.

Ms. Mannathoko submitted the following statement:

We thank staff for a well written set of reports and Messrs. Ray and David for their insightful buff statement. We note that while economic recovery has been sustained in recent years, growth and growth potential remain low, even as the economy contends with sizable risks. Alongside significant climate vulnerabilities, the likelihood of a sizable fiscal shock to the economy when Compact Trust Fund (CTF) grants expire after 2023, also continues to loom large. We applaud the progress made with climate preparedness as well as the impressive 17-fold growth in the FSM Trust Fund savings since 2014, as referenced in the buff statement. We encourage the authorities to continue building up this Fund that will help to address the economy's long-term challenges. We also urge the authorities to attend to the remaining gaps in climate change preparedness, including strengthening project management and mobilizing new grant financing for climate risks. We take note of the authorities' broad agreement with most of staff's assessment and limit our comments to the following issues.

Impact of fiscal cliff: Given that a freeze in Compact capital grants resulted in three years of recession in 2012–14 as the construction sector shrank, we are concerned that the fiscal risks stemming from revenue volatility (induced by the CTF disbursement rules linked to CTF investment returns) could again lead to a sizable adverse impact on growth post 2023, given the GAO's estimate of a 40 percent probability that the CTF will be unable to disburse funds in one or more years during FY2024–34. We note, furthermore that the 40 percent probability was assessed when global market prospects looked better than they do now, and we therefore support the authorities' request for a review of the Compact rules. While we note that the backlog of capital grant disbursements will support capital funding for some years after 2023, these grants will still end. Could staff elaborate on the potential impact of disbursement gaps and the implications of the expiry of the Compact for the authorities' plans with respect to the implementation and continuity of Compact funded projects post 2023.

Fiscal reforms: Despite the level of dependency on grant financing, with the U.S. Compact and supplemental grants supporting about one-third of total FSM national and state government expenditures, while other U.S. grants support an additional 14 percent of total FSM government expenditures, little progress has been made over the past five years with revenue mobilization and expenditure rationalization. We wonder if the main constraint is capacity or a small domestic production (and revenue) base, or if is it disruptive climate shocks or something else? We welcome staff views on what the most binding constraint to reform is, and on what authorities could do to overcome it. Could staff also elaborate on how much of the 2017–20 PFM reform roadmap has been implemented and on whether the team expects it to be completed next year?

Financial sector: Given the risk of regulatory gaps following the planned withdrawal of US FDIC oversight after 2023, we agree with authorities and staff regarding the imperative of strengthening FSM's banking supervision capacity; modernizing banking laws and regulation and protecting correspondent banking relationships. Could staff discuss any progress being made by the authorities on their communications technology agenda, especially the use of digitization and mobile technology to promote financial inclusion?

External sector and competitiveness: With sizable trade and service account deficits, the current account is essentially sustained with official transfers. Growing the export sector is therefore a priority. However, while there are clearly benefits to FSM being a dollar-based economy, there could also be some costs, such as the impact on price competitiveness and the risk of overvaluation. We note that unit labor costs seem especially high for a country with significant poverty and a per-capita GDP of just $3,500. This matters for private sector development (PSD), and in particular, for the competitiveness of key industries targeted in the PSD strategy that are less import-dependent, such as tourism and fisheries. Given this context, we wonder to what extent domestic production may be constrained by price competitiveness challenges and would encourage staff to explore this and also whether the current account norm assumption used in the EBA lite model holds in Micronesia's specific context. We note the data limitations cited in footnote 2 of the external sector assessment but would encourage an effort to estimate the long run equilibrium real exchange rate for Micronesia. Staff views are welcome.

Social welfare: Could staff comment on the social welfare implications of the expiry of the Compact and the authorities' strategy in this regard? Given the extent to which the four FSM States rely on Compact grants, which support 50 percent or more of each state governments' expenditures, and with dependency on grants highest in the state with the most poverty (GAO), we wonder what consideration authorities are giving to a different social welfare strategy - rather than the apparent reliance on government hiring to serve as a form of social safety net. We understand from ADB reporting that already, service delivery in the four state governments is increasingly constrained by the fiscal challenge posed by the Compact's expiration.

With these remarks, we wish the authorities success with their future endeavors.

Mr. Trabinski and Mr. Danenov submitted the following statement:

We thank staff for the insightful set of papers and Mr. Ray and Mr. David for their informative buff statement. The economy of the Federated States of Micronesia has performed encouragingly well in recent years, but the risks to the outlook are tilted to the downside. The outlook mainly reflects the forthcoming expiry of annual grants from the United States and associated risk of fiscal cliff stemming from eventual expiration of the Compact Agreement. The potential Compact renewal or grants from development partners represent a significant upside risk. The challenges related to climate change and natural disasters, emigration, financial sector supervision as well as the weak private sector, also weigh on the economic outlook.

Gradual adjustment is required to cope with the fiscal cliff expected after 2023. We welcome the authorities' measures to save windfall revenues, the creation of the special government committee and the adoption of the Action Plan 2023 that, among other things, sets the aim to build fiscal buffers and increase revenue mobilization. We encourage the authorities to continue building up the self-financed buffer, the FSM Trust Fund, which should increase the resilience of the economy. We agree with staff that improving public financial management and conducting expenditure reforms aimed at prioritizing public spending would contribute to fiscal sustainability, while protecting necessary investment in education, healthcare and infrastructure.

Resilience to climate change and natural disasters should be further developed. We thank staff for the insightful Climate Change Policy Assessment and hope that its results will encourage the authorities to seek further progress in natural disaster preparedness. We would welcome the development of the comprehensive disaster resilience strategy to harmonize actions at the national and state levels. It is also key to invest in climate resilient infrastructure and implement other mitigating measures, in particular, increasing the capacity of renewable energy generation. However, taking into consideration potential expiration of grants from the US, inability to draw funds from the FSM Trust Fund until 2030 and country's limited ability for revenue mobilization, it seems that the only option for financing Climate Response Strategy is by increasing external grants. Could staff provide their opinion on how feasible for the authorities would be to solicit necessary funding for climate?

Private sector activity should be vitalized. In order to ensure long-term growth perspectives, it is critical to improve the business and investment climate. The emphasis should be on easing the conditions for the development of the private sector in the main sectors of the economy – tourism, fisheries and maritime transportation. We commend the authorities for the initiatives aimed at streamlining FDI laws and creating a single national window for FDI. Could staff shed some light on whether the authorities consider exploring opportunities for other engines of growth, that could support the economy in the longer term?

Mr. Raghani, Mrs. Boukpessi and Mr. Ondo Bile submitted the following statement:

We thank staff for the comprehensive reports, and Mr. Ray and Mr. David for their informative buff statement.

We commend the authorities of the Federated States of Micronesia (FSM) for the positive macroeconomic performance of the past few years. Economic growth has remained above the country's historical average. Both fiscal and current account remain in surplus, underpinned by an upswing in corporate tax and saving of the windfall in spite of higher public investment. Inflation has also remained stable. Nonetheless, Micronesia is highly vulnerable to climate change and dependent on foreign support, including under the Compact Agreement with the United States. In this context, the scheduled expiration in 2023 of the Compact Agreement is likely to have a major potential impact on the economy including on banking sector oversight and protection against natural disasters. Thus, we urge the authorities to double their efforts in implementing the needed measures to preserve fiscal sustainability and address long-standing structural issues including by forcefully strengthening the national adaptation and mitigation strategy for resilience to climate change, enhancing the banking sector oversight and fostering private sector growth.

We concur with the thrust of staff appraisal and policy recommendations and would like to provide the following comments for emphasis.

We welcome the authorities' commitment to proceed with gradual fiscal consolidation to ensure fiscal sustainability. Such gradual fiscal adjustment should be achieved through further revenue mobilization and expenditure prioritization, while preserving the much-needed investment in key sectors like education, health and infrastructures. Advancing growth-friendly tax policy reforms, notably the introduction of the value-added tax as well as selected excises are also commendable measures aimed at boosting growth. Current efforts to strengthen public finance management with support from development partners are praise-worthy as they contribute to increase government spending efficiency and create room for spending to enhance climate change resilience.

Banking sector supervision needs to be reinforced to face the potential loss of the sector's oversight by the FDIC post-2023. We take good note of the agreement between the authorities and staff on strengthening the FSM Banking Board's capacity for banking supervision, revising the banking laws, maintaining correspondent banking relationships as well as putting in place prudential measures. In this regard, we welcome the assurances expressed by Messrs. Ray and David in their buff statement. We call on the Fund and other partners to provide the FSM with the appropriate technical assistance to help achieve these financial stability objectives.

We appreciate staff's paper on Climate Change Policy Assessment (CCPA) and would like to encourage them to extend such analysis on this macro-critical issue to other countries vulnerable to climate change. We commend the authorities for their efforts in mitigating the impact of climate-related shocks. Nevertheless, much more needs to be done especially in the context of the scheduled expiration of the U.S.-supported post-disaster assistance. We support the authorities' call to the international community to facilitate small states access to climate finance given the capacity constraints facing those countries.

Private sector development is key for higher and sustainable growth in FSM. We commend the authorities for their efforts aimed at improving the business climate, including through streamlining the FDI regime. Ongoing reforms in areas such as tourism, energy and other key sectors highlighted in the Appendix V of the report are also noteworthy as they help sustain growth, scale up fiscal revenues and foster employment.

With these remarks, we wish the authorities of FSM success in their future endeavors.

The Acting Chair (Mr. Zhang) made the following statement:

Micronesia comprises of more than 600 islands in the Pacific. It is spread over the world's fourteenth-largest geographic exclusive economic zone. The economy of this country has performed relatively well in recent years. However, it faces significant challenges down the road. One is related to the uncertainties associated with the scheduled expiration of the economic support from the United States under the Compact Agreement in 2023. Another is climate change, which is a typical phenomenon for many of the small island economies, and the authorities have already requested help and have agreed to engage with the Fund's activities under the Climate Change Policy Assessment (CCPA). The CCPA, which draws heavily on the expertise and close engagement of the Fund and the World Bank, will bring benefits to these countries.

The staff representative from the Asia and Pacific Department (Mr. Nozaki) made the following statement:

I thank Directors for insightful statements and questions. Several Directors raised questions on the potential renewal of the Compact Agreement and policy implications. I would like to share our views on this important question. The question raised was, can we predict the outcome of negotiations on the renewal of the Compact Agreement? At the current juncture, the answer would be no for several reasons. First, negotiations have just started, as announced by U.S. Secretary of State Pompeo during his visit to Micronesia earlier this month. Some discussions have taken place between Micronesia and the U.S. authorities on the distribution policy of the compact trust fund, but these discussions are not open to the public. As such, it is also difficult for us to assess the effectiveness of the government committee set up by the Micronesian authorities.

Second, renewal of the agreement can take various forms. Hypothetically, the magnitude of the 2023 fiscal cliff can be mitigated by an extension of compact grants for limited years or an ad hoc contribution to build up the Compact Trust Fund.

Third, negotiations can take a long time. The economic support under the Compact Agreement are written in multiple agreements. Perhaps more importantly, the renewal requires approval by the U.S. Congress. Against this background, staff developed the baseline projection based on the current Compact Agreement and highlighted significant macroeconomic uncertainty originating from the expected expiration of the agreement. Faced with the large uncertainty, it is important to prepare for the Compact's expiration. Staff and the authorities agreed on the need for a gradual fiscal adjustment, capacity building for bank supervision, and alternative disaster risk financing options. The level of preparedness of the authorities for the expiration remains low, but the authorities' intentions to consider tax policy reforms and interest in bank supervision technical assistance (TA) are encouraging.

Finally, what would be policy recommendations in case the compact is renewed? It would depend on the details and specifics of the renewal. For example, the timing and size of a fiscal adjustment would depend on reconfiguration of compact grants or the distribution policy for the Compact Trust Fund.

Ms. Moreno made the following statement:

We did not issue a gray statement but would like to emphasize some issues. On the fiscal cliff after 2023, we agree with staff that a gradual fiscal adjustment is needed to allow for fiscal space after the annual U.S. grant expires, and we encourage the authorities to follow growth-friendly tax policy reforms. The trust fund that will replace them most likely will not compensate for the current amount. Given also what the staff said, that there will be some delays in the negotiations and that we do not know the exact timing, we agree with staff's recommendation on using the Federated States of Micronesia Trust Fund (FSMTF) as a stabilizer. We also support the idea of building stronger self-financed buffers, as was stated by Ms. Pollard and Ms. Crane.

On correspondent banking relationships (CBRs), we consider this to be a key challenge and agree that TA by the Fund is very important.

On natural disasters, we know many islands are at risk, and infrastructure gaps remain, so building the fiscal and financial buffers is essential to be able to work toward building resilience and mitigating actions. Also, we believe there is a need to promote private and public partnerships as far as possible. We know it is complicated.

On data shortcomings, we acknowledge the limited staff resources in the Statistics Office, but we encourage the authorities to further work on strengthening data provisions.

Ms. Levonian made the following statement:

We issued a joint gray statement with Mr. Merk, so I want to simply emphasize a few points. First, allow me to repeat the key point made by Mr. Raghani: Climate change is a macrocritical issue. Climate change is resulting in a significant macroeconomic cost, not only to Micronesia, but in economies around the world, and small states are particularly vulnerable. The Fund has a key role to play in helping its members confront the growing cost of climate change. For this reason, we welcome the CCPA, the first such assessment in the Pacific region, and encourage continued collaboration with the World Bank on this critical issue.

Second, as Ms. Pollard outlined in her gray statement, risk pooling mechanisms can play an important role in helping manage the growing risk of climate change. In addition to risk pools, small states in our constituency have strengthened their resilience through resilient debt instruments. These innovative loans are structured to provide temporary debt service relief after natural disasters, reducing the risk of debt distress and likelihood of costly default. We thank staff for its support in developing resilient instruments and encourage further work to expand the resilience toolkit for countries vulnerable to climate shocks.

Finally, we welcome recent negotiations between Micronesia and the United States to extend certain provisions of the Compact of Free Association and welcome your comments in that respect. We share Ms. Pollard's hope that negotiations result in a smoothing of possible cliff effects and improvements in economic resilience. Regardless of how negotiations conclude, we encourage Micronesia to continue its prudent practices of investing fiscal savings to build buffers and to support long-term inclusive growth. With that, I wish the authorities well.

Ms. Pollard made the following statement:

Let me begin by thanking staff for the answers to technical questions, Mr. Ray and Mr. David for their helpful buff statement, and appreciate staff's comments on the Compact. I do not have much more to say to add to what staff said, but let me begin by noting that the United States first established Compacts of Free Association with three of the Pacific island states in 1983, the Federated States of Micronesia, the Marshall Islands, and Palau, and those at the time were a 20-year set of Compacts. Those were renegotiated and established for another 20 years in 2003, so this process is not without precedent. I also note that these Compacts are for more than simply an economic association. They encompass an entire range of relations between those island countries and the United States, including not just fiscal support but the financial sector, security, health care—an entire range of issues that are important to both the United States and these countries.

That said, there is clearly a risk that the support would not be extended and that these countries do need to prepare for a reduction in fiscal support. However, Secretary Pompeo's recent visit, which followed a historic visit by the heads of the three states to the White House in May, give us hope that the negotiations will lead to an extension of key provisions that will benefit both these island states and the United States.

On infrastructure, we would underscore the importance of taking best advantage of the backlog of unspent capital grants committed under the Compact, and in this regard, we welcome support from the Fund's Pacific Financial Technical Assistance Center (PFTAC), as well as that of other donors.

Finally, on the private sector, we want to underscore a point made by Mr. Trabinski and others on the importance of improving the environment for private-sector development and FDI. We encourage the authorities to deepen their structural reforms and welcome efforts to streamline FDI laws and create a single national window for FDI. We hope the authorities will also pursue sector-specific reforms, as recommended by staff.

Mr. Rashkovan made the following statement:

We welcome the progress that the authorities have made over the recent years ensuring solid growth and low inflation. Notwithstanding this, several chairs highlighted that the country faces significant challenges and uncertainty related to the expected expiry of the Compact Agreement with the United States in 2023, with critical implications on its capacity to address climate change-related risks. Since we have issued an extensive gray statement, I would like to limit my comments on this particular aspect.

As has been noted by several Directors, the vulnerability to weather-related natural disasters poses a major risk for macroeconomic and fiscal sustainability, while threatening infrastructure and livelihoods. The increased frequency and intensity of the natural disasters calls for prudent strategies to build policy and financial buffers. To this end, strengthening the resilience against the climate natural disasters shocks is macrocritical for the Federated States of Micronesia.

In this context, we fully support the joint Fund-World Bank Group partnership in developing the CCPA for small states. We welcome the fifth pilot CCPA for Micronesia and appreciate the findings and recommendations of the report, which successfully identifies the policy gaps and reviews mitigation, adaptation, and risk management plans, and suggests strategies to strengthen the resilience to climate change and natural disasters. In this context, like Ms. Pollard, Mr. de Villeroché, we encourage the authorities to increase the use of disaster risk transfer mechanisms, including the risk pooling mechanism like Pacific Catastrophe Risk Insurance Facility.

We also stress the importance of further strengthening of public investment management and mobilizing grant financing going forward. We support Ms. Levonian, Mr. Merk, and Mr. Psalidopoulos on encouraging the authorities to develop a comprehensive disaster resilience strategy in cooperation with World Bank and other development partners.

Finally, we look forward to further CCPAs for other vulnerable small states, which will help them to respond adequately to macroeconomic challenges and safeguard fiscal and external sustainability. With these remarks, I wish the authorities all the success in their future endeavors.

Mr. Rozan made the following statement:

I wanted to limit myself to three short comments in light of that we issued a gray.

First, on the Compact and on the 2023 deadline and possible cliff, I wanted to thank staff, as well as Ms. Pollard, for this very useful information, and we hope to be updated in the future regarding the possible conclusion of this negotiation. In parallel, it will be important for the authorities to continue to build up buffers and to have adequate capability to address any shortfall in revenue after this date.

Second, on structural issues, we agree with staff regarding the recommendation on enhancing transportation, the investment climate, and access to financial services. There is certainly scope to enhance the investment climate, building on the efforts that have already been made, and in particular the absorption capacity for the grants and loans that are yet to be disbursed.

Finally, on climate, we wanted to thank Fund and World Bank staff for the very useful CCPA. It clearly shows how climate issues can be macrocritical for countries. We particularly appreciated Figure 12, which describes the possible scenarios for climate change adaptation spending and shows what can be the impact on the macro framework for a given country. The lessons that can be drawn from the CCPA can be shown across a wider range of countries, in particular in the Pacific, and we encourage the authorities to consider participating in the Pacific Catastrophe Risk Insurance Facility to help mitigate the risks.

Going forward on this pilot project, the CCPA, we believe the project is now at a very mature phase. It is providing a lot of very useful information, both to this Board and to the country's authorities, and it may be time to look at possibly scaling up of this instrument across a wider range of countries. We discussed Mali this morning, and maybe this is the kind of country where it is useful to inform the authorities and the wider development communities on mitigation and adaptation strategies.

Mr. Chikada made the following statement:

I would like to make a few comments to augment our gray statement and echo what others have just said.

First, we commend the mission team for their stocktaking effort and analysis with respect to the possible adverse effects, including those on the banking sector, which could materialize in the event of expiration of the Compact Agreement, and second, the CCPA, which is a first assessment in the Pacific. These outputs are an important contribution of the mission team, and will provide a good and helpful basis for the authorities to consider necessary actions to prepare for and mitigate the possible adverse shocks.

Second, we understand that the expiration of the Compact Agreement and Micronesia's capacity to address climate changes are closely linked, as Micronesia relies greatly on U.S. support to finance disaster management and reconstruction. As climate change is essentially an exogenous factor over which Micronesia has little control but which poses an existential threat to it, we totally agree with staff's remarks that sustained international support is required. On this point, I would like to note that Japan is the second largest donor to the Federated States of Micronesia after the United States, and Japan is contributing disaster relief as well as putting effort into grassroots support, such as providing ambulances and upgrading school facilities. Finally, but perhaps most importantly, as Micronesia faces significant uncertainties and the negotiation has just begun, we ask staff to continue to carefully monitor and assess the progress of the discussions on the post-2023 relationship with the United States and give further policy advice to the authorities as appropriate.

The staff representative from the Asia and Pacific Department (Mr. Nozaki), in response to questions and comments from Executive Directors, made the following statement:

I see that there is an agreement or endorsement of the staff's recommendations to prepare for the large uncertainty originating from the potential scheduled expiration of the Compact Agreement. I fully agree with the positive message on CCPA. The CCPA exercise has been useful for the prospective country team and also for the authorities because it combines expertise of the Fiscal Affairs Department and also World Bank in a wide range of issues for climate change, including adaptation, disaster risk management, and so forth. Thank you again for the very insightful comments.

Mr. Ray made the following concluding statement:

Let me begin by thanking colleagues for their constructive comments. Just a personal observation having been to Micronesia ahead of Secretary Pompeo as the first Fund Executive Director to go, you cannot appreciate how remote a country like Micronesia is until you go there. I understand that Secretary Pompeo's wife thought it a postcard, and I think it is a postcard as you fly into Pohnpei, but I did worry about the observation that the same thing applies to the Marshall Islands. They are quite different places. Just to give you an indication, if you go commercially, you have to fly to Hawaii, and then you have to fly five hours to the Marshall Islands and then take another three one-hour hops to get to the capital of Pohnpei. If you happen to be a member of Congress from Yap, one of the four states, you have to fly out of the Federated States of Micronesia into the United States, into Guam, and then fly back in again to get to Congress meetings, which is a rather interesting thought. These four states are spread across something as wide as Australia or as wide as the United States.

My authorities broadly agree with the thrust of the staff report, including the need to preserve fiscal space up to 2023 and to continue with what is quite a prudent approach to save as much as possible into their own trust fund. They are considering some active tax reform and are looking to prepare themselves as much as possible for the risk that the Compact does not get renewed. As Ms. Pollard stressed, this Compact is an incredibly important thing for these three states. It is not just about the fiscal side. It is about the financial system. It is about aviation safety. It is about biosecurity. It is about the postal service. It is quite critical to them, and it is about security more broadly.

That said, on the Compact, I very much appreciate Mr. Nozaki's comments. It is pretty unfair to ask staff to predict the outcome of a negotiation to which they are not a party. All I can say is that my authorities have been approaching these negotiations extremely positively, as Ms. Pollard said. The historic meeting at the White House has certainly been very important and Secretary Pompeo's visit also very important. My Micronesian authorities have told me that they are approaching this in a very positive way, but at the same time, they are doing as much as they can to prepare for different outcomes.

The second thing that I wanted to comment on is the CCPA. This is the first pilot in the Pacific, and as other chairs have said, it has been very successful. My authorities are very appreciative, including the efforts to be as practical as possible, which is very important for these small states. The last pilot is Tonga later this year, and this chair will be encouraging a quick review of the pilot in order to come back to the Board with a proposal to continue the program.

I would like to reiterate one issue that would be very helpful for staff to think about in the context of the Pacific, which is trust fund governance. As I have said in the Board on a number of occasions, the building up of all these trust funds in the Pacific is a bit scary because the history for these things is not great, and it is an area where the Fund can provide valuable assistance to my authorities and probably others, and I would encourage staff to think about that.

Let me conclude by thanking both teams. We had a group photograph with the U.S. Ambassador, which was an extraordinarily large group given both the Article IV team and the CCPA team. I was struck by how well the two teams worked together and across both the Fund and the Bank, and that is a credit to the mission chiefs. I did want to single out Mr. Nozaki there because believe this is his first role as a mission chief. My authorities asked me to express how much they appreciated his contribution, and one of the great things about Mr. Nozaki is that my authorities recognize him as a listener, and that is very important in this region that mission chiefs listen to the authorities; and it is a credit to the Fund for him to lead this team, and so we thank him very much.

The Acting Chair (Mr. Zhang) noted that The Federated States of Micronesia is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Micronesia's strong economic performance and improved fiscal and external positions. Directors noted, however, that significant challenges remain related to the expected expiration of the U.S. Compact Agreement, climate change, and weak private sector activity. Against this backdrop, Directors emphasized the need for steadfast policy actions and reforms to reduce uncertainty and risks, strengthen resilience, and promote private sector-led growth.

Directors welcomed the authorities' commitment to building fiscal buffers by saving revenue windfalls. In light of the uncertainty regarding the continuation of the Compact grants, they recommended a gradual fiscal adjustment through domestic revenue mobilization and improved expenditure efficiency. In particular, Directors encouraged implementation of growth-friendly tax policy reforms, including the introduction of a value added tax (VAT), and limiting wage bill growth and nonessential expenditures, while safeguarding priority spending on education, healthcare, and climate-resilient infrastructure. Ongoing efforts to improve public financial management would also contribute to fiscal sustainability.

Noting the vulnerability of Micronesia's economy to natural disasters and climate change, Directors welcomed the joint IMF-World Bank Climate Change Policy Assessment. They agreed that Micronesia's resilience to climate change could be strengthened by closing gaps in preparedness, developing a disaster resilience strategy, and through a greater focus on adaptation. Directors encouraged greater use of disaster risk transfer mechanisms, including disaster insurance.

Directors urged the authorities to strengthen their banking regulation and supervision capacity given the possible reduction in FDIC oversight in 2023. They underscored the need to update banking laws, adopt prudential banking regulations, and develop a reform roadmap to strengthen the Banking Board's supervision of commercial banks.

Directors emphasized the importance of vitalizing the private sector to shore up potential growth. In this regard, they emphasized the importance of improving the business and investment climate, including by lowering business startup costs, digitalizing the land registry, and reducing undue regulatory burdens on FDI.

Directors commended the authorities for their efforts to strengthen data provision and encouraged continued use of technical assistance for revenue administration, public financial management, financial sector supervision, and macroeconomic statistics.

It is expected that the next Article IV consultation with Micronesia will be held on a 24-month cycle.

APPROVAL: October 6, 2021

CEDA OGADA
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Fiscal policy

1. ***Further staff comments about the impact of the proposed fiscal consolidation (4-5 percent and 0.1-0.3 percent annually) given the low-growth outlook of around 0.6 percent (its potential) for the short and medium term will be welcomed.***

- As noted in the staff report, the gradual fiscal adjustment recommended over the 2020-24 is estimated to bring down growth by 0.1-0.3 percent annually during this period, against the FSM's potential growth estimated at 0.6 percent.
- Nonetheless, the FSM has scope for mitigating the negative growth impact through structural reforms aimed at improving the implementation capacity of capital projects and vitalizing private sector activities.
- Moreover, an alternative to the gradual fiscal adjustment, i.e., a sudden, large-scale adjustment closer to 2023, would lead to even larger macroeconomic uncertainty and a sharp output contraction.

2. ***Little progress has been made over the past five years with revenue mobilization and expenditure rationalization. We wonder if the main constraint is capacity or a small domestic production (and revenue) base, or if is it disruptive climate shocks or something else? We welcome staff views on what the most binding constraint to reform is, and on what authorities could do to overcome it. Could staff also elaborate on how much of the 2017–20 PFM reform roadmap has been implemented and on whether the team expects it to be completed next year?***

- While it is difficult to ascertain impediments to fiscal reforms, the FSM has faced challenges related to national-level consensus building, given its federal structure, comprising four states with diverse cultures. In-depth analysis of the FSM's fiscal federalism and how to share the burden of fiscal adjustment among states may help increase understanding at state levels.
- The authorities adopted the 2017-20 PFM Roadmap in July 2018. The key elements of the roadmap include implementing a new financial management IT system, a complete review of the Financial Management Regulations, and improving reporting standards. The implementation of the new IT system—the critical building block for the other elements of the roadmap—has started with support from the World Bank, with tender processes starting soon.

US Compact Agreement and FSM Trust Fund

3. ***Could staff comment on the state of negotiations to amend the Compact Trust Fund agreement to smooth distribution volatility?***

- There have been discussions on the CTF distribution policy at technical levels. According to a report issued by U.S. Government Accountability Office in July 2019 (GAO-19-648T), the distribution policy for the Compact Trust Fund has been discussed at trust fund committee meetings participated by U.S. and Micronesian representatives.
- More recently, U.S. State Secretary Pompeo visited Micronesia and met with the leaders of the Freely Associated States (FAS, comprising the FSM, the Marshall Islands, and Palau) in early August. At the visit, Secretary Pompeo announced that the United States has begun negotiations on extending our respective compacts of free association with each of the FAS.

4. ***Further staff comments on the authorities' view of the potential renewal of the Compact and of the effectiveness of the government committee established to plan for the expiry of the grants are welcomed.***

5. ***In light of the visit of the U.S. Secretary of State to FSM in August (after the circulation of the report), could staff update their views on the likelihood of the U.S. Compact Grants being renewed beyond FY 2023?***

6. ***Could staff comment on the chance of a renewed agreement and on the level of preparedness of the authorities in case of a definitive expiration. Could staff elaborate on its policy recommendations in case the Compact is renewed?***

- Staff will respond to Questions 4-6 during the Board meeting.

7. ***We are concerned about the lack of agreement between staff and authorities around the drawdowns from the FSMTF beyond 2023. Could staff comment on this, as well as update on the status of negotiations with the fund managers on the CTF distribution formula and legislation?***

- The authorities and staff agree that the current arrangement restricting post-2023 distributions from the CTF to investment returns will result in large revenue volatility, and that reconfiguring the distribution arrangement aimed at lowering the volatility will help reduce the fiscal risks. The authorities are seeking this route, noting that the FSMTF should be further built up beyond 2023 to ensure benefits for future populations and reduce dependence on foreign financial assistance.
- It remains uncertain whether the distribution arrangement will be reconfigured—this would require amending the Trust Fund Agreement under the U.S. Compact

Agreement, for which congressional approval by the United States is necessary. In this regard, staff views that, *should the current arrangement prevail*, offsetting the revenue volatility by drawdowns from the FSMTF would be better than allowing a potential sudden drop in CTF distributions to translate into undue expenditure cuts.

- On the status of negotiations on the CTF distribution policy, please see the answers for Question 3.

8. ***Could staff elaborate on the possible concessional financing sources to the FSM as an alternative to the U.S. Compact grant post 2023?***

- In the absence of access to the international capital market and a very limited domestic market, possible concessional financing sources for post-2023 include a combination of grants and concessional borrowing from development partners, notably the Asian Development Bank and World Bank, and bilateral lenders and donors.

9. ***While we note that the backlog of capital grant disbursements will support capital funding for some years after 2023, these grants will still end. Could staff elaborate on the potential impact of disbursement gaps and the implications of the expiry of the Compact for the authorities' plans with respect to the implementation and continuity of Compact funded projects post 2023.***

- Unless the Compact Agreement or parts of it are renewed, Compact grants amounting to 20 percent of GDP will expire in FY2023 and be replaced by investment returns accruing to the CTF, projected at around 11 percent of GDP in FY2024. As a result, the overall balance is projected to turn from a surplus of around 4½ percent of GDP in FY2023 to a deficit of 4½ percent of GDP in FY2024.
- The FSM has access to a large amount of unused capital grants committed under the Compact Agreement (around $200 million and more than 50 percent of GDP) which can still be accessed even after the expiration of the Compact in 2023.
- However, the country's limited capacity to implement capital projects remains the main bottleneck behind the underutilization of the Compact capital grants, which calls for strengthening public investment management.

10. ***Could staff comment on the social welfare implications of the expiry of the Compact and the authorities' strategy in this regard? Given the extent to which the four FSM States rely on Compact grants, which support 50 percent or more of each state governments' expenditures, and with dependency on grants highest in the state with the most poverty (GAO), we wonder what consideration authorities are giving to a different social welfare strategy - rather than the apparent reliance on government hiring to serve as a form of social safety net. We understand from ADB reporting that already, service delivery in the four state governments is increasingly***

constrained by the fiscal challenge posed by the Compact's expiration.

- Unless the U.S. Compact grants are renewed, the FSM is expected to face a fiscal cliff in 2024. Without fiscal adjustment, the fiscal cliff may need to be accompanied by expenditure cuts, which would squeeze space for social welfare spending. Therefore a gradual fiscal consolidation for 2020-24 is warranted, with revenue mobilization playing a significant role to preserve spending on education, healthcare, and infrastructure.
- Analysis of fiscal federalism and how to share the burden of the fiscal adjustment among states could be useful to further assess the social welfare implications of the fiscal adjustment.

Debt Sustainability

11. ***The DSA highlights that natural disaster shocks have a particularly adverse impact on debt sustainability. Could staff comment on the potential role climate resilient debt instruments (e.g., loans with "natural disaster clauses") could play in promoting debt sustainability?***

- Climate resilient debt instruments are an attractive vehicle for vulnerable countries with high debt burdens. For instance, Grenada was able to include a hurricane clause in its debt restructuring that provides relief on debt servicing in the event of a natural disaster.
- As FSM's debt is mainly from official lenders, there would be little scope for inserting such clauses. The government's policy to avoid incurring new debt also limits the scope for using climate resilient debt instruments in the FSM context. Staff's advice therefore focuses on continuing to put in place contingent financing arrangements with its main development partners.

12. ***The application of a 20-year time horizon in the Debt Sustainability Analysis is appropriate, helping highlight well ahead of time the elevated risk of debt distress in the outyears. Can staff comment on prospects to broaden available debt data?***

- The data coverage for general government external debt is broadly adequate because data are compiled from audited financial statements for the national and state governments.
- Nonetheless, it would be challenging to expand the coverage to loan guarantee, non-guaranteed debt held by state-owned enterprises, and private sector debt, given the lack of underlying data. While data on contingent liabilities related to public-private partnerships are unavailable, the underdeveloped institutional framework and capacity in the FSM suggests that such liabilities are unlikely to be substantial. Against this background, the Debt Sustainable Analysis (DSA) covers

general government debt owed by national and state governments, while the standard contingent liability stress test with default setting is used to analyze debt not covered by the DSA.

Financial sector

13. ***In what ways can the Fund provide further assistance to the authorities to develop prudential regulations and relevant technical capacity?***

- PFTAC and LEG have assisted the Banking Board and plan to continue. The Board and PFTAC initiated a banking regulatory reform project in 2017, with a workshop providing advice on key components of banking law and regulations and undertaking a preliminary assessment of the banking regulatory framework.
- Recently, PFTAC and LEG started technical assistance to the Banking Board in revising and updating the FSM banking law. A team comprising legal and banking supervision experts visited Pohnpei in July 2019 to stock-take the current banking legal framework, discuss applicable international standards, and recommend options to align the Banking Act with best practices. Follow-up technical assistance will be provided as necessary and subject to resource constraints. Building on these supports, the Banking Board is expected to develop a draft bill to amend the Banking Act. The Board has also requested training for bank examiners, which PFTAC has planned for FY21.

14. ***Further staff comments on the authorities' advances in strengthening banking supervision are welcomed.***

- Please see the answers for Question 13.

15. ***We understand that FSM is in a unique situation and has only one domestic commercial bank, thus we would welcome staff's views on how to promote private sector lending (please also see below) as well as how much resources FSM could put on to build its own banking supervision capacities, and if there is any scope for FSM to learn from other countries' experiences.***

- While only one domestic commercial bank exists in the FSM, the banking sector has a relatively large deposit base, amounting to 90 percent of GDP, while the loan-to-deposit ratio remains as low as 15 percent. Accordingly, the main driver for low private sector credit seems to be structural impediments rather than funding constraints. As discussed in the staff report, such impediments can be addressed by using land lease as collateral, strengthening the business climate, and enhancing financial literacy.

- On resource requirements, it would be important to strengthen technical expertise of bank examiners in the Banking Board through training, while expanding supervisory oversight to the FSM Development Bank and credit unions may require hiring more examiners. PFTAC TA would be able to introduce good practice and successful reform experiences in other Pacific island countries.

16. ***We would appreciate staff's comments on the authorities' view of not placing the FSMDB under the supervision of the Banking Board at this stage?***

- In the authorities' view, expanding the oversight of the Banking Board to the FSM Development Bank (FSMDB) would be premature at this stage, as the FSMDB will remain profitable and fully funded by government capital and retained earnings. The FSMDB's balance sheet shows that its assets are funded mostly by equity, with gross liabilities remaining at US$1.5 million (against total assets of US$60 million) at end-2018.
- Nonetheless, staff considers that the rapid credit growth recorded by the FSMDB would warrant close monitoring, and that placing the bank under the supervision of the Banking Board can help ensure prudent lending and promote sound financial deepening.

17. ***Could staff discuss any progress being made by the authorities on their communications technology agenda, especially the use of digitization and mobile technology to promote financial inclusion?***

- The authorities are undertaking reforms in the ICT sector, in particular for greater and more affordable internet connectivity. Following the landing of fiber optic submarine cables to three of the four states, the authorities are now focusing on capital investments to improve the core on-island infrastructure necessary for widespread access and reforms on the legislative and regulatory frameworks. These reforms can help promote financial inclusion through digitalization.
- The FSM's mobile penetration is the lowest among the Pacific islands, with the penetration rate (i.e., mobile telephone subscribers per 100 inhabitants) at 16 percent in 2016. Thus, more mobile subscriptions will broaden access to internet services, reduce the cost per user, and facilitate financial inclusion efforts, as discussed in a recent IMF paper "Strategy for Fintech Applications in the Pacific Island Countries" (IMF Departmental Paper No 19/14).

External sector

18. ***We wonder to what extent domestic production may be constrained by price competitiveness challenges and would encourage staff to explore this and also whether the current account norm assumption used in the EBA lite model holds in Micronesia's specific context. We note the data limitations cited in footnote 2 of the***

external sector assessment but would encourage an effort to estimate the long run equilibrium real exchange rate for Micronesia. Staff views are welcome.

- While the FSM's real effective exchange rate (REER) appreciated in 2015 due to strengthening of the U.S. dollar, it depreciated since 2016 due to low inflation in the FSM compared with its trading partners. The FSM's manufacturing unit labor cost decreased over the recent years. Accordingly, price competitiveness does not seem to have constrained domestic production. In staff's view, weak private sector activities have originated mainly from the weak business and investment climate and structural impediments to foreign direct investment and private sector credit.
- As discussed in Appendix II, the EBA lite model works relatively well for the FSM, as the current account norm incorporates the policy gap consisting mostly of the fiscal adjustment needs in the FSM. The REER approach is not applied due to data limitations, and is not suitable to address the structural break associated with the expected expiration of the U.S. Compact grants. Further refinements can be considered for the next Article IV Consultation.

Climate change issues and CCPA

19. ***Does the sensitivity analysis include impacts of degraded blue biodiversity on Micronesia's GDP? Are there any key recommendations for the protection of the blue economy that should be considered to help manage risks to growth?***

- As noted in the CCPA, increases in sea level rise, strong winds, ocean temperature and acidification have the potential to impact on natural resources and livelihoods. El Niño and La Niña events will continue to occur in future. These effects would lead to higher uncertainty and volatility in the fishery sector, affecting growth and fishing revenues. Nonetheless, staff did not include these effects in the sensitivity analysis because it is highly challenging to estimate the quantitative impact. Advising on protection of the blue economy is beyond the scope of the CCPA.

20. ***Could staff comment on the potential impact of climate change in relation to the FSM's revenue outlook from the fishing industry, as we note that a large portion of the revenue comes from fishing licenses?***

- Please see the answer for Question 19.

21. ***What plans are there to extend the roll out of CCPAs beyond the pilot phase, and particularly to other small island countries in the region? What lessons can we draw from this CCPA for the region; and how are we sharing them with other islands facing similar risks?***

- Staff will begin a stock take of the CCPA pilot in the coming months, which will chart a way forward for the Fund's own efforts, and collaboration with the World Bank, in supporting countries build resilience to climate change.
- A further pilot CCPA is planned for Tonga later in the fiscal year. This will complete the intended 6 CCPA pilots. In addition to FSM, CCPAs have been completed for St. Lucia, Seychelles, Grenada and Belize. These have all been published.
- The pilot for the FSM suggests that CCPAs can be a highly useful exercise for other Pacific island countries, as they allow in-depth analysis on macroeconomic implications of climate change, drawing on a wide range of expertise from FAD and the World Bank.

22. ***Could staff describe how many CCPA are planned in the coming years and which countries will be analyzed?***

- Please see the answer for Question 21.

23. ***The CCPA highlights key adaptation delivery risks of project delivery capacity constraints within the Government and also a large development financing gap. What consideration has there been for technical assistance from donors and other MDBs to help build project capacity?***

- Donors have been addressing implementation capacity in the context of their own operations. Compact-financed investments are assisted by the US Engineering Corps. The World Bank has provided grant funding for strengthening public financial management, which specifically targets improved tax administration and completeness, reliability and timeliness of financial reporting. The World Bank has also established a Project Implementation Unit (CIU) in the Ministry of Finance. The CIU provides procurement, financial management and safeguards support for World Bank funded projects and has helped improve project implementation.

24. ***On financing, Figure 12 highlights that adaptation investment now could decrease the economic impact of a natural disaster by 40 percent. Given this analysis and the financing gap for adaptation, what analysis has been done of further funding sources and, within the resources available, a prioritization of the pipeline for investment?***

- The CCPA emphasizes that the key priority in the short to medium term is increasing implementation capacity, including through improving prioritization in the public investment program. Undertaking prioritization analysis of the existing pipeline and identification of specific funding sources is important, but it is beyond the scope of the CCPA.

25. ***On paragraph 46, a discrepancy in the evaluation of amounts spent on adaptation across countries undergoing CCPAs is mentioned. Could staff explain if there is plan to harmonize this methodology, as comparability and data reliability is significant to support the CCPA's credibility?***

- Staff draws on existing analysis where possible for CCPAs. The methodology referred to here is specific to the Pacific region and will be drawn on if possible for the forthcoming Tonga CCPA. Applying it in other regions will be considered following the CCPA review.

26. ***Taking into consideration potential expiration of grants from the US, inability to draw funds from the FSM Trust Fund until 2030 and country's limited ability for revenue mobilization, it seems that the only option for financing Climate Response Strategy is by increasing external grants. Could staff provide their opinion on how feasible for the authorities would be to solicit necessary funding for climate?***

- While it is challenging to assess the availability of grants from multilateral and bilateral sources, the FSM continues to have access to grants financing from the ADB and World Bank. The financing gap analysis in the CCPA and further in-depth analysis could help raise the awareness of development partners. Financing constraints can be also mitigated by project prioritization, including shifting the focus from mitigation to adaptation projects.

Structural issues

27. ***Can staff provide an estimate of women's labor force participation and women's formal sector employment in the FSM?***

- According to the FSM's 2010 Census, 41.8 percent of the total labor force were women in 2010. In addition, women accounted for 41.3 percent of the total formal sector employment while the total female employment rate was 83 percent.

28. ***In order to ensure long-term growth perspectives, it is critical to improve the business and investment climate. The emphasis should be on easing the conditions for the development of the private sector in the main sectors of the economy – tourism, fisheries and maritime transportation. We commend the authorities for the initiatives aimed at streamlining FDI laws and creating a single national window for FDI. Could staff shed some light on whether the authorities consider exploring opportunities for other engines of growth, that could support the economy in the longer term?***

- As highlighted in Appendix V, the FSM is currently implementing key structural reforms in the fisheries, information and communication technologies, maritime and energy sectors, with support from the World Bank. Aside from improving the business and investment climate, targeted sector-specific reforms can help to unlock the potential for these sectors as engines of growth.

Other

29. ***We took note in the Information Annex of the limited staff resources in the Statistics Office, which, in turn, limits the support that PFTAC can effectively provide. Staff comments would be welcome.***

- The National Statistics Office (NSO) is in charge of producing a wide range of economic statistics, including national accounts, price statistics, balance of payment, government financial statistics, and household surveys. According to its website, the NSO is based at the capital (Palikir) with 8 staff, while branch offices in the 4 states are manned with 3 working staff each. Retention and possible new hiring of skilled statisticians would be helpful in increasing the effectiveness of PFTAC TA.