



FEDERATED STATES OF MICRONESIA

May 2026

2026 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR FEDERATED STATES OF MICRONESIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2026 Article IV consultation with Federated States of Micronesia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its April 27, 2026 consideration of the staff report that concluded the Article IV consultation with Federated States of Micronesia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on April 27, 2026, following discussions that ended on January 28, 2026, with the officials of Federated States of Micronesia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 6, 2026.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Statement by the Executive Director** for Federated States of Micronesia.

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IMF Executive Board Concludes 2026 Article IV Consultation with The Federated States of Micronesia

FOR IMMEDIATE RELEASE

- *Growth is expected to moderate to 0.7 percent in FY2026 as real income compression and elevated import costs weigh on activity, while inflation is projected at 3.2 percent.*
- *The priority is to expedite climate-resilient public investment and improve project quality, with the support of development partners. Consensus building is needed to reignite reforms that would support a vibrant private sector, helping create high-quality jobs.*
- *The medium-term fiscal strategy needs to carefully balance the preservation of fiscal buffers with financing development goals and climate adaptation needs.*

Washington, DC – May 5, 2026: On April 27, 2026, the Executive Board of the International Monetary Fund (IMF) completed the Article IV Consultation for The Federated States of Micronesia.^{1, 2}

The FSM is progressing to achieve development goals, under challenging circumstances. Growth rebounded to an estimated 2.3 percent in FY2024, before moderating to 1.1 percent in FY2025 as the effects of higher fishing output and public sector wage increase dissipated and commencement of new infrastructure projects was delayed³. Inflation slowed to 3.2 percent in FY2025 as global commodity prices moderate and US inflation gradually eases.

The fiscal surplus narrowed as revenues normalized following windfall gains and states increased expenditure in response to the higher revenue envelope from a greater share of fishing fees. Public debt declined to 8.9 percent of GDP in FY2025, while the assets of the trust funds reached 510 percent of GDP.

Growth moderates to 0.7 percent in FY2026 as real income compression and higher import costs, particularly for the relatively fuel intensive fishing sector, weigh on activity. At the same time, activity is bolstered by a gradual pickup in public investment funded by the Compact of Free Association with the United States. Inflation is expected to remain at 3.2 percent in 2026 reflecting gradual passthrough of higher oil prices due to the conflict in the Middle East.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

² Under the IMF's Articles of Agreement, publication of documents that pertain to member countries is voluntary and requires the member consent. The staff report will be shortly published on the www.imf.org/fsm page.

³ Fiscal year ends on September 30.

There are significant downside risks to the economic outlook from slower than envisaged implementation of infrastructure projects, intensifying climate change and prolonged conflict. On the upside, reforms to ease bottlenecks could ignite private sector activity, create jobs and reduce aid dependency.

Executive Board Assessment⁴

Executive Directors agreed with the thrust of the staff appraisal. They highlighted Micronesia's progress on development goals, under challenging circumstances. While welcoming the renewal of the Compact of Free Association, Directors noted that medium-term growth prospects remain subdued, reflecting capacity constraints, sustained emigration, and the intensifying effects of climate change. They called for efforts to expedite climate-resilient public investment and advance structural reforms to bolster growth and strengthen resilience. Directors underscored the importance of support from the Fund and other development partners to strengthen capacity and reform implementation.

Directors agreed that the medium-term fiscal strategy should carefully balance preserving fiscal buffers with addressing development goals and climate adaptation needs. They stressed the importance of anchoring fiscal policy in a credible medium-term framework along with measures to strengthen public financial and investment management, particularly at the state level. Noting the importance of fostering private sector investments and strengthening revenue mobilization, Directors welcomed plans to modernize the tax system. They recognized the importance of continued reliance on grants and concessional borrowing to safeguard long-term fiscal sustainability. Prudent use of trust funds to finance public investment is appropriate.

Directors welcomed that the financial sector remains sound, while underscoring that the recent increase in nonperforming loans warrants close monitoring. They agreed that the sector could play a greater role in supporting private-sector development and encouraged greater efforts to support financial deepening through digital banking and measures to close information gaps. They noted that reinforcing institutional cooperation and regulatory oversight remains critical to broadening access to credit.

Directors emphasized the need for stronger coordination across national and state governments to accelerate structural reforms to unlock private-sector-led growth. They noted that priorities include streamlining laws and regulations, particularly related to foreign direct investment, business regulations, and land use. Ongoing efforts to promote job creation and address skill mismatches to mitigate emigration pressures are important. Directors welcomed improvements in disaster risk financing layering and progress on developing the National Adaptation Plan. Noting the substantial climate adaptation needs, they underscored the need to integrate climate-specific provisions in infrastructure planning. Directors underscored the need to support effective decision-making through timely publication of statistics.

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

⁴ At the conclusion of the discussion, the Managing Director, as Chair of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.IMF.org/external/np/sec/misc/qualifiers.htm>.

Table 1. Selected Economic Indicators

Nominal GDP (FY2023):	US\$443 million									
Population (FY2023):	94,654									
GDP per capita (FY2023):	US\$4,680									
IMF Quota:	SDR 7.2 million									
	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031
			Est.	Projections						
Real sector (annual percent change)										
Real GDP	-3.1	1.1	2.3	1.1	0.7	1.1	1.4	1.0	0.7	0.7
Consumer prices	5.0	6.2	5.4	3.2	3.2	4.0	1.7	2.0	2.0	2.0
Consolidated government finance (in percent of GDP)										
Revenue and grants	76.1	61.3	61.5	60.6	62.4	66.6	69.3	69.2	64.8	62.2
Revenue	47.5	32.2	32.3	32.9	32.4	31.9	31.3	30.9	30.5	30.2
Tax revenue	26.9	13.3	13.8	16.2	15.6	15.8	15.6	15.6	15.5	15.5
of which: corporate income tax	14.2	1.8	2.4	4.0	3.3	3.3	3.3	3.3	3.3	3.3
Non-tax revenue	20.6	18.9	18.5	16.8	16.8	16.1	15.7	15.3	15.0	14.7
of which: Fishing license fees	17.6	16.1	15.1	13.5	13.8	13.1	12.7	12.3	12.0	11.6
Grants 2/	28.6	29.1	29.2	27.7	29.9	34.7	38.0	38.3	34.3	32.0
Expenditure	59.4	63.2	59.8	60.2	62.0	66.9	69.9	70.0	65.7	63.4
Expense	59.0	61.0	55.4	56.3	55.9	55.9	55.9	56.3	56.0	55.8
Net acquisition of nonfinancial assets	0.4	2.1	4.4	3.9	6.1	11.0	14.0	13.7	9.7	7.6
Gross Public Investment	5.9	7.3	9.0	8.3	10.2	14.7	18.0	18.1	14.5	12.5
Net lending/borrowing	16.8	-1.8	1.7	0.4	0.4	-0.3	-0.6	-0.8	-0.9	-1.2
Net lending/borrowing (excl. grants)	-11.8	-31.0	-27.5	-27.3	-29.5	-35.0	-38.6	-39.1	-35.2	-33.2
Public debt (outstanding stock, end of period)	15.1	12.8	10.4	8.9	7.5	7.3	7.7	8.4	9.1	9.5
Balance of trust funds 3/	298.1	325.6	412.9	509.6	517.3	518.2	528.4	539.2	551.5	563.0
Commercial banks (in percentage of GDP; end of period)										
Loans 4/	13.2	11.6	10.3	10.4	10.6	10.8	11.0	11.2	11.4	11.6
Deposits	103.1	100.0	92.0	96.4	94.3	93.2	92.1	91.0	89.9	88.8
Interest rates (in percent, average for FY)										
Consumer loans	14.3	14.3	14.8	15.3	...	...	...	...	...	...
Commercial loans	4.8	4.8	4.6	4.8	...	...	...	...	...	...
Balance of payments (in millions of U.S. dollars)										
Trade balance	-183.8	-189.2	-207.7	-204.3	-227.4	-254.0	-269.2	-276.9	-270.2	-268.3
Net services and income	34.1	21.4	17.9	10.5	12.1	10.5	9.4	8.2	7.3	6.5
Private and official transfers	218.3	192.1	206.5	212.7	221.0	241.3	255.7	262.1	256.3	255.9
Current account	68.6	24.4	16.6	18.9	5.7	-2.2	-4.2	-6.7	-6.6	-5.9
(in percent of GDP)	16.5	5.5	3.5	3.8	1.1	-0.4	-0.7	-1.1	-1.1	-1.0
External debt (in millions of U.S. dollars; end of period)										
Outstanding stock	59.4	49.8	45.3	40.2	35.1	37.0	41.0	46.4	52.5	57.3
(in percent of GDP)	14.3	11.2	9.4	8.0	6.7	6.7	7.2	8.0	8.8	9.3
Memorandum items:										
Real effective exchange rate 5/	108.0	115.1	126.1	136.3	...	...	...	...	...	...
Nominal GDP (in millions of U.S. dollars)	415.2	443.0	481.1	501.8	521.3	548.2	565.4	582.7	598.3	614.3

Sources: FSM authorities and IMF staff estimates and calculations.
1/ Fiscal year ends on September 30. Data for FY2021-23 is estimate from authorities and subject to revision.
2/ Excludes contributions to the Compact Trust Fund.
3/ Compact Trust Fund and FSM Trust Fund.
4/ Includes only domestic lending and does not account for loans to customers outside the country.
5/ Calendar year. 2010=100. The U.S. dollar is legal tender and the official currency.



FEDERATED STATES OF MICRONESIA

STAFF REPORT FOR THE 2026 ARTICLE IV CONSULTATION

April 6, 2026

KEY ISSUES

Context. The Federated States of Micronesia (FSM) is progressing to achieve development goals, under challenging circumstances. Medium-term growth prospects remain subdued, with inflation gradually moderating. Risks are tilted to the downside; further delays in executing public investment amidst intensifying climate change would depress growth, which exacerbates emigration and skills shortages, leading to a negative feedback loop.

Recommendations. The renewal of the Compact of Free Association with the US, with a significant step-up in grants, provides an opportunity to reset the economic trajectory, if coupled with reforms. Recommendations are informed by the Country Engagement Strategy and focus on strategies to achieve higher sustainable growth.

- **Supporting development goals.** The priority is to expedite climate-resilient public infrastructure expenditure and improve project quality, with the support of development partners. Currently available grants are insufficient to finance the required capital expenditure to meet development goals; part of the shortfall can be financed using a mix of domestic revenue mobilization, concessional loans and trust fund withdrawals.
- **Empowering the private sector.** Streamlining and harmonizing laws and regulations across states – particularly those related to foreign direct investment and business regulations – would allow sectors where the FSM has a comparative advantage to flourish. Enabling the productive use of land, while protecting customary ownership rights, would support growth. Digital banking and fiscal reforms can be leveraged to ease constraints on the demand and supply of credit. These measures would help create high-quality jobs and – along with efforts to address skills mismatches – slow emigration.
- **Building resilience.** Strengthening climate-specific provisions in infrastructure planning is important for long-term sustainability. Once completed, the National Adaptation Plan should provide strategic sectoral priorities. Improving hazard mapping, as well as early warning and detection systems would also strengthen resilience.

Approved By
Rahul Anand (APD)
and Cemile Sancak
(SPR)

Discussions took place in Palikir, Kolonia and Weno during January 15 – 28, 2026. The team comprised D. Prihardini (Head), S. Cirikisuva, K. Jo, N.M.A. Purwanto (all APD), and E. Tandberg (PFTAC). M. Tumsok (OED) attended selected mission meetings. The mission met with Finance and Administration Secretary R. Nakanaga, Transport, Communications and Infrastructure Secretary C. Apis, Justice Secretary L. Bacalando Jr., other senior officials from the national government, as well as the states of Chuuk and Pohnpei, along with representatives from the private sector and other organizations. T. Dao and S. Rao (both APD) provided superb research, editorial, and logistical assistance for the discussions and the preparation of this report.

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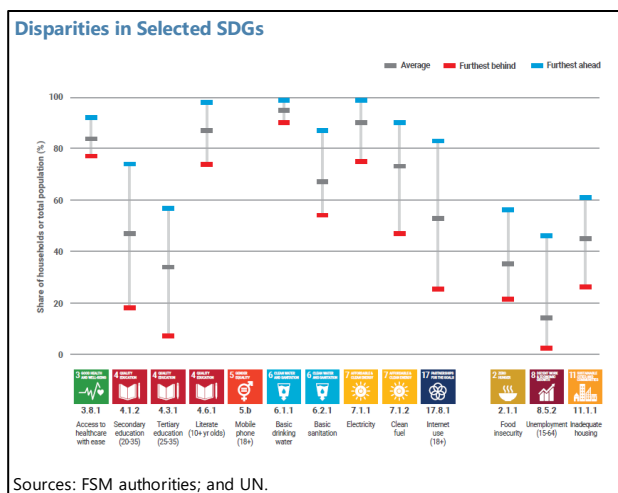
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CONTEXT

1. The Federated States of Micronesia (FSM) is progressing to achieve development goals, under challenging circumstances.

There is near universal access to basic services and digital connectivity has improved¹. These are commendable achievements given the country’s fragility, which is driven by remoteness, dispersed population, high vulnerability to climate change and governance challenges (Country Engagement Strategy (CES), Annex I). However, service quality is impacted by an aging infrastructure, and wide disparities remain, particularly in outer islands and for low-income households.



2. The Strategic Development Plan 2024-2043 (SDP) appropriately focuses on private sector development to drive long term growth.

The SDP was approved by the FSM Congress, prior to the March 2025 elections, however many members were reelected providing policy continuity. The SDP highlights tourism and fisheries as sectors that can drive sustainable growth. Remoteness, a small domestic market, and high cost of doing business has hindered private sector development. As discussed in the CES (Annex I), the renewal of the Compact of Free Association with the US (COFA, 2024-2043), with a significant step-up in grants, provides an opportunity to reset the economic trajectory, if coupled with reforms (Annex II)². Accelerating reforms requires close collaboration between national and state governments, and – given significant capacity constraints – development partners.

RECENT DEVELOPMENTS

3. Growth rebounded in FY2024, before slowing to 1.1 percent in FY2025 as stagnant public investment, lackluster private sector activity and emigration hold back momentum.

FY2024 growth was estimated to be 2.3 percent, supported by a jump in fishing output, the public sector wage increase and high bank profitability, with added impetus from the removal of a ban on deploying foreign workers to the FSM. Inflationary pressures moderated but remain elevated, with headline inflation at 5.4 percent in FY2024, driven by high import prices for food, fuel and the wage increase (as reflected in high services inflation, particularly hotels and restaurants). Preliminary data

¹ FSM Second Voluntary National Review, 2025.

² FSM and the US signed updated COFA agreements and FSM Congress ratified them in 2023. The US Congress passed the Compact Amendments Act, signed by President Biden on March 9, 2024. Diplomatic notes exchanged on March 18, 2024 brought the agreements into effect.

suggest further slowing of inflation to 3.2 percent in FY2025, in line with falling global commodity prices and gradual easing of U.S. inflation.³

4. The fiscal position has deteriorated, driving a commensurate narrowing of the current account surplus. The general government fiscal balance turned to a deficit of 1.8 percent of GDP in FY2023 from a sizeable surplus of 16.8 percent of GDP in FY2022, as windfall corporate income tax (CIT) revenues from foreign-sourced income normalized, while government spending continued to rise. Although the wage bill increased, a fiscal surplus of 1.7 percent of GDP was achieved in FY2024 thanks to cuts in congressional projects and an increase in grants under the new COFA⁴. The surplus narrowed to 0.4 percent of GDP in FY2025, primarily due to a decrease in fishing fees, which are mainly collected from foreign vessels. In line with these fiscal developments, the current account (CA) surplus has been in decline, falling from 16.5 percent in 2022 to 3.5 percent in 2024. The CA surplus slightly increased in 2025 to 3.8 percent of GDP as the trade deficit narrowed to 40 percent of GDP, and higher income flows from CIT paid by foreign-owned offshore entities more than offset the decline in income from fishing fees.

OUTLOOK AND RISKS

5. In the near term, growth will continue to be supported by the public sector, while elevated oil prices pose a headwind. Real GDP growth is expected to moderate to 0.7 percent in FY2026 as real income compression and higher import costs, particularly for the relatively fuel intensive fishing sector, weigh on activity. At the same time, growth is bolstered by a gradual pickup in public investment funded by COFA. The direct effect of US tariffs is assessed to be minimal for FSM given its limited export exposure to the US⁵. Headline inflation is expected to remain at 3.2 percent in 2026 reflecting gradual passthrough of higher oil prices due to the conflict in the Middle East. The general government fiscal surplus is projected to remain modest at 0.4 percent of GDP in FY2026 driven by elevated state government spending and hence imports, with the current account surplus declining to 1.1 percent of GDP.

6. Medium-term prospects remain subdued. Higher grants from multilateral financial institutions (MFI) and spillovers from the Yap airport expansion by the US Department of War (estimated to cost 80 percent of GDP) are expected to support a temporary pickup in growth in FY2027 and FY2028. Additional impetus from housing construction to accommodate foreign workers is expected, following a tripling of foreign worker arrivals between 2023 and 2025. Growth subsequently slows to 0.7 percent over the medium term, below the pre-pandemic average of 1 percent. This reflects persistent capacity constraints; in particular, ongoing labor shortages driven by sustained emigration which limit productive potential. Importantly, the impacts of climate change

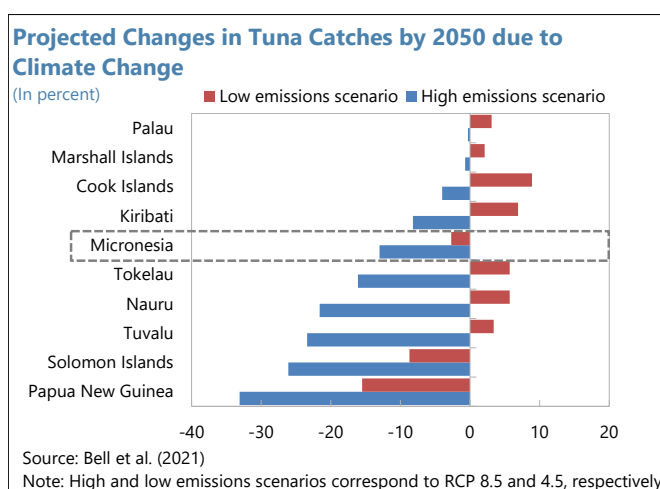
³ The US Dollar is legal tender in FSM and there is no central bank.

⁴ Compared to the previous COFA, sectoral grants for education and health increased. However, because COFA grants for FY2024 were awarded only in August, a substantial portion remained unspent by end-FY2024 (September), contributing to an improvement in the fiscal balance.

⁵ Prior to the February 20, 2026 Supreme Court ruling, a 10 percent tariff was levied on exports from the FSM to the US.

increasingly constrain the economy, with effects likely to intensify in the long term in the absence of reforms and progress in resilient infrastructure investment. Inflation is expected to pick up to 4.0 percent, reflecting the lagged effect of elevated oil prices.

7. The general government fiscal balance and current account are expected to shift into a deficit, as external concessional loans are used to support development needs. This implies a moderately expansionary fiscal stance over the medium term. In addition, fishing fees (23 percent of total revenue in FY2024) gradually fall due to a climate-change driven decrease in tuna biomass and state government spending accelerates. Sovereign trust funds continue to provide a buffer; in FY2025, the FSM Trust Fund (FSMTF) and the Compact Trust Fund (CTF) balances are 115 percent and 395 percent of GDP, respectively. Notwithstanding a temporary improvement due to grants, the trend is for a narrowing of the current account surplus, in line with the declining fiscal surplus and moderating growth in tuna exports. The external position is substantially stronger than the level implied by medium-term fundamentals and desirable policies, reflecting weak domestic private investment activity, delays in public investment execution and precautionary saving given inherent vulnerabilities (Annex III).⁶



8. Risks are tilted to the downside (Annex IV). In addition to the downside scenario (Box 1), extreme climate events remain a significant downside risk; natural disasters destroy infrastructure, impair livelihoods, exacerbate food insecurity and delay the development agenda as scarce resources are diverted to disaster response and reconstruction. In such an event, contingency funds can be deployed to provide immediate relief, before additional support is provided through COFA. Prolonged conflict in the Middle East, leading to higher-than-assumed oil prices would widen the trade deficit and exacerbate the projected deterioration of the current account balance. Given the heavy reliance on imported fuel and food, a 10 percent shock to global oil prices could increase inflation, with a lag, by 0.7 percentage points^{7,8}. While higher oil prices could temporarily boost import-tax and state sales-tax revenues, this is likely to be offset by greater expenditure pressures, mainly through higher subsidies for public utilities in the medium term⁹. The negative terms of trade shock would be a drag on consumption growth, but the overall effect on GDP growth would be

⁶ The Balance of Payments available up to 2023 and the external sector assessment is based on Staff's estimates for FY2025.

⁷ Historically, oil imports average about 7.8 percent of GDP and food imports average 19 percent of GDP.

⁸ See Annex III of the [2023 Article IV Staff Report](#).

⁹ Imported diesel accounts for over 85 percent of electricity generation.

moderated by import compression and continued public investment activity. On the upside, reforms aimed at easing bottlenecks could ignite private sector activity, create jobs and reduce aid dependency, thereby mitigating risks from a potential withdrawal of donor support.

Box 1. Downside Scenario

Slower implementation of infrastructure projects amidst intensifying climate change would depress growth, which exacerbates emigration and skills shortages, leading to a negative feedback loop. Inadequate infrastructure impedes private sector activity, further undermining growth prospects. Fishing revenues would fall faster than envisaged, while slower growth would impair tax collection, deteriorating the fiscal balance. Drought and saltwater intrusion reduce domestic food production, increasing import dependence and public health expenditure. Authorities should deepen collaboration with stakeholders to resolve impediments to project execution and request additional technical support from development partners. Domestic revenue mobilization, prioritizing adaptation expenditure and easing regulatory barriers to private sector participation become crucial.

Authorities' Views

9. The authorities agreed that risks to the outlook are tilted to the downside and noted that, should they materialize, the impact may be much larger. They stressed that skills shortages, procurement challenges and stricter bonding requirements have delayed project execution and resulted in large unspent capital grants. Given prevailing bottlenecks and the impact of slow-moving effects of climate change (e.g. drought), growth may be slower than staff's baseline projection. Authorities considered the impact of the Yap airport project to be modest given that local contractors are unlikely to be engaged. They highlighted substantial cleanup and containment costs from the recent oil spill and its strain on fiscal resources, coastal ecosystems and tourism, noting that such incidents will remain a risk going forward, given that there are over sixty shipwrecks in Chuuk lagoon.

POLICY DISCUSSIONS

Recommendations are informed by the CES and focus on strategies to achieve higher sustainable growth. The near-term priority is to expedite climate-resilient public infrastructure expenditure and improve project quality, with the support of development partners. Consensus building across stakeholders is needed to reignite reforms that would support a vibrant private sector, a priority of the SDP. These measures would help create high-quality jobs, stemming the tide of emigration.

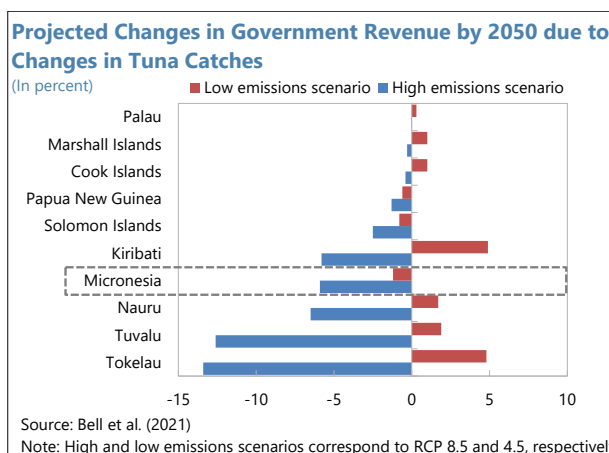
A. Fiscal Policy

10. Despite higher grants and low public debt, the general government fiscal balance is expected to weaken over the medium term, reflecting expenditure pressures to meet development needs and revenue risks. COFA grants increased to USD 140 million (29 percent of GDP) annually from 19 percent of GDP in FY2023, helping to fund development goals while placing

public debt – already low at 9 percent of GDP in FY2025 – on a sustainable path. Overall, the projected fiscal easing is appropriate given FSM’s substantial buffers and large development and climate-adaptation needs, subject to continued efforts to preserve fiscal buffers and strengthen policy frameworks. Debt sustainability risks are assessed to be moderate (DSA); however, other challenges remain:

- Expenditure.** Development needs remain substantial, with limited progress on SDGs such as food security and health¹⁰. Moreover, the 2025-2034 Infrastructure Development Plan (IDP) identifies USD 4 billion (794 percent of GDP) in the project pipeline, two thirds of which are unfunded. High climate-change adaptation costs, and expenditure to address legacy environmental risks will mainly be borne by the public sector, given an underdeveloped private sector. These expenditure pressures can potentially erode fiscal buffers and undermine long-term debt sustainability. Shortcomings in public investment management (PIM) and capacity constraints delay project implementation and weaken the link between investment and growth. There are contingent liability risks from state-owned enterprises (SOEs) and the social security fund.

- Revenues.** Declining tuna biomass due to climate change is expected to reduce fishing fees¹¹. Support from MFIs shifted from grants to a mix of grants and concessional loans starting in 2025. However, the committed project pipeline means that the level of grants will not decline until FY2030.



- Fiscal Federalism.** Since FY2024, a share of fishing fees has been transferred from the national government to the states, which is appropriate given their larger spending needs. At the same time, the national government cancelled transfers to the FSMTF and reduced congressional projects by an estimated 1.3 percent of GDP over two years^{12,13}. Even with these adjustments,

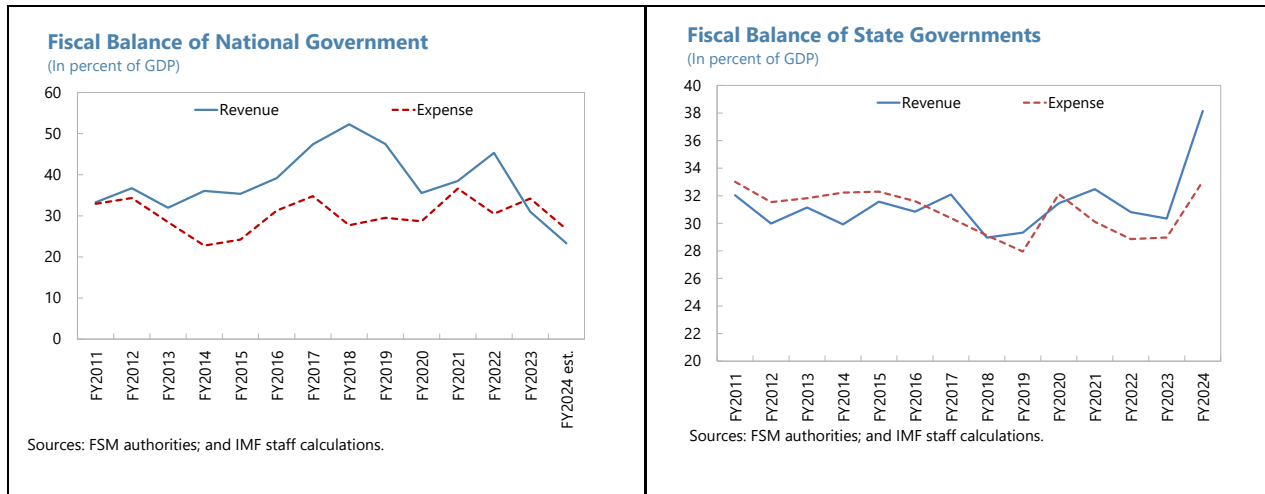
¹⁰ [The FSM Second Voluntary National Review 2025](#).

¹¹ Bell et al. (2021), 'Pathways to Sustaining Tuna-dependent Pacific Island Economies during Climate Change', *Nature Sustainability*

¹² Congressional projects are initiated and directed by individual members of Congress. Under Public Law No. 20-178, the FSM Congress appropriated USD 9.8 million for public projects and social programs across its four states. For example, in Yap State, the funds supported initiatives such as medical referrals for uninsured patients, construction of a seawall in Ngari and Rull, and infrastructure improvements, including extensions to the power and water systems in remote villages such as Binik and Faraulap.

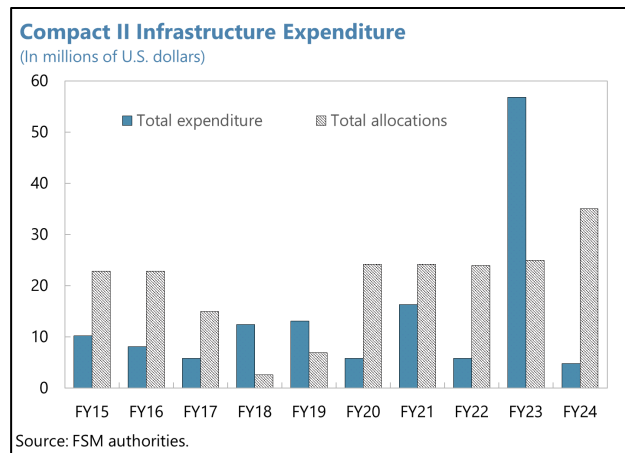
¹³ Prior to FY2023, all fishing fee revenues were allocated to the national government. Since the fiscal surplus began increasing in the mid-2010s, 20 percent of taxes and fishing fees, as well as 50 percent of CIT revenue have been deposited into the FSMTF by the national government. These transfers were suspended to help the COVID-19 response and were cancelled in FY2024.

the national government’s fiscal balance turned to a deficit, while states’ fiscal surplus widened, as they gradually absorb the additional revenue. However, states have not made any contributions to the FSMTF, preferring to establish and contribute to their own trust fund. Amidst tight fiscal space for the national government, efforts to mobilize revenue and rationalize spending are warranted, while states should focus on improving spending efficiency.



11. Enhancing capacity to plan and implement public spending, particularly at the state level, is crucial.

Capacity building to scale up the size and quality of investments is highlighted by the CES as a near-term priority. There are unused infrastructure funds from the previous COFA in addition to current grants. MFI-financed projects have also faced delays. Strengthening PIM to prioritize projects using evidence-based approaches and ensuring competitive procurement would improve public investment efficiency. The IDP is a welcome step in preliminary project screening. Measures to make public spending more effective and efficient, coupled with reforms to invigorate the private sector (1133), can help unlock the potential of public investment to drive growth. This is particularly important for debt-financed investments, which must generate sufficient returns to service debt.

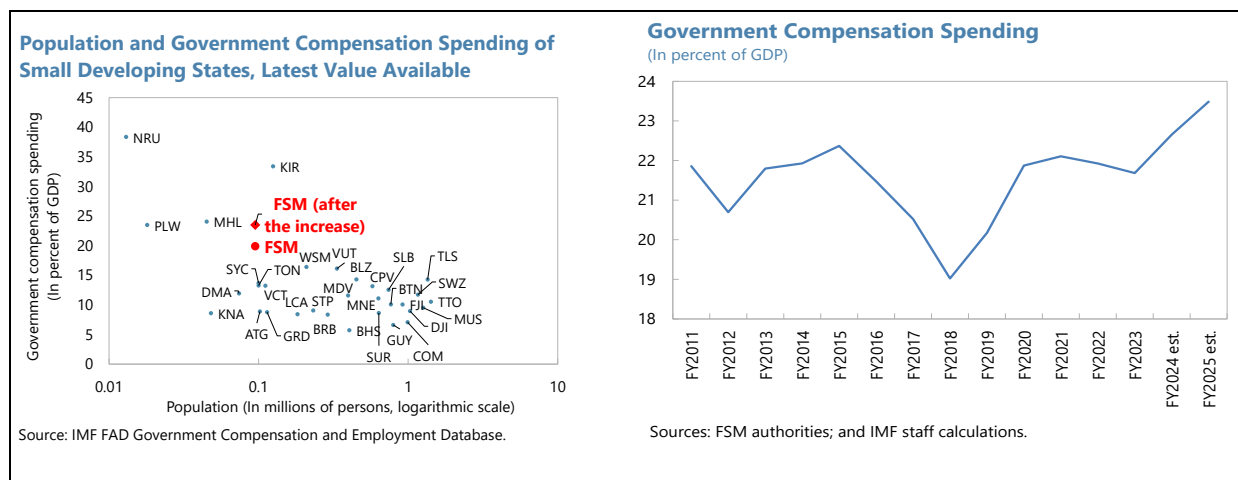


12. Developing a standard methodology for appraising and selecting investment projects would improve prioritization and sequencing.

Upgrading the technical skills of Project Management Offices (PMO), with the support of development partners, developing a standard project implementation manual, and strengthening consolidated oversight of the public investment portfolio by Department of Finance and Administration (DOFA), would increase the pace of project implementation. Oversight can be enhanced by supporting forward looking project management so that issues are handled proactively. The updated procedures for project development, appraisal,

management and oversight should be reflected in a government regulation on public investment management to ensure transparency and support effective enforcement. This will define a common framework to be applied for all public investment projects, regardless of financing source, but some externally financed projects may require additional procedures defined by the development partner.

13. Public sector compensation policy should aim to recruit and retain skilled workers while maintaining fiscal prudence. A statutory freeze on annual salary increases for public sector employees was in place from 1997 to 2022. Wages were subsequently increased in FY2023 for the national civil service and in FY2024 for states. Even with unfilled vacancies, compensation spending is high compared to peers, especially after the recent wage increase. Regular periodic reviews of the compensation policy are preferable to large, one-off wage increases. While the significant increase slowed attrition of public servants, it widened the public sector wage premium over the private sector and added to inflationary pressure. Cautious management of the wage bill is advisable, including by targeting increases to critical positions. The resumption of annual performance evaluation of employees is welcome and staff encourage linking future salary adjustments to these evaluations.



14. To contain fiscal risks from SOEs, cost-reflective pricing, efficiency-enhancing reforms, and stronger accountability measures should be adopted. Risks are mainly concentrated in state utility corporations, though many SOEs are financially weak. State governments provide budget transfers to utilities and, at times, cover their debt service obligations¹⁴. Cost-recovery tariffs for utilities are needed to improve financial performance and ensure sufficient resources for infrastructure maintenance and grid upgrades. Utility costs are high in the FSM, even amongst Pacific Island countries (PICs), however cost-of-living support should be targeted to vulnerable households. Greater renewable energy generation can potentially lower tariffs. To support efficiency,

¹⁴ The state government provided USD 0.8 million to the Pohnpei Utilities Corporation (PUC) in FY2023, which is also the beneficiary of state guarantees for ADB loans. Following PUC’s past debt service shortfalls, the national government withheld approximately USD 0.6 million of Pohnpei state’s revenue share in FY2023 to meet these obligations. The Yap State Government paid USD 0.8 million in FY2023 to cover the principal and interest of the ADB loan owed by the Yap State Public Service Corporation.

staff recommend conditioning future transfers and guarantees on the preparation and regular updating of statements of corporate intent, specifying financial objectives, performance targets, and reporting obligations. Similarly, the FSM Social Security Administration receives annual transfers of at least USD 1 million from the national government to ensure long-term solvency¹⁵. Staff welcome the ongoing actuarial assessment which will provide recommendations on how to improve Pacific Island countries sustainability.

15. The tax reforms under consideration can help promote private sector investment. The reforms include introducing a 10 percent value-added tax (VAT) and replacing the gross revenue tax (BGRT) with a net profit tax (NPT). A VAT is ultimately a tax on consumption, hence reducing the tax burden on capital goods and business inputs, which are currently subject to sales taxes. Compared with the BGRT, an NPT encourages risk taking as businesses do not pay taxes if they make a loss and these losses can offset future tax liabilities; this would be particularly beneficial for start-ups. The reforms would raise revenue by 1.5 percent of GDP. Revenue sharing agreements should take into consideration the public service responsibilities of each level of government (Annex V). Communicating how these additional revenues will be used to provide public services and measures that will be implemented to alleviate the burden for vulnerable households can garner support for these reforms. Like other PICs, capacity development (CD) will be needed to support tax reform efforts.

16. The medium-term fiscal strategy should balance preserving fiscal buffers with financing development goals, including climate-change adaptation. A potential strategy is to commit to an operational surplus (excluding capital grants). Windfall revenues should continue to be saved to preserve intergenerational equity and shield the economy from undue volatility. Currently available grants are insufficient to finance the required capital expenditure to meet development goals. Part of the shortfall can be financed by a mix of domestic resource mobilization (¶115), concessional loans and trust fund withdrawals (¶117). Additional development partner support would be needed for the remainder. A cost-benefit analysis should guide the mix of loans and withdrawals, and reflect spillovers from concessional loans (e.g., accompanying technical assistance and impact on debt sustainability).

17. The goal of preserving the value of the FSMTF in real terms is sound.¹⁶ Along with the current withdrawal cap, a lower bound on withdrawals could be considered based on projected long-term investment returns. This lower bound ensures continued budget support even during times of negative investment returns, while the withdrawal cap continues to limit drawdowns in periods of strong returns. Together, these rules make transfers from the FSMTF more predictable and shield the economy from volatility in investment returns, while safeguarding its long-term

¹⁵ According to the [2023 actuarial valuation](#), without the annual transfer from the national government, assets of the social security administration will be depleted after 25 years.

¹⁶ Under the law, annual withdrawals are capped at the lesser of 5 percent of the average total Fund balance over the preceding five financial years or the balance of the B Account, which holds accumulated investment earnings available for distribution. The law also states that withdrawals from FSMTF are restricted until FY2030.

sustainability. Escape clauses can specify the circumstances where FSMTF withdrawals can exceed the cap or be used for operational expenses. Within these overarching safeguards, states should be given greater autonomy over their sub-accounts to encourage contributions into the FSMTF rather than establishing separate state-level trust funds, which increase fragmentation.

18. A medium-term fiscal framework (MTFF) can help ensure that annual budgets are consistent with the fiscal strategy. The FSM is the only PIC without an MTFF or fiscal rules, though the effectiveness of these frameworks vary.^{17,18} The FSM's budget manual outlines fundamental components of an MTFF, such as fiscal strategy, the balanced budget rule, medium-term macroeconomic and expenditure projections, and expenditure ceilings. The COFA also includes reporting requirements that are broadly aligned with key elements of an MTFF. Going forward, the key priority is to move from formal articulation to implementation. A medium-term strategy is particularly important for states, given their higher revenue, as it can help prioritize spending and address asset maintenance gaps. The implementation of such frameworks would require CD support.

19. Restarting concessional borrowing places greater emphasis on entrenching a medium-term perspective, to ensure that loans can be serviced, particularly by states. The agreement by national and state governments to utilize concessional loans is a positive step. To mitigate repayment risks, the national government could complement on-lending arrangements with stronger safeguards, including DOFA approval of all state borrowing, limits on borrowing aligned with states' repayment capacity, screening of project proposals to reduce the risk of misutilization, and regular fiscal reporting and monitoring of state finances. Going forward, greater debt management capacity is needed, and an important first step is reinstating regular publication of the debt bulletin.

20. A follow-up PFM roadmap should be developed. Achievements under the 2023-26 reform roadmap include implementation of automated systems for customs data (ASYCUDA), the revenue management system (RMS), and the partial rollout of the financial management information system (FMIS). The new plan could focus on aspects other than new information management systems, including efforts to strengthen public investment management and implementation of MTFFs. An update of the 2017 public expenditure and financial accountability assessment could be used as an input for the new roadmap.

¹⁷ Flores *et al.* (2024), 'Upgrading Fiscal Frameworks in Asia-Pacific', IMF APD DP/2024/008.

¹⁸ The amended Compact imposes reporting requirements on FSM that resemble the elements of MTFF. For example, the SDP is evaluated and modified continuously during the annual budget cycle, and is designed to provide ongoing, multi-year forecasts. The FSM also has a "balanced budget" provision in their law, but the law also allows for supplemental or deficiency appropriations, which makes the provision procedural rather than binding.

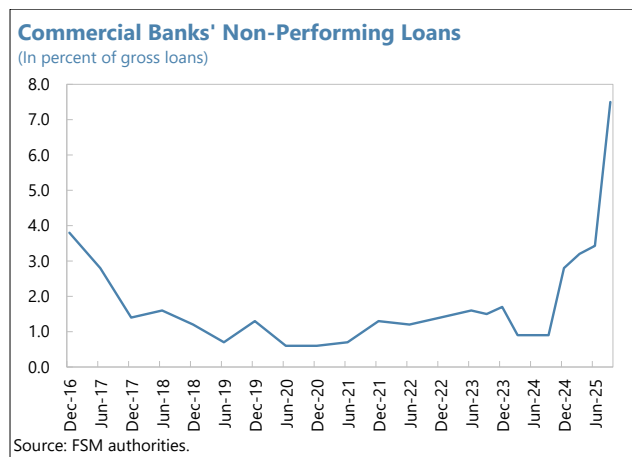
Authorities' Views

21. The authorities broadly concurred with staff's recommendations, while noting that capacity constraints continue to weigh on implementation. They acknowledged the need to further strengthen public investment management, including through technical assistance. They agreed with the proposed public sector wage policy, emphasizing that the repeal of the statutory freeze on step wage increases and the resumption of annual performance evaluations would facilitate its implementation. While elements of an MTFF are articulated in the budget manual, limited capacity has hindered its effective operationalization. The authorities indicated that consensus on the tax reforms is gradually emerging, with the National Tax Reform Task Force recently concluding consultations with all states. They noted that states are supportive or neutral, but an amendment to the constitution for Yap state is needed before implementation can proceed. Looking ahead, they acknowledged the importance of further outreach to the private sector and households on the potential benefits of introducing a VAT and a NPT for businesses, drawing on reform experiences in Palau and the Republic of the Marshall Islands.

22. The authorities emphasized that while they have been able to maintain a broadly balanced budget, this belies substantial development and climate-resilience spending needs. That said, they underscored the importance of safeguarding trust funds assets alongside efforts to meet priority investment needs and will review withdrawal rules in the coming years. They noted that closer coordination between national and state governments is required to manage the contribution to and the drawdown from the FSMTF state sub-accounts. With new revenue-sharing rules altering the fiscal landscape, the national government plans to reassess the allocation of responsibilities across levels of governments. They highlighted that improving climate resilience remains the primary criterion for the use of COFA infrastructure grants.

B. Financial Sector

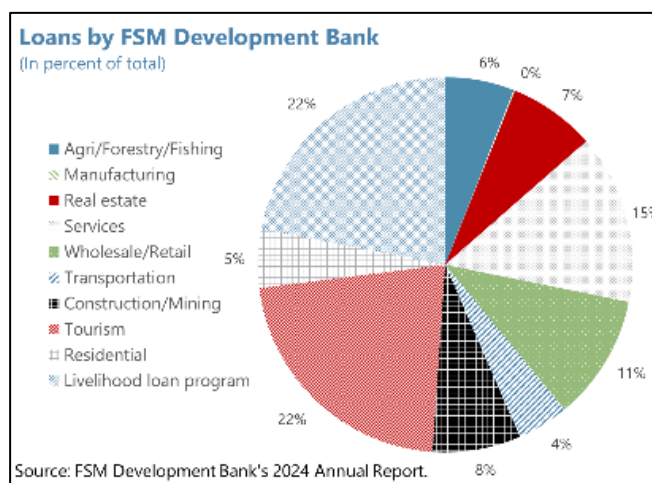
23. The commercial banking system remains broadly sound, but rising NPLs warrant prompt supervisory attention. Banks remain well capitalized and have ample liquidity, but asset quality has started to deteriorate, with non-performing loans increasing sharply from 2.8 percent in 2024 to 7.5 percent in 2025. Deposits rose to 96.1 percent of GDP, while the loan-to-deposit ratio stayed low at 10.8 percent, and lending continues to be



dominated by consumer loans.¹⁹ Despite the increase in NPLs, systemic risks remain contained due to limited macro-financial linkages, since the size of domestic lending relative to deposits and GDP is small, with most banking assets invested offshore. Staff recommend that the authorities strengthen supervision to identify the drivers of rising NPLs, enhance NPL resolution and risk-management practices to protect asset quality and prevent further reductions in already limited domestic lending.

24. Deepening financial intermediation will require structural reforms that ease constraints on both credit supply and demand. On the supply side, banks face information gaps and weak collateral frameworks, which limit their willingness to extend lending. Greater use of digital banking, digital payments, and fiscal reforms would generate transaction data that can ease firms’ financial reporting constraints, while supporting sound credit assessment. Banks in FSM already use Business Gross Receipts Tax (BGRT) returns in their credit assessment of potential borrowers. The introduction of a value-added tax (VAT) and a Net Profits Tax (NPT), and associated returns, could further improve the quality of data underpinning credit decisions. On the demand side, credit uptake remains constrained by informality, limited financial literacy, and the high cost of borrowing, which discourage firms from seeking formal financing. Expanding financial literacy programs for SMEs, supported by development partners, can encourage sound business practices and improve their ability to meet lenders’ documentation requirements. Reinforcing institutional cooperation and regulatory oversight remains critical to broadening access to credit and ensuring that financial deepening proceeds prudently (Annex VI).

25. FSM Development Bank (FSMDB) plays a significant role in extending credit to the private sector. Outstanding loans reached 8.5 percent of GDP in FY2025, with the majority directed to businesses. NPLs fell sharply from 55 percent in 2022 to 22 percent in September 2025, driven by restructuring efforts. The elevated credit risk reflects FSMDB’s focus on start-ups and SMEs. The recovery in asset quality has strengthened retained earnings available for new lending, contributing to asset growth. FSMDB was accredited by the Green Climate Fund (GCF) in 2023 and is currently establishing a dedicated unit to operationalize its access to GCF financing and support the development of climate-resilient projects.



26. The FSM Banking Board (FSMBB) should continue enhancing its legal and regulatory framework. Strengthening oversight by bringing FSMDB and credit unions under its supervision

¹⁹ The loan to deposit ratio is 16 percent if government deposits are excluded. The quoted figure also excludes around 38% of total loans offered to customers abroad.

and implementing clearer regulatory and supervisory measures for climate risks should be prioritized. The authorities should also promote digitalization of banking services while ensuring that risks to financial integrity are appropriately mitigated. Additionally, authorities should continue emphasizing the risk-based application of AML/CFT measures by reporting entities, as well as consumer protection, to preserve trust in the domestic financial sector and ensure the sustainability of correspondent banking relationships.²⁰

Authorities' Views

27. The authorities agreed with the staff's assessment that the very low level of domestic lending warrants coordinated policy action. They noted that broader use of digital banking and the rollout of additional digital services—including e-commerce and digital payments—would improve transaction documentation and help support greater domestic lending. The authorities acknowledged that rising NPLs require close monitoring to safeguard asset quality and maintain credit flows to the economy. The authorities also supported the recommendation to expand the FSMBB's mandate to regulate and supervise FSMDB and credit unions, particularly with respect to their credit operations, as a key step toward strengthening the financial sector's oversight framework.

C. Climate-Change Resilience

28. The FSM has substantial climate change adaptation needs, but progress has been constrained. With frequent and intensifying natural disasters, and sea-level rise, the FSM ranks amongst the most vulnerable PIC. The FSM's NDC 3.0 commits to net-zero by 2050, 70 percent renewable electricity by 2030, robust adaptation for coastal communities and food security—conditional on international support. Annual adaptation needs are estimated at one third of 2024 GDP. However, limited private sector and institutional capacity, fragmented inter-agency coordination, and insufficient integration of climate risks into fiscal and infrastructure planning has constrained progress. The Office of the National Public Auditor made a similar assessment, identifying persistent weakness in data reporting and monitoring systems which reduce the effectiveness of adaptation efforts; gaps in regulatory and institutional frameworks; and fragmented coordination across agencies and levels of government.²¹

29. Integrating climate adaptation into the medium-term fiscal strategy is essential (Annex VII). Strengthening climate-specific provisions in infrastructure planning is important to ensure accountability and long-term sustainability. Development of the National Adaptation Plan (NAP) is ongoing, the NAP should provide clear sectoral priorities and address interactions of climate change with legacy environmental risks such as oil spills. Meeting climate resilient infrastructure needs requires mobilizing additional financing. While grants continue to be the preferred method for

²⁰ US FDIC insurance covers both commercial banks and provides supervisory oversight.

²¹ [Global Cooperative Performance Audit of the Implementation of Climate Change Adaptation Planning and Actions in FSM](#) and [Climate Scanner Assessment Report](#).

financing climate investments, domestic revenue mobilization can have positive spillovers (¶15, 24) and concessional borrowing to invest in resilient infrastructure can support economic growth without undermining long term fiscal sustainability (Annex VII). Closing PFM and capacity gaps – including the ability to access climate finance – is essential for scaling up investment and ensuring that these financing sources are used effectively.

30. Disaster risk financing layering has improved. FSM became a member of the Pacific Catastrophe Risk Insurance Company in November 2025. In addition, the Disaster Assistance Emergency Fund has been strengthened through increased contributions and expanded drawdown limits.²² Recently, the fund was used to provide essential supplies to households affected by the Chuuk oil spill. These reforms are in line with the Climate Change Policy Assessment recommendations. The NAP will continue to advance climate change and disaster risk financing.

31. Efforts to strengthen climate and disaster resilience should continue. Priorities include improving data systems for climate and disaster-risk information such as expanding the coverage of hazard maps, scaling up renewable energy capacity and energy efficiency measures to deliver on NDC 3.0 commitments, and enhancing disaster preparedness including through continuing to improve early warning and detection systems. Accelerating efforts to develop a National Building Code is also an important element of closing regulatory gaps for climate-resilient construction.

Authorities' Views

32. The authorities stressed that substantial spending requirements, together with complex implementation demands of adaptation initiatives, remain key policy constraints. Onerous requirements associated with accessing climate financing continue to pose challenges and they welcomed recent efforts by the GCF to simplify its procedures. They also pointed out that high staff turnover continues to impede project implementation. Authorities confirmed progress with the NAP, supported by upcoming national and state level consultations. The preparation of a national drought policy is also ongoing. Authorities agreed that technical capacity limitations particularly around project selection and planning, coupled with coordination challenges across state governments, continue to hinder timely and effective implementation of climate related investment projects.

D. Structural Reforms

33. Progressing with critical structural reforms to invigorate the private sector requires close coordination between stakeholders. Several impediments to private sector development are within the state's purview and fragmented policies across states continue to be a barrier. Given the

²² The Disaster Assistance Emergency Fund is reserved for emergency situations. Under Compact III arrangements, the annual contributions have been USD250,000 each from the US Government and FSM, an increase of USD50,000 from the previous arrangement. Withdrawals above USD100,000 under Compact II required U.S. Chief of Mission concurrence; under Compact III, the threshold increased to USD250,000, giving FSM greater flexibility in accessing emergency funds.

complex governance structure identified in the CES, concerted efforts are needed to strengthen coordination across national and state governments and build consensus for accelerating reforms. This would allow sectors of comparative advantage, such as tourism and fisheries, to flourish.

- Updating foreign investment laws to harmonize them across states, increase transparency and broaden sectors eligible for investment. Currently the national government and states operate a “traffic light” system for foreign investment and industry classifications vary across states.
- Create opportunities for private sector participation in industries currently served by SOEs e.g., renewable energy generation, ports and telecommunications.
- Supporting long-term leaseholds which enable productive use of land, while protecting customary ownership rights by e.g., improving cadastral maps, digitizing land and lease registry, as well as providing standardized lease templates. Ensuring each state has land regulations would establish greater transparency and reduce delays in settling land disputes.
- Streamlining and standardizing business regulations across states. Improved connectivity also provides scope for digitalizing regulatory processes e.g., a single online business portal covering national and state requirements eases compliance.

34. A vibrant private sector, supported by efforts to address skills mismatches, can help slow emigration (Annex VIII). Emigration has exacerbated existing labor shortages, particularly in skilled trades and technical roles, which are increasingly filled by foreign workers. The limited availability of suitable jobs, coupled with low wages and a high cost of living has contributed to emigration of better educated citizens, particularly youth. Improving the quality of education, including vocational training, can improve employability and address skills mismatches. Revitalizing the private sector creates better employment opportunities; helping to retain workers and attract skilled returnees. Deeper diaspora engagement, through dedicated programs to foster ties and inward investments, can support the domestic economy.

Authorities’ Views

35. Authorities broadly agreed with the recommended structural reforms, noting that many elements are reflected in their strategic plans. However, gaining traction with states has been challenging, leading to stalled reforms. This is partly because states consider harmonizing laws nationally to be akin to ceding power and prefer to reflect their own priorities in laws and regulations. Discussions with states on streamlining regulatory requirements continue, particularly in strategic areas, such as fishing and allied industries. Authorities agreed that creating high paying jobs is key to slowing emigration and acknowledge that a more organized approach in diaspora outreach would be beneficial. A migration taskforce is conducting a survey to determine factors that drive outward migration.

E. Data Issues

36. Improving the availability and timeliness of economic statistics would support policy formulation. Overall, the FSM's statistics have shortcomings which somewhat hamper surveillance (Annex IX). Many macroeconomic data series are only available with a substantial time lag, though timeliness has recently improved, with most series now available up to FY2023. The authorities are working closely with PFTAC to overcome data sharing hurdles which constrain National Accounts (NA) compilation. Staff are also working with authorities and development partners to improve the NA methodology.²³ Public sector financial audits – the basis for Government Financial Statistics – have been delayed. Authorities and the new auditors are systematically working through past fiscal years, with audited FY2024 data expected in mid-2026. Staff encourage authorities to publish the 2023 Population Census as it is a key input to policy formulation (e.g., education planning, design of social safety nets, active labor market policies). Monetary statistics reflect FSM's institutional setup, as the absence of a central bank precludes compilation of central bank balance sheet and reserve/base money data. However, banking system balance sheet data are available and adequate for surveillance of the relatively shallow financial sector.

37. Closing data gaps (e.g. External Sector Statistics) and reducing publication lags would require additional hands-on CD and resources for the Statistics Department. Moreover, development partner support is needed to integrate new information management systems (ASYCUDA, FMIS, RMS) into the compilation process. These databases can automate data collection and support timely data releases.

Authorities' Views

38. There is agreement regarding the importance of timely data provision. Authorities appreciated the prompt CD support by IMF and PFTAC. Authorities acknowledged identified data gaps and that additional resources are needed to close these gaps and support succession planning.

STAFF APPRAISAL

39. Medium-term economic prospects remain subdued. The economy experienced a temporary rebound in FY2024, before slowing in FY2025. Inflation gradually declined but remains elevated. In the medium-term growth is expected to be constrained by structural bottlenecks, intensifying threat of climate change and limited private sector participation, underscoring the urgent need for reforms to raise potential growth. Fiscal deficits are envisaged over the medium term as concessional loans are used to support development goals. The external position is substantially stronger than the level implied by medium-term fundamentals and desirable policies,

²³ GSUSA supports the compilation of macroeconomic statistics in the three COFA countries.

reflecting weak investment activity and precautionary saving, given volatile balance of payment flows.

40. Establishing a standardized framework for evaluating and screening investment projects is essential to strengthen prioritization and delivery. Enhancing capacity in PMOs, supported by clearer implementation guidelines and stronger portfolio oversight by the DOFA, would help accelerate project execution. Codifying updated appraisal and oversight procedures in a public investment management regulation would enhance transparency and enforcement. In this context, the 2025-2034 IDP is a good first step in improving project screening.

41. A modernized tax system can foster private sector investments, and strengthen revenue mobilization. The proposed VAT and NPT would reduce distortions by easing the tax burden on business inputs and encouraging risk-taking. They would also improve business record-keeping, with positive implications for access to credit. Revenue-sharing arrangements should be aligned with expenditure responsibilities across national and state governments.

42. Financing development and climate-adaptation needs, while protecting fiscal buffers, should be a key priority in the medium-term fiscal strategy. Saving windfall revenues in the trust funds would help safeguard intergenerational equity and reduce macroeconomic volatility. Given development needs relative to currently available grants, a mix of domestic revenue mobilization, concessional borrowing and trust fund withdrawals is necessary. Strengthening the FSMTF withdrawal framework through clearer rules, including a lower-bound on withdrawals and well-defined escape clauses, and granting states greater autonomy over sub-accounts would enhance the predictability of budget support and incentivize states to save.

43. The financial sector has scope to play a greater role in supporting private-sector development. Strengthening SME financial capacity, expanding digital banking to generate usable transaction data, and capitalizing on tax reforms to improve the availability of business financial information would help ease long-standing credit constraints. Continued efforts to enhance financial literacy, deepen institutional cooperation, and reinforce supervisory oversight will be essential to safeguard financial integrity and support prudent financial deepening.

44. Efforts should focus on completing the National Adaptation Plan and ramping up climate resilient infrastructure investment. Advancing these efforts will require strengthening PFM and climate finance capacity. Enhancing climate preparedness, including by sustaining progress in disaster risk data reporting and adopting national building codes would help address persistent structural gaps and strengthen long term resilience.

45. Bold structural reforms are needed to unlock private-sector-led growth. Streamlined business regulations and digitalizing regulatory processes would improve business conditions and reduce barriers to entry. A more open and predictable environment for foreign investment can help diversify the export base and bolster external resilience. This requires harmonized and transparent investment rules and enabling access to long-term land-lease arrangements to remove

long-standing impediments. Together, these reforms can support the creation of high-quality jobs and when combined with measures to address skills mismatches, can ease emigration pressures.

46. Efforts to close data gaps should continue, with support from development partners.

Timely compilation of macroeconomic statistics supports effective decision-making. While data provision has improved, long publication lags remain. Avenues for utilizing new information management systems in statistical compilation should be explored.

47. It is recommended that the next Article IV consultation be held on a 24-month cycle.

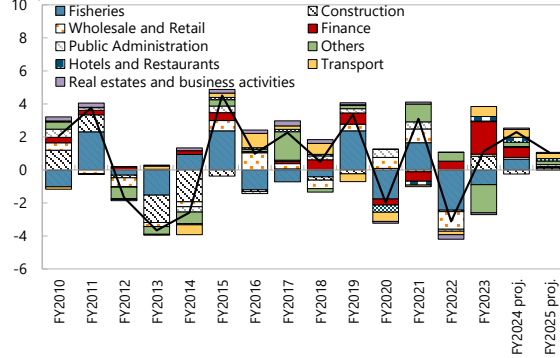
Figure 1. Federated States of Micronesia: Real Sector Developments

The economic rebound in FY2024 was not sustained in FY2025...

...reflecting a slowdown in the execution of public investment.

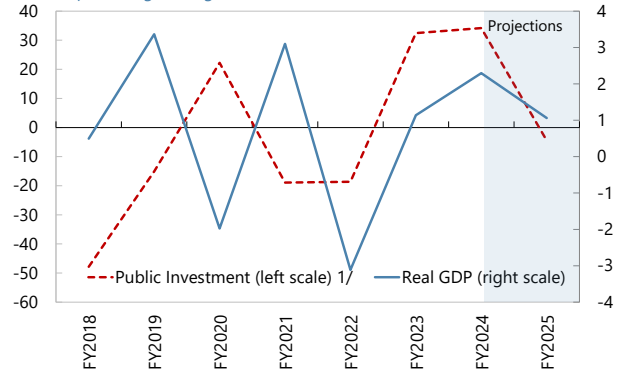
Contribution to Growth

(In percent)



Public Investment and Growth

(Annual percentage change)



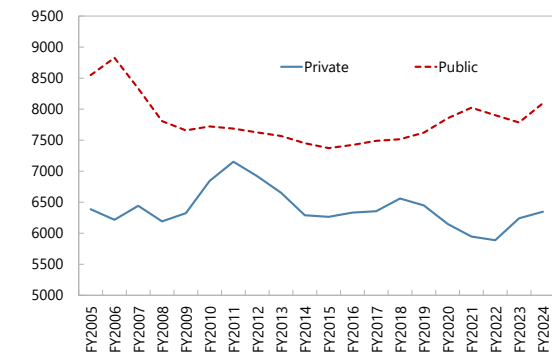
1/ Net acquisition of non-financial assets and consumption of fixed capitals.

Loss of workers due to outmigration have been more pronounced in the private sector.

Real GDP growth has been heterogeneous across states.

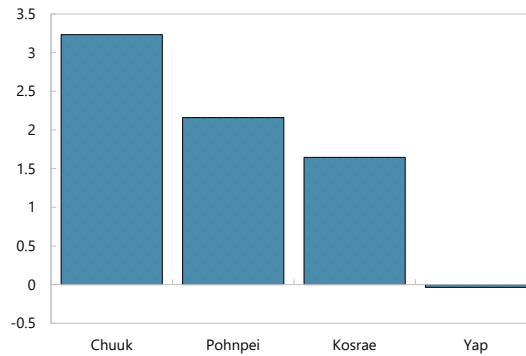
Employment

(Number of workers)



Real GDP Growth Rate by States

(Average annual growth rate of 2015-23, in percent)

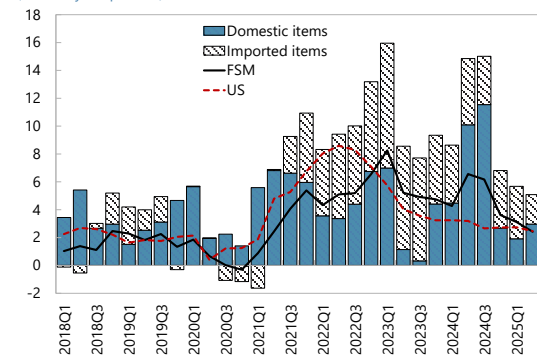


Inflation eased in FY2025, supported by lower prices of domestic items...

...coupled with the lagged impact of easing global commodity prices.

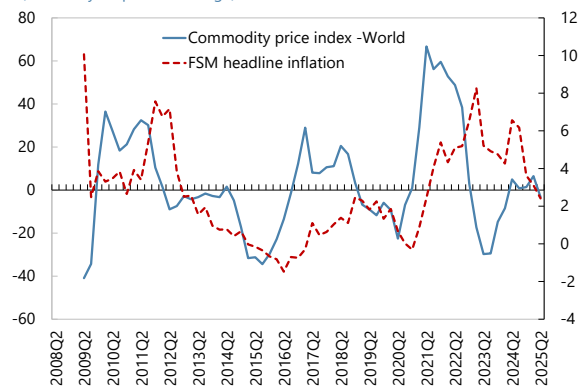
Inflation Rate

(Year on year, percent)



Global Commodity Price and FSM Headline Inflation

(Year-on-year percent change)



Sources: FSM authorities; IMF World Economic Outlook database; and IMF staff estimates and calculations.

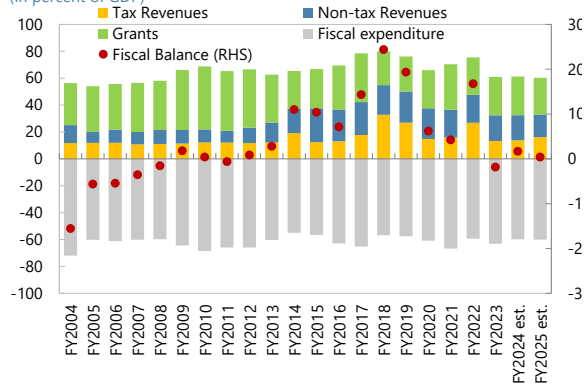
Figure 2. Federated States of Micronesia: Fiscal Developments

The fiscal surplus has narrowed due to a decline in revenues from corporate income taxes and fishing fees.

State governments have contributed to most of the recent fiscal surplus, thanks to the revised revenue sharing rule.

Fiscal Balance

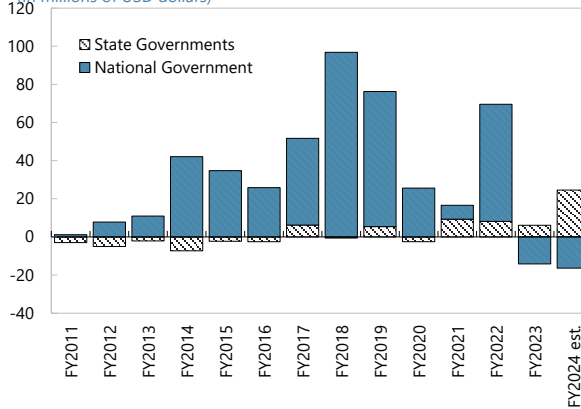
(In percent of GDP)



Capital spending remains below pre-pandemic levels.

Fiscal Balance: National and State Governments

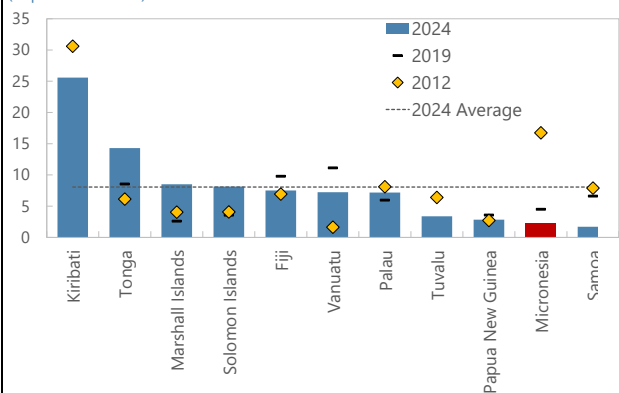
(In millions of USD dollars)



Public spending on health is low, while education expenditure is relatively high.

Government Capital Expenditure

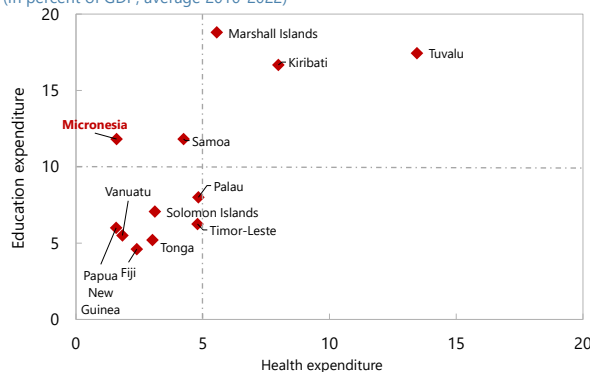
(In percent of GDP)



The FSM's trust fund balance has continued to grow, albeit at a slower pace due to a decline in the surplus.

Pacific Islands: Public Expenditure in Health and Education

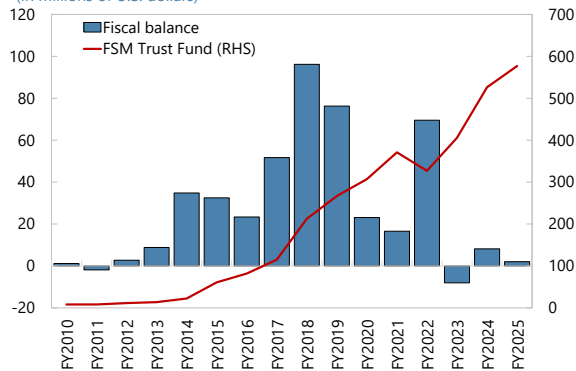
(In percent of GDP, average 2010-2022)



Compact trust fund (CTF) balances have risen sharply, thanks to additional upfront US contributions in 2024-25.

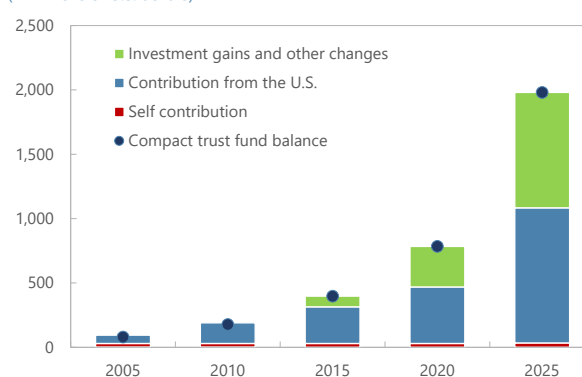
Trust Fund Balance

(In millions of U.S. dollars)



Compact Trust Fund Outstanding

(In millions of U.S. dollars)



Sources: FSM authorities, World Bank's World Development Indicator database, Gratcheva and Emery (2021), and IMF staff estimates.

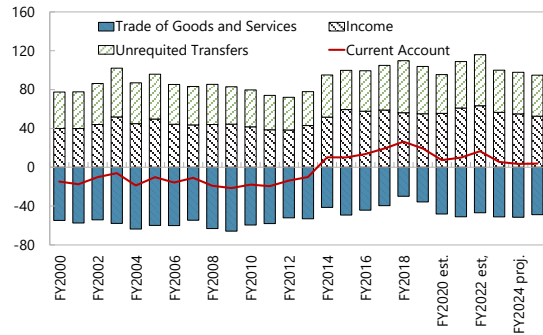
Figure 3. Federated States of Micronesia: External Sector Developments

The current account balance registered a surplus in recent years, with fishing license fees, foreign grants and corporate tax windfalls financing the trade deficit.

Limited exports and local production led to large trade deficits.

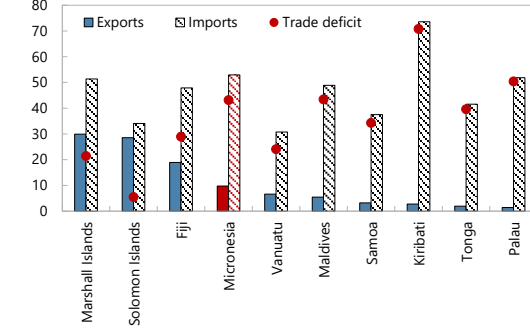
Balance of Payments

(In percent of GDP)



Trade Balances

(In percent of GDP, 2024 data)

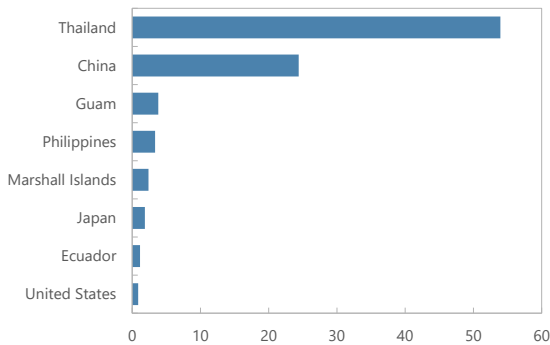


FSM's main export partners are related to the fishing industry's supply chains.

Imports come mostly from Guam and the United States, reflecting proximity and strong economic ties.

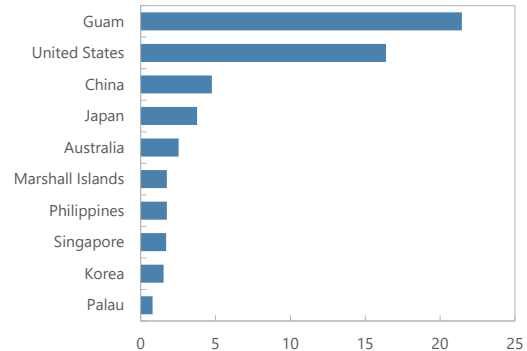
Exports by Trading Partners

(In percent of total, 2024 data)



Imports by Trading Partners

(In percent of total, 2024 data)

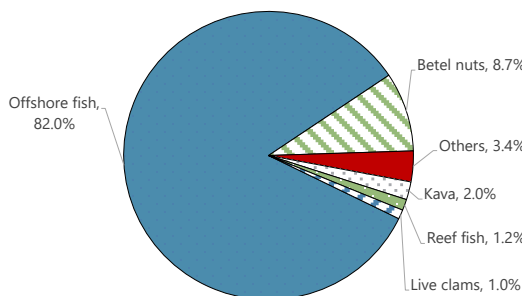


Offshore fish dominates as the FSM's primary export good.

Many essential items, such as food and fuel, are imported.

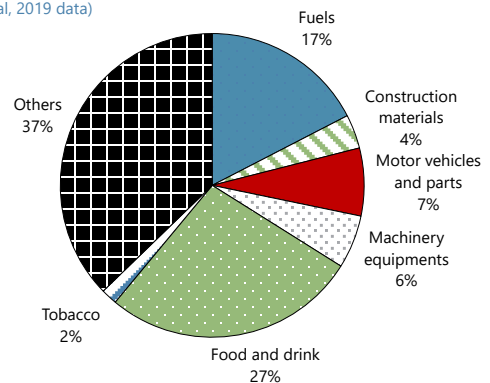
Main Export Products

(In percent of total, 2019 data)



Main Import Products

(In percent of total, 2019 data)



Source: FSM Statistics.

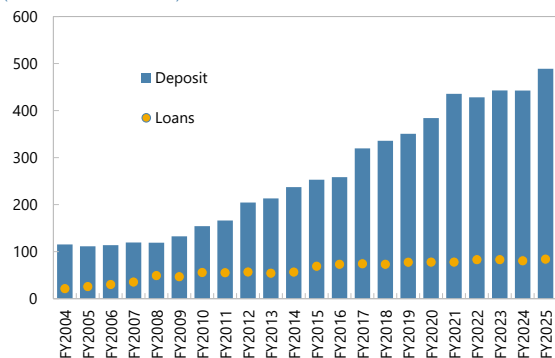
Sources: FSM Statistics, IMF Direction of Trade Statistics, IMF World Economic Outlook database, and IMF staff calculations.

Figure 4. Federated States of Micronesia: Monetary and Financial Sector Developments

Bank deposits continue to rise while loans were relatively flat.

Commercial Bank Deposits vs. Loans

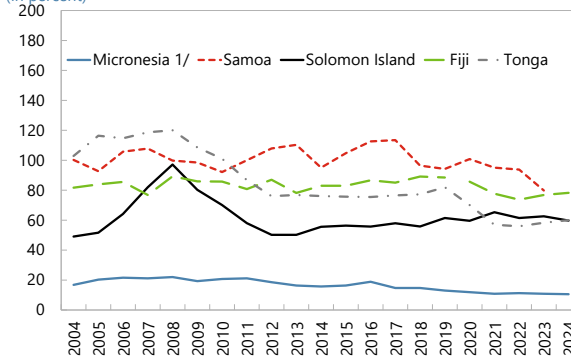
(In millions of U.S. Dollars)



The loan-to-deposit ratio remains at historically low levels, and below other PICs.

Loan-to-Deposit Ratio

(In percent)

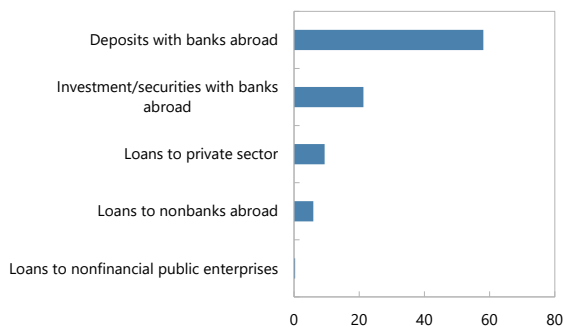


1/ Excludes loans to non-banks abroad.

Excess deposits were invested in deposits and investment securities with banks abroad.

Major Components of Commercial Bank Assets 1/

(In percent of total assets, 2025Q3 data)

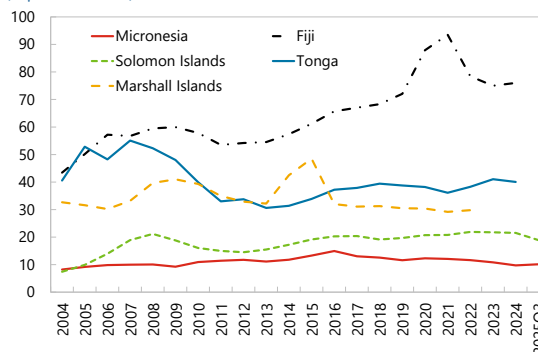


1/ Comprises two commercial banks in FSM.

Financial deepening lags peers.

Commercial Bank Credit to Private Sector

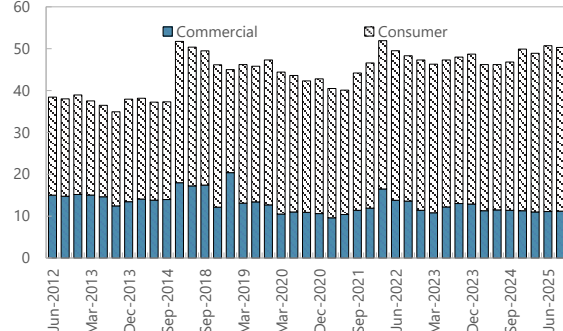
(In percent of GDP)



Domestic lending is dominated by consumer credit.

Private Loan Distribution 1/

(In millions of U.S. Dollars)

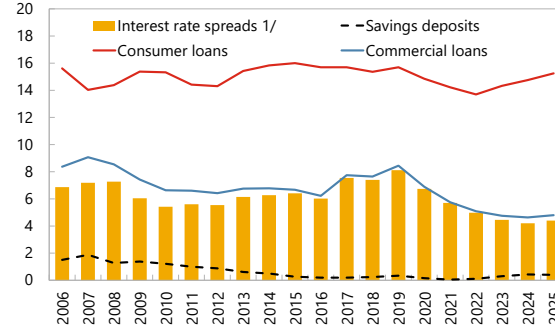


1/ Comprises commercial banks' domestic lending to private sector.

Interest rates on commercial loans fell as deposits grew.

Interest Rates

(In percent)



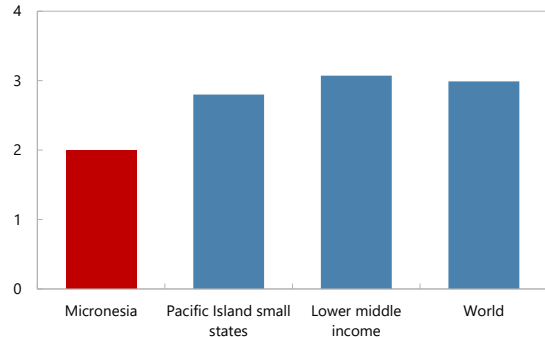
1/ Difference between interest rates for commercial loans and savings deposits.

Sources: FSM Banking Board, IMF World Economic Outlook database, and IMF staff calculations.

Figure 5. Federated States of Micronesia: Bottlenecks to Growth 1/

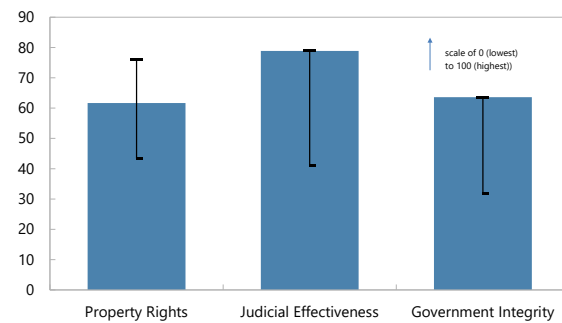
The FSM's structural bottlenecks remain large, including heavy regulatory burdens for businesses and weak institutions.

Business Regulatory Environment
(2022-2024 average, 1=lowest to 6=highest)



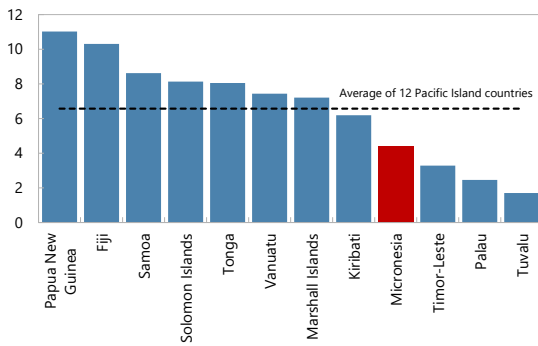
Rule of Law

(2021-2025 average, black line shows the score range for 8 Pacific Island countries)



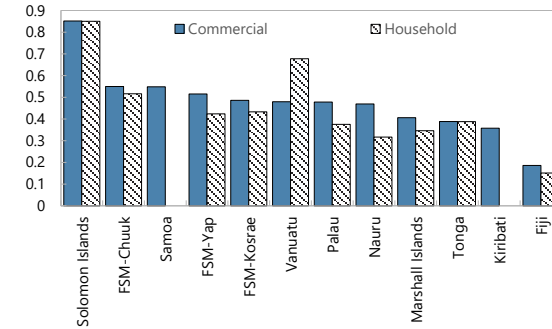
The FSM's geographical dispersion and remoteness hinder physical connectivity.

Liner Shipping Connectivity Index
(Maximum value = 100, 2021 data)



The cost of doing business is relatively high compared to peers.

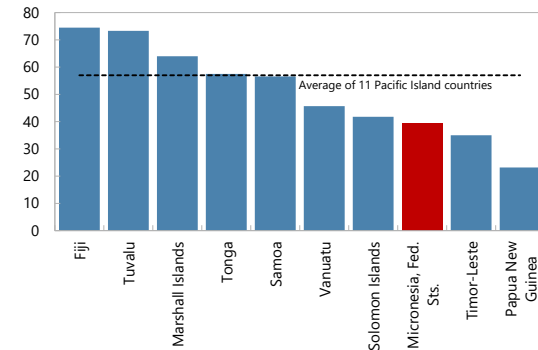
Regional Electricity Prices
(In U.S. dollars by kilowatt-hour, 2023)



Sources: Pacific Power Association; and IMF staff calculations.

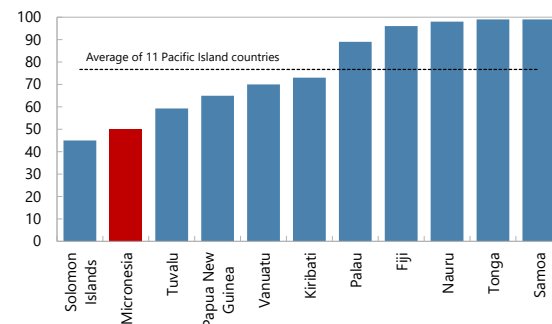
Increasing access to digital and mobile technology could enhance the FSM's connectivity.

Individuals Using the Internet
(In percent of population, 2021 data)



3G Mobile Network

(Percentage of population covered by 3G mobile network, 2022 data)



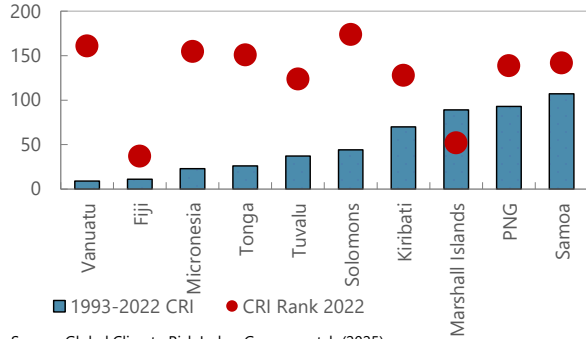
Sources: World Bank's Country Policy and Institutional Assessment (CPIA), World Development Indicator database, World Telecommunication/ICT Indicators database, and Terry Miller, Anthony B. Kim and James M. Roberts, *Index of Economic Freedom* (Washington: The Heritage Foundation).

1/ The World Bank's CPIA assess the conduciveness of a country's policy and institutional framework to poverty reduction, sustainable growth, and the effective use of development assistance. The rule of law indicators are components of the Heritage Foundation's Economic Freedom Index, reflecting the country's business climate. Non-IMF indicators provide qualitative information about country policy and institutional framework. They do not represent the IMF's assessment of the quality of policies and institutions.

Figure 6. Federated States of Micronesia: Climate Change Adaptation

FSM is among the most climate-vulnerable countries in the Pacific region.

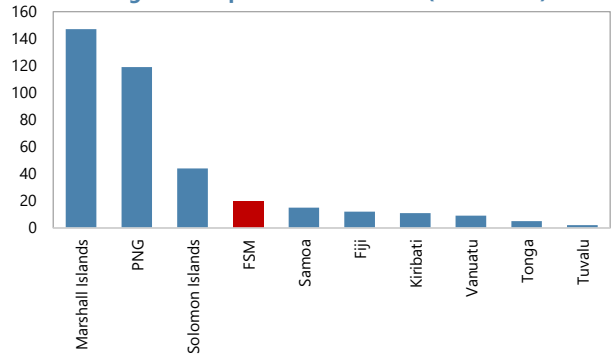
Long-term Climate Risk Index for Pacific Island Countries



Source: Global Climate Risk Index, Germanwatch (2025).
Note: the lower the ranking the higher the risk to climate-related extreme weather events.

....and ranks fourth in projected economic losses per unit of GDP

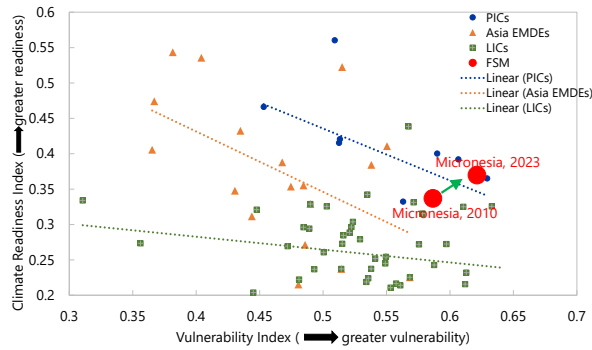
PICs: Average Losses per Unit GDP Rank (2000-2019)



Source: Climate Risk Index, Germanwatch.com
Note: Higher number indicate higher impact

Despite improvements, FSM's climate readiness remains below other PICs....

Climate Readiness and Vulnerability Indices, 2023

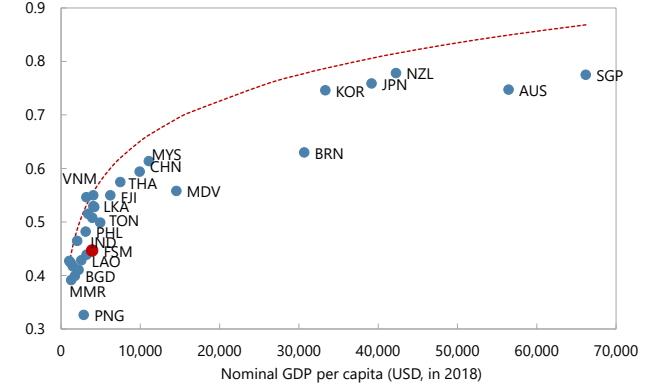


Source: Notre Dame Global Adaptation Initiative.

Climate adaptation has been hindered by weak implementation and resource constraints.

Adaptive Capacity Index

(Higher = greater adaptive capacity)



Source: IMF staff estimates.

Table 1. Federated States of Micronesia: Selected Economic Indicators, FY2022-30 1/

Nominal GDP (FY2023):	US\$443 million								
Population (FY2023):	94,654								
GDP per capita (FY2023):	US\$4,680								
IMF Quota:	SDR 7.2 million								
	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030
			Est.	Projections					
Real sector (annual percent change)									
Real GDP	-3.1	1.1	2.3	1.1	0.7	1.1	1.4	1.0	0.7
Consumer prices	5.0	6.2	5.4	3.2	3.2	4.0	1.7	2.0	2.0
Consolidated government finance (in percent of GDP)									
Revenue and grants	76.1	61.3	61.5	60.6	62.4	66.6	69.3	69.2	64.8
Revenue	47.5	32.2	32.3	32.9	32.4	31.9	31.3	30.9	30.5
Tax revenue	26.9	13.3	13.8	16.2	15.6	15.8	15.6	15.6	15.5
of which: corporate income tax	14.2	1.8	2.4	4.0	3.3	3.3	3.3	3.3	3.3
Non-tax revenue	20.6	18.9	18.5	16.8	16.8	16.1	15.7	15.3	15.0
of which: Fishing license fees	17.6	16.1	15.1	13.5	13.8	13.1	12.7	12.3	12.0
Grants 2/	28.6	29.1	29.2	27.7	29.9	34.7	38.0	38.3	34.3
Expenditure	59.4	63.2	59.8	60.2	62.0	66.9	69.9	70.0	65.7
Expense	59.0	61.0	55.4	56.3	55.9	55.9	55.9	56.3	56.0
Net acquisition of nonfinancial assets	0.4	2.1	4.4	3.9	6.1	11.0	14.0	13.7	9.7
Gross Public Investment	5.9	7.3	9.0	8.3	10.2	14.7	18.0	18.1	14.5
Net lending/borrowing	16.8	-1.8	1.7	0.4	0.4	-0.3	-0.6	-0.8	-0.9
Net lending/borrowing (excl. grants)	-11.8	-31.0	-27.5	-27.3	-29.5	-35.0	-38.6	-39.1	-35.2
Public debt (outstanding stock, end of period)	15.1	12.8	10.4	8.9	7.5	7.3	7.7	8.4	9.1
Balance of trust funds 3/	298.1	325.6	412.9	509.6	517.3	518.2	528.4	539.2	551.5
Commercial banks (in percentage of GDP; end of period)									
Loans 4/	13.2	11.6	10.3	10.4	10.6	10.8	11.0	11.2	11.4
Deposits	103.1	100.0	92.0	96.4	94.3	93.2	92.1	91.0	89.9
Interest rates (in percent, average for FY)									
Consumer loans	14.3	14.3	14.8	15.3	...	...	...	...	...
Commercial loans	4.8	4.8	4.6	4.8	...	...	...	...	...
Balance of payments (in millions of U.S. dollars)									
Trade balance	-183.8	-189.2	-207.7	-204.3	-227.4	-254.0	-269.2	-276.9	-270.2
Net services and income	34.1	21.4	17.9	10.5	12.1	10.5	9.4	8.2	7.3
Private and official transfers	218.3	192.1	206.5	212.7	221.0	241.3	255.7	262.1	256.3
Current account	68.6	24.4	16.6	18.9	5.7	-2.2	-4.2	-6.7	-6.6
(in percent of GDP)	16.5	5.5	3.5	3.8	1.1	-0.4	-0.7	-1.1	-1.1
External debt (in millions of U.S. dollars; end of period)									
Outstanding stock	59.4	49.8	45.3	40.2	35.1	37.0	41.0	46.4	52.5
(in percent of GDP)	14.3	11.2	9.4	8.0	6.7	6.7	7.2	8.0	8.8
Memorandum items:									
Real effective exchange rate 5/	108.0	115.1	126.1	136.3	...	...	...	...	...
Nominal GDP (in millions of U.S. dollars)	415.2	443.0	481.1	501.8	521.3	548.2	565.4	582.7	598.3

Sources: FSM authorities and IMF staff estimates and calculations.

1/ Fiscal year ends on September 30. Data for FY2021-23 is estimate from authorities and subject to revision.

2/ Excludes contributions to the Compact Trust Fund.

3/ Compact Trust Fund and FSM Trust Fund.

4/ Includes only domestic lending and does not account for loans to customers outside the country.

5/ Calendar year. 2010=100. The U.S. dollar is legal tender and the official currency.

Table 2a. Federated States of Micronesia: General Government Operations, FY2022-31 1/
(In millions of U.S. dollars)

	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031
			Est.	Projections						
Revenue	316.1	271.8	295.8	304.2	325.1	365.3	391.7	403.1	387.7	382.2
Tax revenue	111.6	59.1	66.4	81.2	81.4	86.5	88.1	90.6	93.0	95.4
Wage and salary tax	10.4	10.4	11.9	16.5	17.1	17.9	18.3	18.7	19.1	19.5
Gross revenue tax	25.3	25.7	26.7	28.3	28.9	30.4	31.4	32.3	33.2	34.1
Corporate Tax	59.2	8.0	11.3	19.9	17.0	17.9	18.4	19.0	19.5	20.0
Import taxes	16.2	13.9	15.8	15.7	17.6	19.6	19.2	19.8	20.3	20.8
Other taxes	0.6	0.4	0.7	0.7	0.8	0.8	0.8	0.8	0.9	0.9
Grants 2/	118.8	129.1	140.3	139.0	156.0	190.4	214.8	223.1	205.0	196.7
Current	107.6	114.1	133.1	128.2	134.8	155.2	171.0	174.2	159.6	152.9
U.S. Compact sector grants	67.0	71.2	100.8	93.2	96.1	100.0	101.5	103.7	105.5	107.9
Other U.S. grants	27.5	24.3	17.3	14.7	15.2	15.8	16.0	16.4	16.7	17.0
Other	13.1	18.6	15.0	20.3	23.6	39.5	53.6	54.2	37.4	28.1
Capital	7.5	12.3	5.0	9.3	21.2	35.2	43.7	48.9	45.4	43.8
U.S. Compact sector grants	1.1	4.7	4.7	3.9	15.0	25.0	30.0	35.0	35.7	36.4
Other U.S. grants	6.4	7.6	0.3	0.3	0.3	0.3	0.3	0.4	0.4	0.4
Other	0.0	0.0	0.0	5.1	5.9	9.9	13.4	13.5	9.3	7.0
Other	3.6	2.7	2.2	1.5	0.0	0.0	0.0	0.0	0.0	0.0
Non-tax revenue	85.7	83.6	89.1	84.1	87.7	88.4	88.8	89.3	89.7	90.1
Fishing license fees	73.0	71.1	72.7	67.8	71.8	71.8	71.7	71.6	71.5	71.4
Dividend and interest income	0.5	2.6	1.4	1.5	1.5	1.6	1.6	1.7	1.7	1.8
Other nontax revenues	12.2	9.9	15.0	14.8	14.3	15.1	15.5	16.0	16.4	16.9
Expenditure	246.5	279.9	287.6	302.2	323.1	366.8	395.3	408.0	393.3	389.5
Expense	244.8	270.4	266.5	282.5	291.2	306.7	316.2	328.1	335.1	342.9
Wages and salaries	91.0	96.1	109.0	118.3	122.0	127.0	129.1	131.7	134.3	137.0
Purchases of goods and services	100.9	124.6	117.7	128.5	135.7	146.0	151.3	157.4	158.4	161.7
Interest payments	1.5	0.9	0.9	0.9	0.8	0.8	0.7	0.6	0.5	0.5
Subsidies	0.8	1.2	0.8	0.8	0.8	1.1	1.2	0.9	0.9	1.0
Grants	8.1	9.3	10.1	8.6	6.8	7.2	7.4	7.6	7.8	8.0
Other expenses	42.5	38.4	28.0	25.5	25.0	24.7	26.5	29.8	33.2	34.6
Net acquisition of nonfinancial assets	1.7	9.4	21.1	19.7	31.9	60.1	79.2	79.9	58.1	46.7
Gross Public Investment	24.5	32.4	43.5	41.6	53.1	80.8	101.6	105.5	86.9	76.9
Gross operating balance	71.2	1.4	29.3	21.7	33.9	58.6	75.5	75.0	52.5	39.3
Net lending/borrowing	69.6	-8.1	8.2	2.0	2.0	-1.4	-3.6	-4.9	-5.6	-7.3
Memorandum items:										
U.S. Compact sector grants	68.0	75.9	105.6	97.1	111.1	125.0	131.5	138.7	141.2	144.3
Other U.S. grants	34.0	31.9	17.6	15.0	15.5	16.1	16.4	16.7	17.1	17.4
Net lending/borrowing excluding:										
Total grants	-49.2	-137.1	-132.1	-137.0	-154.0	-191.9	-218.4	-228.1	-210.6	-204.1
U.S. grants	-32.4	-115.9	-114.9	-110.1	-124.5	-142.5	-151.5	-160.4	-163.9	-169.0
Balance of trust funds	1,237.8	1,442.5	1,986.6	2,557.2	2,696.8	2,840.6	2,987.6	3,141.9	3,299.7	3,458.8
Compact Trust Fund	910.7	1,036.7	1,460.2	1,980.0	2,090.8	2,204.3	2,319.5	2,440.3	2,563.1	2,688.4
FSM Trust Fund	327.0	405.8	526.3	577.2	606.0	636.3	668.1	701.5	736.6	770.4
Nominal GDP	415.2	443.0	481.1	501.8	521.3	548.2	565.4	582.7	598.3	614.3

Sources: FSM authorities and IMF staff estimates and calculations.

1/ Fiscal year ending September. The consolidated fiscal accounts cover the national and four state governments.

2/ Excludes contributions to the Compact Trust Fund.

Table 2b. Federated States of Micronesia: General Government Operations, FY2022-31 1/
(In percent of GDP)

	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031
			Est.	Projections						
Revenue	76.1	61.3	61.5	60.6	62.4	66.6	69.3	69.2	64.8	62.2
Tax revenue	26.9	13.3	13.8	16.2	15.6	15.8	15.6	15.6	15.5	15.5
Wage and salary tax	2.5	2.4	2.5	3.3	3.3	3.3	3.2	3.2	3.2	3.2
Gross revenue tax	6.1	5.8	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6
Corporate Tax	14.2	1.8	2.4	4.0	3.3	3.3	3.3	3.3	3.3	3.3
Import taxes	3.9	3.1	3.3	3.1	3.4	3.6	3.4	3.4	3.4	3.4
Other taxes	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Grants 2/	28.6	29.1	29.2	27.7	29.9	34.7	38.0	38.3	34.3	32.0
Current	25.9	25.7	27.7	25.5	25.9	28.3	30.3	29.9	26.7	24.9
U.S. Compact sector grants	16.1	16.1	21.0	18.6	18.4	18.2	17.9	17.8	17.6	17.6
Other U.S. grants	6.6	5.5	3.6	2.9	2.9	2.9	2.8	2.8	2.8	2.8
Other	3.2	4.2	3.1	4.0	4.5	7.2	9.5	9.3	6.2	4.6
Capital	1.8	2.8	1.0	1.8	4.1	6.4	7.7	8.4	7.6	7.1
U.S. Compact sector grants	0.3	1.1	1.0	0.8	2.9	4.6	5.3	6.0	6.0	5.9
Other U.S. grants	1.6	1.7	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other	0.0	0.0	0.0	1.0	1.1	1.8	2.4	2.3	1.6	1.1
Other	0.9	0.6	0.5	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Non-tax revenue	20.6	18.9	18.5	16.8	16.8	16.1	15.7	15.3	15.0	14.7
Fishing license fees	17.6	16.1	15.1	13.5	13.8	13.1	12.7	12.3	12.0	11.6
Dividend and interest income	0.1	0.6	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Other nontax revenues	2.9	2.2	3.1	3.0	2.7	2.7	2.7	2.7	2.7	2.7
Expenditure	59.4	63.2	59.8	60.2	62.0	66.9	69.9	70.0	65.7	63.4
Expense	59.0	61.0	55.4	56.3	55.9	55.9	55.9	56.3	56.0	55.8
Wages and salaries	21.9	21.7	22.7	23.6	23.4	23.2	22.8	22.6	22.4	22.3
Purchases of goods and services	24.3	28.1	24.5	25.6	26.0	26.6	26.8	27.0	26.5	26.3
Interest payments	0.4	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Subsidies	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Grants	1.9	2.1	2.1	1.7	1.3	1.3	1.3	1.3	1.3	1.3
Other expenses	10.2	8.7	5.8	5.1	4.8	4.5	4.7	5.1	5.5	5.6
Net acquisition of nonfinancial assets	0.4	2.1	4.4	3.9	6.1	11.0	14.0	13.7	9.7	7.6
Gross Public Investment	5.9	7.3	9.0	8.3	10.2	14.7	18.0	18.1	14.5	12.5
Gross operating balance	17.2	0.3	6.1	4.3	6.5	10.7	13.4	12.9	8.8	6.4
Net lending/borrowing	16.8	-1.8	1.7	0.4	0.4	-0.3	-0.6	-0.8	-0.9	-1.2
Memorandum items:										
Primary balance	16.5	-1.4	1.8	0.5	0.5	-0.1	-0.5	-0.7	-0.7	-1.0
U.S. Compact sector grants	16.4	17.1	21.9	19.4	21.3	22.8	23.2	23.8	23.6	23.5
Other U.S. grants	8.2	7.2	3.7	3.0	3.0	2.9	2.9	2.9	2.9	2.8
Net lending/borrowing excluding:										
Total grants	-11.8	-31.0	-27.5	-27.3	-29.5	-35.0	-38.6	-39.1	-35.2	-33.2
U.S. grants	-7.8	-26.2	-23.9	-21.9	-23.9	-26.0	-26.8	-27.5	-27.4	-27.5
Balance of trust funds	298.1	325.6	412.9	509.6	517.3	518.2	528.4	539.2	551.5	563.0
Compact Trust Fund	219.3	234.0	303.5	394.6	401.1	402.1	410.2	418.8	428.4	437.6
FSM Trust Fund	78.8	91.6	109.4	115.0	116.3	116.1	118.2	120.4	123.1	125.4
Public external debt	14.3	11.2	9.4	8.0	6.7	6.7	7.2	8.0	8.8	9.3

Sources: FSM authorities and IMF staff estimates and calculations.

1/ Fiscal year ending September. The consolidated fiscal accounts cover the national and four state governments.

2/ Excludes contributions to the Compact Trust Fund.

Table 3. Federated States of Micronesia: Balance of Payments, FY2022-31

	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031
	Est.			Projections						
	(In millions of U.S. dollars)									
Current account balance	68.6	24.4	16.6	18.9	5.7	-2.2	-4.2	-6.7	-6.6	-5.9
Trade balance	-183.8	-189.2	-207.7	-204.3	-227.4	-254.0	-269.2	-276.9	-270.2	-268.3
Exports, f.o.b.	48.5	41.9	46.9	47.1	46.6	47.3	48.2	47.2	48.2	49.4
Imports, f.o.b.	232.2	231.1	254.6	251.4	273.9	301.3	317.4	324.2	318.4	317.7
of which: petroleum products	32.9	29.0	37.7	39.3	45.5	47.2	47.6	47.8	48.0	48.8
Services account	-11.0	-37.1	-40.0	-41.4	-42.7	-43.6	-44.6	-45.6	-46.4	-47.3
Receipts	71.7	56.1	61.0	63.6	66.1	69.5	71.6	73.8	75.8	77.8
of which: travel	24.2	34.5	37.5	39.1	40.6	42.7	44.1	45.4	46.6	47.9
Payments	82.6	93.3	101.0	105.0	108.7	113.0	116.2	119.4	122.2	125.1
of which: freight and insurance	38.0	38.0	41.3	43.0	44.7	47.0	48.5	50.0	51.3	52.7
of which: transportation 1/	3.3	15.3	16.6	17.3	18.0	17.9	18.5	19.0	19.6	20.1
Income, net	45.0	58.5	57.9	51.9	54.8	54.1	53.9	53.8	53.8	53.8
Receipts	79.3	89.1	91.4	86.6	90.7	91.7	92.6	93.6	94.7	95.8
of which: fishing license fees	71.3	69.8	70.5	65.8	69.7	69.6	69.5	69.4	69.4	69.3
Payments	34.3	30.6	33.5	34.7	35.9	37.6	38.7	39.9	40.9	42.0
of which: foreign workers earnings	4.4	3.4	3.7	3.8	4.0	4.2	4.3	4.5	4.6	4.7
Transfers	218.3	192.1	206.5	212.7	221.0	241.3	255.7	262.1	256.3	255.9
Private	90.0	51.7	46.5	56.9	58.4	61.8	64.0	66.1	68.1	70.1
Inflows 2/	100.5	62.6	57.6	68.1	69.7	73.3	75.6	77.9	80.0	82.1
Outflows	10.5	10.9	11.0	11.2	11.3	11.5	11.6	11.8	11.9	12.1
Official	128.3	140.4	159.9	155.7	162.6	179.5	191.7	195.9	188.2	185.9
US Compact	67.0	77.0	100.8	93.2	96.1	100.0	101.5	103.7	105.5	107.9
Other	61.3	63.4	59.1	62.5	66.5	79.5	90.2	92.2	82.7	78.0
Capital account balance	26.8	8.5	12.5	16.7	28.6	42.6	51.1	56.3	52.8	51.2
Capital inflow	26.8	8.5	12.5	16.7	28.6	42.6	51.1	56.3	52.8	51.2
Compact Capital grants	1.1	0.8	4.7	3.9	15.0	25.0	30.0	35.0	35.7	36.4
Other	25.7	7.7	7.7	12.8	13.6	17.6	21.1	21.3	17.1	14.7
Financial account balance	98.5	21.8	29.1	35.6	34.3	40.4	46.9	49.6	46.2	45.2
Direct Investment (net)	-0.2	-0.2	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Portfolio investment (net)	-37.2	-8.9	-9.1	-7.3	-11.3	-8.0	-8.0	-7.9	-7.8	-11.9
Other investment (net)	135.9	30.8	38.4	43.1	45.9	48.7	55.2	57.8	54.3	57.5
Errors and Omissions	3.0	-11.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	(In percent of GDP)									
Current account balance	16.5	5.5	3.5	3.8	1.1	-0.4	-0.7	-1.1	-1.1	-1.0
Trade balance	-44.3	-42.7	-43.2	-40.7	-43.6	-46.3	-47.6	-47.5	-45.2	-43.7
Exports	11.7	9.5	9.7	9.4	8.9	8.6	8.5	8.1	8.1	8.0
Imports	55.9	52.2	52.9	50.1	52.6	55.0	56.1	55.6	53.2	51.7
Service	-2.6	-8.4	-8.3	-8.3	-8.2	-7.9	-7.9	-7.8	-7.8	-7.7
Income (net)	10.8	13.2	12.0	10.3	10.5	9.9	9.5	9.2	9.0	8.8
Receipts	19.1	20.1	19.0	17.3	17.4	16.7	16.4	16.1	15.8	15.6
of which: fishing license fees	17.2	15.8	14.7	13.1	13.4	12.7	12.3	11.9	11.6	11.3
Payments	8.3	6.9	7.0	6.9	6.9	6.9	6.8	6.8	6.8	6.8
Transfers	52.6	43.4	42.9	42.4	42.4	44.0	45.2	45.0	42.8	41.7
Private 2/	21.7	11.7	9.7	11.3	11.2	11.3	11.3	11.3	11.4	11.4
Official	30.9	31.7	33.2	31.0	31.2	32.7	33.9	33.6	31.5	30.3
Capital account balance	6.5	1.9	2.6	3.3	5.5	7.8	9.0	9.7	8.8	8.3
Capital grants	6.5	1.9	2.6	3.3	5.5	7.8	9.0	9.7	8.8	8.3
of which Compact capital grants	0.3	0.2	1.0	0.8	2.9	4.6	5.3	6.0	6.0	5.9
Financial account balance	23.7	4.9	6.0	7.1	6.6	7.4	8.3	8.5	7.7	7.4
Direct investment (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Portfolio investment (net)	-9.0	-2.0	-1.9	-1.4	-2.2	-1.5	-1.4	-1.4	-1.3	-1.9
Other investment (net)	32.7	7.0	8.0	8.6	8.8	8.9	9.8	9.9	9.1	9.4
Errors and omissions	0.7	-2.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Sources: FSM authorities and IMF staff estimates and calculations.

1/ Refers to passenger services transportation.

2/ Includes household remittance and corporate tax on income from abroad.

Table 4. Federated States of Micronesia: Medium Term, FY2022-31
(In percent of GDP, unless otherwise noted)

	FY2022	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031
			Est.	Projections						
Real sector (annual percent change)										
Real GDP	-3.1	1.1	2.3	1.1	0.7	1.1	1.4	1.0	0.7	0.7
Consumer prices	5.0	6.2	5.4	3.2	3.2	4.0	1.7	2.0	2.0	2.0
Consolidated government finance (in percent of GDP)										
Revenue and grants	76.1	61.3	61.5	60.6	62.4	66.6	69.3	69.2	64.8	62.2
Revenue	47.5	32.2	32.3	32.9	32.4	31.9	31.3	30.9	30.5	30.2
Tax revenue	26.9	13.3	13.8	16.2	15.6	15.8	15.6	15.6	15.5	15.5
of which: corporate income tax	14.2	1.8	2.4	4.0	3.3	3.3	3.3	3.3	3.3	3.3
Non-tax revenue	20.6	18.9	18.5	16.8	16.8	16.1	15.7	15.3	15.0	14.7
of which: Fishing license fees	17.6	16.1	15.1	13.5	13.8	13.1	12.7	12.3	12.0	11.6
Grants 2/	28.6	29.1	29.2	27.7	29.9	34.7	38.0	38.3	34.3	32.0
Expenditure	59.4	63.2	59.8	60.2	62.0	66.9	69.9	70.0	65.7	63.4
Expense	59.0	61.0	55.4	56.3	55.9	55.9	55.9	56.3	56.0	55.8
Net acquisition of nonfinancial assets	0.4	2.1	4.4	3.9	6.1	11.0	14.0	13.7	9.7	7.6
Gross Public Investment	5.9	7.3	9.0	8.3	10.2	14.7	18.0	18.1	14.5	12.5
Net lending/borrowing	16.8	-1.8	1.7	0.4	0.4	-0.3	-0.6	-0.8	-0.9	-1.2
Net lending/borrowing (excl. grants)	-11.8	-31.0	-27.5	-27.3	-29.5	-35.0	-38.6	-39.1	-35.2	-33.2
Public debt (outstanding stock, end of period)	15.1	12.8	10.4	8.9	7.5	7.3	7.7	8.4	9.1	9.5
Balance of trust funds 3/	298.1	325.6	412.9	509.6	517.3	518.2	528.4	539.2	551.5	563.0
Commercial banks (in percentage of GDP; end of period)										
Loans 4/	13.2	11.6	10.3	10.4	10.6	10.8	11.0	11.2	11.4	11.6
Deposits	103.1	100.0	92.0	96.4	94.3	93.2	92.1	92.1	92.1	92.1
Interest rates (in percent, average for FY)										
Consumer loans	14.3	14.3	14.8	15.3	...	...	...	...	...	...
Commercial loans	4.8	4.8	4.6	4.8	...	...	...	...	...	...
Balance of payments (in millions of U.S. dollars)										
Trade balance	-183.8	-189.2	-207.7	-204.3	-227.4	-254.0	-269.2	-276.9	-270.2	-268.3
Net services and income	34.1	21.4	17.9	10.5	12.1	10.5	9.4	8.2	7.3	6.5
Private and official transfers	218.3	192.1	206.5	212.7	221.0	241.3	255.7	262.1	256.3	255.9
Current account	68.6	24.4	16.6	18.9	5.7	-2.2	-4.2	-6.7	-6.6	-5.9
(in percent of GDP)	16.5	5.5	3.5	3.8	1.1	-0.4	-0.7	-1.1	-1.1	-1.0
External debt (in millions of U.S. dollars; end of period)										
Outstanding stock	59.4	49.8	45.3	40.2	35.1	37.0	41.0	46.4	52.5	57.3
(in percent of GDP)	14.3	11.2	9.4	8.0	6.7	6.7	7.2	8.0	8.8	9.3
Memorandum items:										
Real effective exchange rate 5/	108.0	115.1	126.1	136.3	...	...	...	...	...	...
Nominal GDP (in millions of U.S. dollars)	415.2	443.0	481.1	501.8	521.3	548.2	565.4	582.7	598.3	614.3

Sources: FSM authorities and IMF staff estimates and calculations.

1/ Fiscal year ends on September 30. Data for FY2019-22 is estimate from authorities and subject to revision.

2/ Excludes contributions to the Compact Trust Fund.

3/ Compact Trust Fund and FSM Trust Fund.

4/ Includes only domestic lending and does not account for loans to customers outside the country.

5/ Calendar year. 2010=100. The U.S. dollar is legal tender and the official currency.

Table 5. Federated States of Micronesia: Deposit Money Banks, FY2020-25
(In millions of U.S. dollars, unless otherwise noted)

	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025
Assets and liabilities						
Assets	423.3	474.1	463.9	488.0	493.3	535.9
Foreign assets 1/	362.3	330.2	399.1	426.2	430.1	470.9
Claims on private sector	42.3	44.2	48.3	48.0	46.8	50.3
Consumer loans	31.4	32.8	34.7	35.0	35.4	39.1
Commercial loans	10.9	11.4	13.6	13.0	11.4	11.2
Claims on nonfinancial public enterprises	8.5	7.4	6.5	3.2	2.6	1.9
Others assets	10.4	10.1	10.0	10.6	46.5	83.9
Liabilities	423.3	474.1	463.9	488.0	493.3	535.9
Deposits	384.1	435.5	428.2	442.9	442.7	483.7
Of which: national government	80.5	89.6	85.3	75.5	59.4	69.3
Capital accounts	28.7	27.9	25.0	33.4	38.1	39.7
Other liabilities	10.4	10.7	10.8	11.7	12.4	12.5
Memorandum items:						
Loan/deposit ratio (in percent) 2/	13.2	11.8	12.8	11.6	11.2	10.8
Deposits (percent change)	9.5	13.4	-1.7	3.4	0.0	9.3
Loans (percent change)	0.0	1.6	6.2	-6.6	-3.5	5.7
Interest rates (percent)						
Deposit rates						
Savings deposits 3/	0.2	0.0	0.3	0.3	0.4	0.4
CDs	0.2	0.0	0.4	0.4	0.5	0.5
Time Deposits	0.1	0.0	0.0	0.0	0.0	0.0
Loans rates 4/						
Consumer loans	14.9	12.7	14.3	14.3	14.8	15.3
Commercial loans	6.9	3.0	4.8	4.8	4.6	4.8

Sources: FSM authorities and IMF staff estimates and calculations.

1/ Includes loans to abroad.

2/ Excludes loans to abroad.

3/ Average rates offered by the deposit money banks.

4/ Average rates charged by the deposit money banks.

Table 6. Federated States of Micronesia: Vulnerability Indicators, FY2023-31

	FY2023	FY2024	FY2025	FY2026	FY2027	FY2028	FY2029	FY2030	FY2031
			Est.				Proj.		
Deposit money banks									
Deposits (in percent of GDP)	100.0	92.0	96.4	94.3	93.2	92.1	91.0	89.9	88.8
Deposits (Year-on-year percent change)	3.4	0.0	9.3	1.6	3.9	1.9	1.8	1.4	1.4
Loans (in percent of GDP)	11.6	10.3	10.4	10.6	10.8	11.0	11.2	11.4	11.6
Loans (Year-on-year percent change)	-6.6	-3.5	5.7	5.9	7.1	5.0	4.9	4.5	4.5
Loan to deposit ratio (in percent)	11.6	11.2	10.8	11.2	11.6	11.9	12.3	12.7	13.1
Foreign assets (in percent of GDP)	96.2	89.4	93.8	...	...	...	...	...	...
Equity capital (in percent of total asset)	6.8	7.7	7.4	...	...	...	...	...	...
FSM Development Bank									
Loans (in percent of GDP) 1/	7.9	8.7	8.5	...	...	...	...	...	...
External indicators									
Exports (goods & services, y/y percent change)	-18.4	10.0	2.7	1.7	3.7	2.6	1.1	2.4	2.6
Imports (goods & services, y/y percent change)	3.0	9.6	0.2	7.4	8.3	4.6	2.3	-0.7	0.5
Current account balance (percent of GDP)									
Including official transfers	5.5	3.5	3.8	1.1	-0.4	-0.7	-1.1	-1.1	-1.0
Excluding official transfers	-26.2	-29.8	-27.3	-30.1	-33.1	-34.6	-34.8	-32.6	-31.2
Total external debt									
In millions of U.S. dollars	49.8	45.3	40.2	35.1	37.0	41.0	46.4	52.5	57.3
In percent of exports of goods and services	50.8	42.0	36.3	31.2	31.6	34.2	38.3	42.3	45.0
In percent of GDP	11.2	9.4	8.0	6.7	6.7	7.2	8.0	8.8	9.3
Debt service									
In millions of U.S. dollars	6.2	6.1	5.9	5.8	5.9	5.0	4.6	4.6	3.4
In percent of exports of goods and services	6.3	5.7	5.3	5.1	5.1	4.2	3.8	3.7	2.7
In percent of GDP	1.4	1.3	1.2	1.1	1.1	0.9	0.8	0.8	0.6

Sources: FSM authorities, FSMDB and IMF staff estimates and calculations.

1/ Loans are calendar year data.

Table 7. Federated States of Micronesia: Financial Soundness Indicators, 2021-25

(In percent)

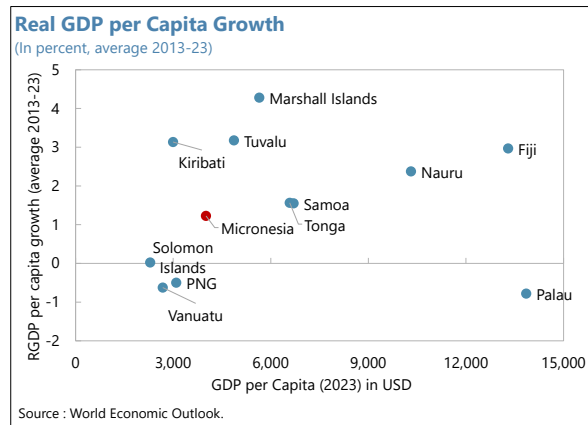
	Jun-21	Dec-21	Jun-22	Dec-22	Jun-23	Dec-23	Jun-24	Dec-24	Jun-25	Sep-25
Capital adequacy										
Regulatory capital to risk-weighted assets	40.6	37.2	38.1	38.5	37.4	38.9	43.9	42.1	44.6	43.3
Regulatory Tier 1 capital to risk-weighted assets	40.6	37.2	38.1	38.5	37.4	38.9	43.9	42.1	44.6	43.3
Non-Performing Loans (NPL) net of provisions to capital	1.4	2.9	2.8	3.7	3.5	4.3	2.2	6.3	7.2	16.2
Asset quality										
NPL to total gross loans	0.7	1.3	1.2	1.4	1.6	1.7	0.9	2.8	3.4	7.5
Sectoral distribution of loans										
Residents	64.6	68.2	66.2	62.6	62.5	64.5	61.6	63.3	63.9	62.2
Deposit-takers	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Central bank	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial corporations	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
General government	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Nonfinancial corporations	58.6	62.9	61.7	58.5	58.6	60.9	58.3	60.3	61.3	59.8
Other domestic sectors	1.2	1.1	1.7	1.6	0.8	3.6	3.3	3.0	2.6	2.4
Nonresidents	35.4	31.8	33.7	37.4	37.5	35.5	38.4	36.7	36.1	37.8
Earnings and profitability										
Return on assets	0.6	0.7	0.9	3.3	3.0	3.4	3.1	3.0	2.6	2.6
Return on equity	9.2	11.7	16.6	59.1	50.0	46.9	41.6	39.2	36.1	37.1
Interest margin to gross income	83.6	82.4	78.9	84.5	90.8	91.0	90.2	89.9	88.7	89.0
Non-interest expenses to gross income	65.3	64.7	56.2	44.7	35.2	33.7	37.6	38.6	41.5	40.9
Personnel expenses to noninterest expenses	50.4	50.2	47.7	48.7	45.1	45.2	44.9	45.3	45.7	46.1
Liquidity										
Liquid assets to total assets	66.9	67.4	64.8	60.4	59.1	58.5	59.8	60.4	62.0	67.9
Other										
Capital to assets	5.4	5.3	5.6	5.6	5.7	5.8	6.3	5.9	5.8	5.8
Gross asset position in financial derivatives to capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross liability position in financial derivatives to capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Trading income to total income	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Customer deposits to total (non-interbank) loans	584.5	553.6	498.9	493.7	498.3	505.2	514.5	548.2	598.0	575.5
Foreign-currency-denominated loans to total loans	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Foreign-currency-denominated liabilities to total liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: FSM authorities

Annex I. Country Engagement Strategy¹

A. Drivers of Fragility

1. FSM is a geographically dispersed Pacific Island country (PIC) which has a Compact of Free Association (COFA) with the United States. FSM is a federation of four states—Pohnpei, Chuuk, Yap, and Kosrae—spanning over 600 islands, which provides the country with one of the world’s largest Exclusive Economic Zones, at approximately 3 million km². Arable land in FSM is limited (2.8 percent of land area) with the total agricultural land of approximately 50km² mainly used for subsistence-based farming. The population is estimated at around 95,000, although the latest (2023) unpublished census suggests it is substantially lower due to outward migration. GDP per capita is estimated at USD 5,089 in 2024. FSM’s political structure is highly decentralized, with significant autonomy for states. Since independence, FSM has maintained a COFA with the United States, which remains central to its economic and development trajectory. The renewed COFA agreement (2024) provides USD 2.8 billion in sector grants through 2043, to support FSM’s development priorities in infrastructure, sustainable growth, climate resilience, governance, and human capital. FSM’s trust funds have accumulated assets of roughly 510 percent of GDP by FY2025.²



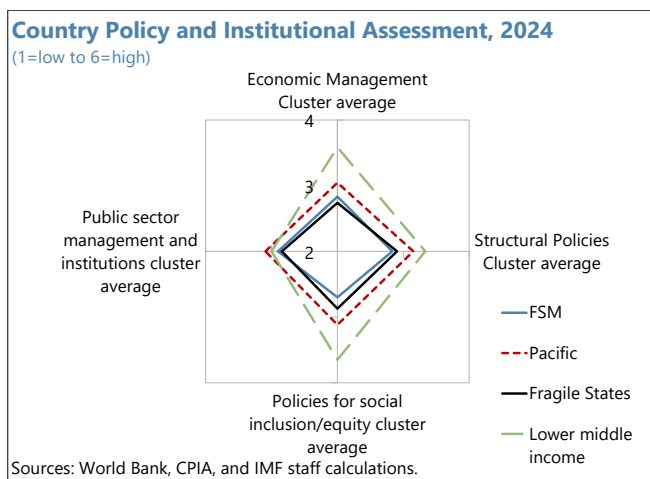
2. Economic development is constrained by several interrelated fragility drivers. FSM faces severe climate risks with adaptation needs estimated at around 30 percent of 2024 GDP, annually. Climate change is expected to reduce tuna catches by 13 percent, potentially lowering GDP by 4 percent. Loss of small islands may also shrink the EEZ, impacting fishing license revenues. Connectivity between islands (especially outer islands) and other countries is poor, with low frequency and small fleets. FSM has one of the worst maritime connections, even among PICs, adding to costs. Marine transport services are only available on a biannual basis to some outer islands. In terms of air connectivity, FSM’s ranks at 210 out of 219 countries, ahead of only 3 other PICs as flights are usually unreliable, time-consuming and expensive. At the same time, the availability and quality of essential infrastructure lags peers. For instance, the share of population having access to electricity is lower than PICs average. Additionally, existing critical infrastructure (e.g., water, energy) continues to deteriorate due to inadequate maintenance and the compounding effects of climate change. Weak public service delivery stems from limited institutional capacity and is worsened by governance issues. Decentralized decision making under the federal structure

¹ Prepared by Salote Cirikisuva and Choonsung Lim

² Covers both the Compact Trust Fund and the FSM Trust Fund which was created to act as an additional fiscal buffer.

complicates coordination while political fragmentation often stalls major policy initiatives due to a lack of consensus.

3. Fragility drivers translate to a narrow economic base that is dominated by the public sector, and weak growth. The private sector remains underdeveloped, with the public sector employing over half of the workforce. Growth averaged only 1.0 percent in the decade pre-COVID, Outward migration, particularly to the US – where FSM citizens can study and work without a visa – has exacerbated skilled labor shortages. Fragility drivers and regulatory barriers, impede the development of a vibrant private sector. Business regulations are complex and vary by state, while foreign investment and land ownership are restricted. Import dependence, remoteness and population dispersion increase the cost of public service delivery. Aid dependency is pronounced, with donor grants representing nearly half of fiscal revenue.



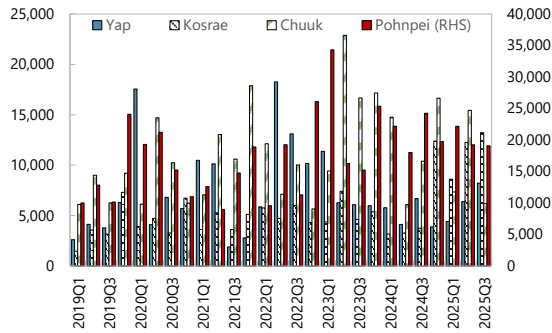
B. Constraints to Reforms and Policies to Address Fragility

4. The pace of reform implementation is slow, due to capacity constraints and a complex governance structure. Weak institutional capacity in areas such as procurement, financial management and monitoring and evaluation, as well as weak public financial and investment management frameworks, impedes delivery of development projects. This is compounded by limited technical expertise within the domestic labor market, with an acute shortage of professional and vocational skills. The significant loss of civil servants between 2019 and 2022 (12 percent) added to the strain in administrative capacity and exacerbated skills shortages. International consultants are used to fill skills gaps, but, thus far, has not led to a sustained increase in domestic capacity, partly due to high rates of turnover as staff with newly acquired skills move to new roles, including outside the civil service. FSM’s decentralized structure also presents a challenge, as many necessary reforms (e.g., taxation, land, business regulation, FDI) require consensus between national and state governments. Administrative fragmentation and divergent local priorities create tensions between the states particularly around resource allocation. The allocation of COFA funds remains a key source of inter-state friction, with states heavily reliant on these funds for development and administrative functions. Despite oversight mechanisms provided by the Joint Economic Management Committee which is designed for accountability, this arrangement sometimes leads to disagreements over spending priorities and transparency issues, affecting inter-state relations and trust in the national government.

Figure 1. FSM State Characteristics

Import Volume by Port

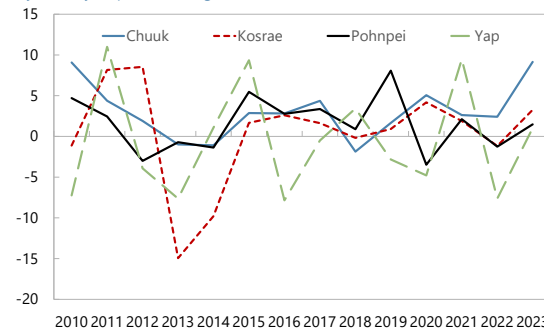
(In metric tons)



Sources: PortWatch; and IMF staff calculations.

Growth Rate by State

(In year-on-year percent change)



Source: FSM authorities.

Table 1. FSM State Population, GDP per Capita, and Infrastructure

State	Population ('000s) FY 2022 (e)	GDP per capita (USD) FY 2022	Infrastructure Rating	Comments
Yap	11.6	3,307	Moderate	Moderate infrastructure with a focus on water systems and education; airport modernization underway.
Chuuk	49.7	1,557	Limited	Limited infrastructure with significant challenges in transport and utilities. Chuuk is the most populous state, yet it accounts for only about 27 percent of GDP.
Pohnpei	36.9	3,821	Developed	Most developed infrastructure; strong in government facilities, roads, and utilities but upgrades for resilience are needed. Accounts for more than 50 percent of GDP.
Kosrae	6.8	3,399	Moderate	Infrastructure development is based on clear, unified planning, underpinned by stakeholder consensus, but is limited by geographic isolation and small population.

Source: FSM Infrastructure Development Plans (FY2016–2025 and FY2025–2034) and FSM Department of Resources and Development.

5. Efforts to address fragility and bolster sustainable and inclusive growth need to be intensified. Policy priorities include:

- **Reviving the reform momentum.** A set of ambitious, mutually reinforcing, and transformative reforms is needed for higher, sustainable economic growth. It will require building broad consensus across all states on critical, but difficult long-standing reforms and support from the international community given capacity constraints. Effective communication strategies – outlining the reform’s benefits and mitigating measures for those negatively affected – are needed to garner support for challenging reforms.
- **Strengthening public financial management (PFM) to achieve larger growth dividends.** Developing a medium-term fiscal framework and public investment management capacity will be key to promote sustainable economic growth and better manage risks. This would require support from development partners to build domestic capacity in project prioritization and implementation. Greater transparency and accountability in PFM processes would help address governance risks.
- **Removing obstacles to private sector development.** Priority areas include simplifying business regulations, land reform, easing FDI restrictions, and addressing skills mismatches (Annex VIII). Transportation and communication (including digital) infrastructure needs to be strengthened. Improving access to credit will require both supply and demand side interventions (Annex VI).
- **Addressing climate challenges, including food security,** will require greater efforts on climate adaptation with donor support (see [Climate Change Policy Assessment](#)). Preparing a comprehensive National Adaptation Plan is a priority as this would provide a strategic, coordinating framework for building climate resilience. Climate strategies will be more effective if well integrated into public financial management processes. Undertaking hazard mapping for key infrastructure assets can help identify areas vulnerable to climate and disaster risk, supporting risk mitigation efforts.

C. International Partnerships and Fund Engagement including Capacity Development Priorities

6. The Fund’s engagement with FSM should remain centered around surveillance and capacity development (CD). The strategy was shared with the authorities during the mission and benefited from their feedback. Recent CD activities have mainly been delivered by the Pacific Financial Technical Assistance Center (PFTAC) with support from headquarters. Activities include: compilation of macroeconomic statistics (National Accounts, government finance and public sector debt); development of a macro-fiscal projections tool; designing tax policy reform options; and

strengthening financial sector supervision. Near-term CD priorities should concentrate on enhancing the authorities' capacity for prioritizing and implementing public investments effectively. The IMF's CD could support the authorities to: enhance the timeliness of macroeconomic statistics; close data gaps (e.g. Balance of Payments compilation); improve PFM and public investment management (including by incorporating climate change considerations); and revenue mobilization (including support to implement a VAT). A medium-term approach to CD, incorporating on-the-job training, can help enhance effectiveness as it would allow sufficient time for knowledge transfer. Potential turnover of officials should be considered when designing CD strategies. Close coordination with development partners remains crucial. The US is the most important donor to FSM, other partners include the World Bank, the Asian Development Bank, United Nations agencies, and the governments of Australia, New Zealand and Japan.

7. The Fund's engagement with FSM is subject to several significant risks that may impede successful reform implementation. Key challenges include ongoing emigration and resulting labor shortages, which constrain domestic capacity; fiscal vulnerabilities arising from uncertainties in tax revenues, external grant flows and unexpected climate-change related expenditures; political fragmentation and limited political will, which can undermine policy continuity; and persistent vulnerabilities to climate change, which exacerbate economic and social fragilities. Addressing these risks is essential to ensure the effectiveness and sustainability of the Fund's support.

Annex II. Main Recommendations of the 2023 Article IV Consultation

Fund Recommendations	Policy Actions
Fiscal policy	
Develop a stable and sustainable spending path over the medium term, and accumulate appropriate fiscal buffers to manage risks and save for future generations.	Partially implemented. To align with the lower revenue envelope, national government expenditure has been reduced by cutting Congressional projects.
Strengthen capacity to plan and implement public spending, especially investment, and programs.	Partially implemented. Authorities are working with development partners (e.g., the World Bank) to strengthen institutional capacity and enhance project management skills.
Address sustainability of the social security fund over time.	Partially implemented. Authorities are conducting in-depth actuarial studies to guide policy formulation to ensure the sustainability of the social security fund.
Strengthen public financial management, especially public investment management.	Partially implemented. The payroll module of Financial Management Information System was rolled out at the state and national level in October 2025. While the PFM Reform agenda has largely completed the introduction of new information systems, progress in strengthening public investment management remains pending.
Improve revenue administration and modernize the tax system.	Partially implemented. The ASYCUDA system was operationalized in March 2024, while the Revenue Management System was launched in August 2025. Work on tax policy and administration reforms is ongoing; the National Tax Reform Task Force concluded consultations with all states in December 2025.
Structural Reforms	
Improve the business environment and ensure reliable supply of utilities.	Partially implemented. Development partners continue to support investments in energy, water and sanitation, as well as transport infrastructure.

Fund Recommendations	Policy Actions
Amend the Foreign Investment Act to harmonize FDI laws and regulations across states and reduce barriers to foreign ownership.	Not implemented.
Reform land tenure system.	Not implemented.
Improve digitalization.	Partially implemented. With the support of the World Bank, entry level broadband service was made available throughout FSM in May 2025. Legal and regulatory frameworks for the provision of digital government services have been drafted and comments from states are being sought. Pilot government services are being rolled out.
Financial Sector Development	
Enhance the institutional framework for the FSMDB and address gaps in corporate governance to promote appropriate balance between policy goals.	Not implemented.
Extend the FSM Banking Board supervisory authority to the FSMDB and credit unions.	Not implemented. This remains under consideration by authorities. Part of the challenge is the capacity of FSMDB to supervise additional institutions given that they have a technical team of two.
Climate Adaptation	
Implement a comprehensive National Adaptation Plan in coordination with states.	Partially implemented. The National Adaptation Plan is planned for completion in 2026
Statistics	
Improve the data collection process, strengthen the capacity of the statistical agency, and promote greater disclosure of data across all government levels and agencies.	Partially implemented. Technical assistance has been provided by PFTAC to anonymize administrative tax data, this will support data sharing across government departments and agencies. Full implementation requires deeper capacity development from development partners and additional resources for the Statistics Department.

Annex III. External Sector Assessment

Overall Assessment: *The FSM's external position is assessed to be substantially stronger than the level implied by fundamentals and desirable policies, based on projected data and EBA-lite model results.¹ However, because of data gaps for FY2024-FY2025, the FSM's heavy dependence on volatile foreign grants, foreign corporate tax revenue, and fishing license fees, these results should be interpreted with caution. Economic support under the new Compact agreement with the United States also significantly impacts the assessment.*

Potential Policy Responses: *As the current account balance is projected to deteriorate in the medium-to long-term, structural reforms to promote private sector development could help improve competitiveness, diversify the export base, reduce import reliance and hence reduce external stability risks. Nonetheless, the new Compact agreement provides a significant and reliable increase in capital inflows and financial support, strengthening the FSM's external position.*

Current Account

Background. In FY2025, the current account balance is estimated to reach a surplus of 3.8 percent of GDP, as the inflows of donor grants, fishing license fees and corporate income tax on offshore captive insurance companies were used to finance the trade deficit and accumulate assets. The current account surplus in FY2025 is higher than the surplus of 3.5 percent of GDP in FY2024, due to the increase in foreign corporate tax revenue from 2.4 to 4 percent of GDP that more than offset a slight decline in fishing license fees. The FSM had a positive net

international investment position (NIIP) of 192 percent of GDP at end-FY2025, mainly reflecting limited liabilities due to relatively small and declining foreign debt, a large share of bank deposits invested abroad and the buildup of the FSM Trust Fund².

Assessment. The external balance assessment (EBA) suggests that the external sector position of the FSM is substantially stronger than the level implied by fundamentals and desirable policies. The model-based gap estimates are subject to uncertainty given data gaps and volatility in balance-of-payments flows for the FSM.

Federated States of Micronesia: EBA-lite Model Results, 2025

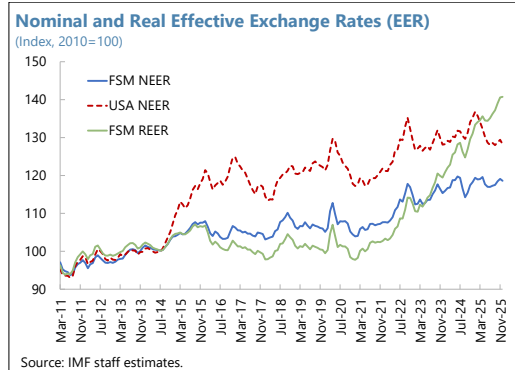
	CA model 1/ (in percent of GDP)
CA-Actual	3.8
Cyclical contributions (from model) (-)	0.0
Natural disasters and conflicts (-)	-0.3
Adjusted CA	4.1
CA Norm (from model) 2/	-1.5
Adjusted CA Norm	-1.5
CA Gap	5.6
o/w Relative policy gap	5.9
Elasticity	-0.3
REER Gap (in percent)	-19.0
1/ Based on the EBA-lite 3.0 methodology	
2/ Cyclically adjusted, including multilateral consistency adjustments.	

- The adjusted current account balance is at a surplus of 4.1 percent in FY2025 after considering model-based cyclical contributions. The EBA-lite methodology estimates the FSM’s current account norm, the level consistent with fundamentals and desirable policies to be -1.5 percent of GDP. This implies a model-estimated current account gap of around 5.6 percent of GDP. The EBA-lite identified policy gaps of about 5.9 percent of GDP, mainly due to tight fiscal policy—which reflects the accumulation of savings for building long-term fiscal buffers, as well as capacity constraints in public investment project execution, and is not taken into account in the model.
- On balance, staff assess the external position in FY2025 to be substantially stronger than the level implied by fundamentals and desirable policies, while noting the data limitations, large uncertainties surrounding the model estimates and the special characteristics of the FSM economy. In particular, the high uncertainty around large BOP flows (tax revenues from foreign-sourced income, fishing licenses, and foreign grants) justify a more precautionary approach and accumulation of savings in recent years. The current account surplus is anticipated to narrow gradually in subsequent years in line with the declining fiscal surplus and moderating growth in tuna exports. Nonetheless, the new COFA agreement represents a major change as it implies the need for less savings.

Real Exchange Rate

Background. The US dollar is used as legal tender and official currency in FSM, and there is no central bank. The nominal and real effective exchange rates appreciated by 0.24 percent and 0.8 percent (monthly average) respectively in FY2025.

Assessment. The use of the U.S. dollar as the official currency is appropriate given the small size of the economy, close financial and trade linkages with the United States, and limited administrative capacity for independent monetary and exchange rate policies.



Capital and Financial Accounts

Background. Both capital and financial accounts have been in surplus in recent years. The capital account surplus is estimated to be 3.3 percent of GDP in FY2025, which is mainly composed of inflows of capital grants from the U.S. Compact and other IFIs or donors. For financial accounts, foreign direct investment (FDI) is likely to remain a negligible source of financing. The portfolio investment account is projected to increase, driven by returns on government investment in foreign securities.

Assessment. The new COFA agreement represents stability in the capital account inflow and the continued surplus of capital and financial accounts in the medium term.

FX Intervention and Reserves Level

Background. The FSM does not have a central bank or foreign exchange reserves. The national government's bank deposits fell to around 13.8 percent of GDP at end-FY2025 from 17 percent of GDP at end-FY2023, following changes in revenue-sharing rules with state governments. The end-FY2025 balance corresponds to more than 2 months of imports and more than 2 months of general government's current expenditure.

Assessment. Government deposits could play a role in absorbing short-term liquidity shocks.

¹ The Real Effective Exchange Rate (REER) approach in the EBA-lite framework is not applied due to data and structural limitations. FSM is fully dollarized and lacks an independent monetary policy framework, preventing construction of the real short-term interest rate variable required by the EBA-lite REER specification. Significant publication lags for high-frequency and consistently compiled price data further constrain REER estimation. The external sustainability approach is not applicable, given FSM's positive net international investment position in both historical and projection periods.

² The NIIP does not include accumulated U.S. contributions to the Compact Trust Fund.

Annex IV. Risk Assessment Matrix¹

Risk	Relative Likelihood /Time Horizon	Expected Impact	Main Impacts → Recommended Policy Actions
Domestic Risks			
Accelerating reform momentum. Successful consensus building across national and state governments, as well as the community, results in implementation of wide-ranging reforms to improve the business environment.	Medium MT	High	Implementation of growth-friendly structural reforms reinvigorates the private sector, improves climate change resilience and boosts potential growth. → Build fiscal buffers at a faster pace → Increase investment in adaptation
Slow implementation of infrastructure projects. Delays in key infrastructure projects due to capacity constraints.	High MT	Medium	Slow implementation of infrastructure projects will depress potential growth and could lead to greater emigration. → Deepen collaboration across stakeholders to address bottlenecks in implementation.
External Risks			
Commodity Price Volatility. Supply and demand imbalances—triggered by geopolitical tensions, coordinated production decisions, shifts in investor preferences, or structural changes in demand—fuel commodity price swings, amplifying external and fiscal pressures, social unrest, and macro instability.	High ST, MT	Medium	Increase inflation volatility and contribute to cost-of-living pressures as the bulk of food is imported and electricity generation relies on imported diesel. → Provide targeted fiscal assistance to vulnerable households, accelerate transition to renewable energy, and increase domestic food production.
Climate Change. Extreme climate events and rising temperatures could cause loss of life, damage to infrastructure, food insecurity, supply disruptions, and heighten economic and financial instability.	Medium ST, MT and LT	High	The FSM is one of the most vulnerable countries among PICs. Natural disasters such as typhoons, king tides and drought damages housing and infrastructure, and cause losses in crop and livestock. It also sets back the development agenda as the country's thin institutional capacity is redirected towards disaster recovery and reconstruction. - Deploy contingency funds to provide immediate relief, before seeking additional support through COFA → Strengthen fiscal buffers to help finance immediate disaster response. → Finalize the National Adaptation Plan, speed up implementation of adaptation investment projects, improve data systems for managing disaster risks,

¹ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("L" (low) is meant to indicate a probability below 10 percent, "M" (medium) a probability between 10 percent and 30 percent, and "H" (high) a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Risk	Relative Likelihood /Time Horizon	Expected Impact	Main Impacts → Recommended Policy Actions
			strengthen capacity for public investment management, and mobilize external grant financing.
<p>Disorderly AI Correction. An abrupt revision in expectations of strong AI-led productivity gains causes a sharp market correction, investment decline, and wealth loss, which suppress demand and tighten financial conditions globally.</p>	<p>High ST, MT</p>	<p>Medium</p>	<p>Sharp market corrections could result in large losses in the trust funds, eroding fiscal buffers which have been built over decades.</p> <p>→ Mobilize domestic revenue to diversify and expand the country's revenue base.</p> <p>→ Continue to transfer windfall gains into the FSM trust fund.</p>
<p>Geopolitical Tensions and Intensification of Conflicts. Rising geopolitical tensions, and a weakening of multilateralism, raise the risk of an escalation in military conflicts, accompanied by damage to key physical and financial infrastructure, disruptions in major transit routes and supply chains, higher migration pressures, additional financial frictions and market volatility.</p>	<p>High ST</p>	<p>Medium</p>	<p>Tensions may cause withdrawal of cash and in-kind grants. Increases in input costs could trigger inflationary pressure. Greater financial frictions could affect the cost and availability of cross-border payment channels.</p> <p>→ Mobilize domestic revenue to diversify revenue base away from grants.</p> <p>→ Diversify sources of critical imports to enhance supply chain resilience.</p> <p>→ Implement structural reforms to reinvigorate the private sector and reduce reliance on the public sector for economic growth.</p> <p>→ Prepare alternative payment channels e.g., through participation in the Pacific CBR project.</p>
<p>New Trade Agreements. Tangible progress in trade talks reduces uncertainty and trade barriers. Wider cooperation on services, FDI, and taxation boosts investment and bolsters public finances.</p>	<p>Low</p>	<p>Medium</p>	<p>Trade agreements, complimented by progress in meeting quality standards of destination countries would expand export markets and support private sector growth.</p> <p>→ Communicate the new export opportunities through awareness-raising campaigns and provide a dedicated focal point to help business navigate export requirements.</p> <p>→ Upgrade logistics infrastructure to meet increased volumes.</p> <p>→ Accelerate regulatory reforms to improve ease of doing business to ensure firms can expand production as well as encourage new entrants.</p>

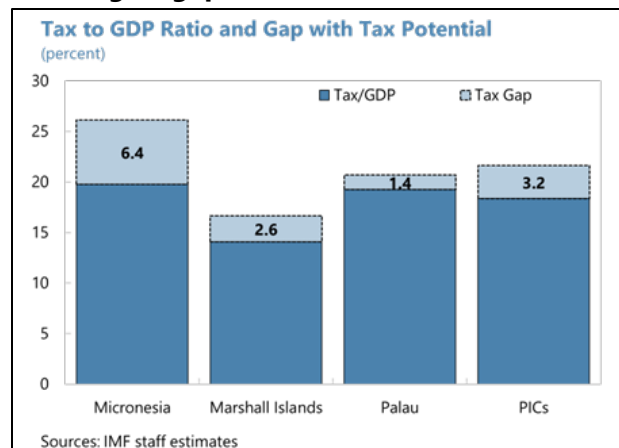
Annex V. Potential Gains from Tax Reform¹

Tax policy reforms could increase government revenue, while supporting investment and improving efficiency. Key proposals include introducing a 10 percent VAT, converting import duties into excises, and replacing the gross revenue tax with a net profits tax. These reforms are projected to increase net revenue by 1.5 percent of GDP, with the VAT generating the largest portion. Similar reforms in Palau have raised revenues successfully, while the Republic of Marshall Islands (RMI) is planning to introduce a VAT in FY2027. For the reforms to be successful, there needs to be strong support from states, the private sector, and the public, facilitated by clear communication about benefits of the reforms.

1. FSM reconstituted the National Taskforce on Tax Reform in 2025 to propose tax policy and administration reform options. Previous attempts, starting as early as 2005, at major tax reform have not progressed. For example, the most recent attempt at introducing a VAT took place in 2021, but failed due to a lack of consensus across states and private sector reticence. The most recent initiative primarily stems from the national government, which is seeking to simplify and unify the tax system nationally. At the same time, additional revenue sources could help close funding gaps for the national government following the change in revenue-sharing rules with state governments. The launch of the revenue management system in July 2025 creates a favorable environment for implementing tax reforms because it can support better compliance and reporting.

2. Amongst peers, FSM is estimated to have the largest gap between its actual tax revenue collection and tax revenue potential.

Based on a stochastic tax frontier analysis, FSM’s actual tax revenue falls short of its potential by over six percentage points.² This gap exceeds those of Palau and RMI, as well as the average in PICs. FSM’s relatively high trade openness and institutional quality (corruption control and government effectiveness) explain its high tax potential. Although the estimated tax potential can be sensitive to the econometric model and country characteristics used, these results



¹ Prepared by Kangchul Jo

² The goal of stochastic tax frontier analysis is to determine the maximum level of tax revenue (as a percent of GDP) possible given a country’s structural characteristics. For this analysis, panel data covering 188 countries from 2002 to 2023 were used. Each country’s characteristics include GDP per capita, trade openness, agricultural share of GDP (a proxy for informality of the economy), corruption control and government effectiveness (indicators for institutional quality), and a commodity exporter dummy variable.

suggest that FSM has room to increase its revenue through tax reforms.

3. Reforming the tax system, including by introducing a VAT, can improve equity, efficiency and reduce volatility in revenue collection. The recommended tax reform package is as follows³:

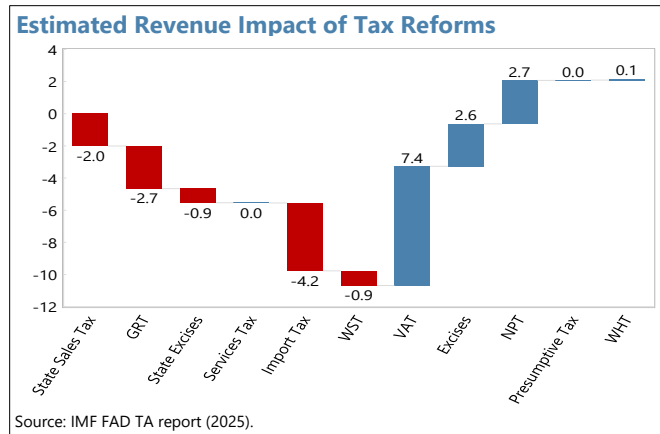
- Introduce a 10 percent VAT with a registration threshold of USD100,000 to replace the current state sales taxes on goods and services. VAT can reduce economic distortions and improve efficiency by broadening the tax base to include services and eliminating most cascading effects.⁴ Notably, business inputs and investment goods would not be subject to a VAT, encouraging investment. It would also harmonize indirect taxes across states.
- Convert existing import duties to excises on certain goods, such as tobacco, alcohol, fuel, sugary products, and motor vehicles. The excises are the same as the current duty rates. Excises provide a stable source of revenue due to low demand elasticity, help address harmful externalities, and are acceptable under trade agreements.
- Introduce a tax-free threshold of USD5,000 for the Wages and Salaries Tax (WST), replacing the existing low-income deduction of USD1,000. This measure is intended to simplify the tax system and partially offset cost-of-living increases following the introduction of the VAT.
- Repeal the Gross Revenue Tax (GRT) and replace it with a Net Profits Tax (NPT) of 25 percent and a presumptive tax of USD150 for businesses with a turnover below USD10,000.⁵ The NPT promotes fairness by exempting loss-making businesses from tax, while the presumptive tax simplifies compliance for small businesses. Relative to the GRT, the NPT is particularly beneficial for start-ups.
- Introduce Withholding Taxes (WHT) of 15 percent on payments to non-residents, additionally covering dividends and technical service fees. This measure protects the domestic tax base by ensuring that foreign entities, which might otherwise avoid taxation through tax planning or profit shifting, pay their fair share of taxes.

³ Mullins (2022), 'Federated States of Micronesia: Tax Reform – Policy Design and Modeling', PFTAC Technical Assistance Report

⁴ Cascading occurs when tax is charged on goods that have already been taxed. This happens because tax may be charged at each stage of the production chain.

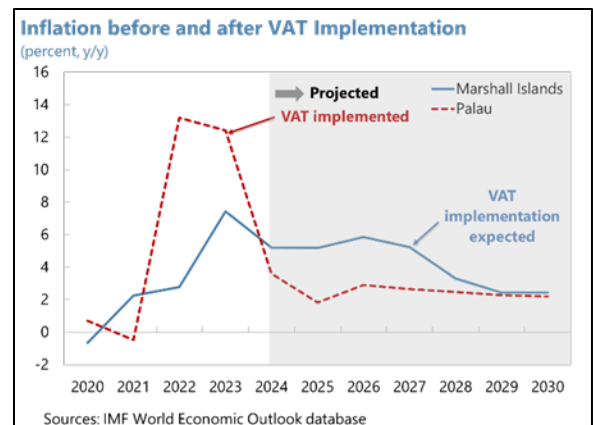
⁵ In the revenue update (Mullins (2025), 'Federated States of Micronesia: Revised Tax Reform Revenue Estimates', IMF FAD Report), PFTAC assumed a presumptive tax of at least USD150 instead of USD80 because businesses with a gross turnover just below USD10,000 have a significant advantage over those with a turnover just above USD10,000 when the presumptive tax is USD80.

4. The proposed tax reform is estimated to increase net revenue by 1.5 percent of GDP. With limited exemptions, the impact on tax revenue collection is 2.1 percent of GDP, however the net impact on the government budget is smaller, an increase of 1.5 percent GDP⁶. This is because the VAT is also applied to goods and services purchased by governments, and hence government expenditure would also increase. Replacing or modifying existing taxes, such as import taxes, state sales taxes and excises, GRT, and WST, is estimated to reduce tax revenue by 10.7 percent of GDP. However, this reduction would be offset by introducing new taxes, including VAT, NPT, and excises, which are expected to generate 12.8 percent of GDP. VAT alone is projected to raise revenue by 7.4 percent of GDP at a rate of 10 percent⁷. A 12.5 percent VAT rate would increase revenue further (9.3 percent of GDP), while an 8 percent rate would generate less (5.9 percent of GDP). For comparison, in 2021, the average main VAT rate was 12 percent for Pacific Island countries and 16 percent globally.⁸



5. Similar reforms have been implemented or are being planned in other Compact countries, and the FSM can leverage lessons learned from these countries as it prepares for its own.

- In Palau, tax reforms were implemented in 2023. These reforms included the introduction of the Palau Goods and Services Tax (PGST, a value-added tax) of 10 percent with a registration threshold of USD300,000 and the Business Profits Tax, the elimination of import duties, and the lowering of wage and salary taxes. The reforms were successful in increasing revenue collection; the tax-to-GDP ratio rose from 18.1 percent before the reforms to 21.6 percent in FY2023 and 22.8 percent in FY2024. This success can be partly attributed to a surge in inflation, which rose sharply in 2022 due



⁶ If exemptions are expanded beyond those recommended by the reform package, then the impact on tax revenue will be smaller.

⁷ This revenue estimate is slightly above that of most other small island developing countries in the region, which lies between 6 to 7 percent of GDP for a 10 percent VAT.

⁸ Sy *et al.* (2022), 'Funding the Future: Tax Revenue Mobilization in the Pacific Island Countries', IMF APD DP/2022/015.

to the global spikes in food and fuel prices, and remained high in 2023. However, this was a one-time occurrence, as it stabilized sharply the following year. Palau's experience demonstrates that successful tax reform and public acceptance require thorough stakeholder engagement, including international partners, as well as strong communication strategies, such as community outreach and financial literacy programs. Measures such as WST credits and grants for informal workers helped address concerns about increased living costs. Maintaining fiscal restraint despite the surge in revenue has also prevented a further increase in inflation.

- RMI's tax reform is progressing in two phases, the first comprises adjusting the personal income tax rates and brackets, while in the second phase the Gross Revenue Tax and import duties will be replaced by a VAT of 12 percent, and a Business Profit Tax will be introduced for large firms. The second phase of tax reforms is planned for FY2027.⁹ Overall, these tax reforms are expected to have a minimal impact on revenue. However, the second phase of reforms, comparable to those in other Compact countries, are forecasted to generate 0.6 percent of GDP in revenue. As in the case for Palau, the reform is expected to induce a temporary increase in inflation.

6. To capitalize on this opportunity for tax reforms, it is crucial for the authorities to secure the support of individual states, the private sector, and the public. States' views for the reforms are generally positive, though an issue related to the state constitution in Yap will need to be resolved before implementation can proceed. Revenue sharing arrangements should take into consideration the public service responsibilities of each level of government. Devising effective communication strategies to bring the private sector on board is also essential. It is important to emphasize the advantages that the tax reforms would provide to the private sector. When VAT is introduced, taxes paid on the purchase of capital goods and intermediate inputs will be fully credited to firms, thereby promoting investment in the private sector. Compared with the GRT, an NPT encourages risk taking as businesses do not pay taxes if they make a loss and these losses can offset future tax liabilities; this would be particularly beneficial for start-ups. To reduce public resistance, it is necessary to showcase the benefits that the tax reforms would bring to the entire economy while addressing concerns about increases in the cost of living. The authorities can emphasize that the proposed tax reforms include introducing a USD5,000 tax-free threshold for the WST, which could provide partial compensation for price increases resulting from the introduction of VAT. As in Palau's case, additional targeted transfers could be considered for the most vulnerable, providing additional relief. Like other PICs, capacity development would be needed to support the introduction of a VAT.

⁹ The first phase, which took effect in April 2025, adjusted the personal income tax rates and corresponding income brackets. Another measure, the removal of the top income tax rate of 16 percent, will take place in FY2026.

Annex VI. Financial Sector Reforms for Development¹

Transitioning to private sector-led growth is needed to secure long-term economic resilience. Realizing this vision requires a more dynamic financial sector that actively channels domestic credit and enables broader economic participation. Effective financial sector reform must prioritize measures that address both the banks' reluctance to lend (supply) and the private sector's inability to qualify for credit (demand).

1. Transitioning to private sector-led growth is needed to secure long-term economic resilience. This shift is critical to move the economy beyond the heavy reliance on the public sector and develop a diversified private sector capable of creating new jobs and economic opportunities. Realizing this vision requires a more dynamic financial sector that actively channels domestic credit and enables broader economic participation.

2. FSM's financial sector exhibits limited depth, with domestic lending severely constrained by structural inefficiencies. Despite a deposit base almost matching GDP, only 10 percent is channeled into domestic credit, as commercial banks exhibit institutional risk aversion and prefer to hold high liquidity buffers offshore. This low level of domestic lending is directly linked to structural constraints on both the supply and demand sides of credit. Effective financial sector reform must prioritize measures that address both the banks' reluctance to lend (supply) and the private sector's inability to qualify for credit (demand).

A. Addressing Supply-Side Constraints: Collateral, Digital Infrastructure, and Risk

3. The lack of legally viable collateral is the main barrier to credit expansion. Traditional land ownership restrictions prevent the use of real estate as loan security, forcing commercial banks to treat most domestic lending as unsecured. To address this, FSM authorities, supported by the Pacific Private Sector Development Initiative (PSDI), enacted the Secured Transactions Act in 2006 and established an online Secured Transactions Registry (STR)². This framework enables businesses to use movable assets such as inventory, equipment, and accounts receivable as collateral, offering a feasible alternative to complex land reform. Despite the legal framework being in place for nearly two decades, the practical impact on credit expansion has been limited. Banks regularly use the STR, but because movable assets typically have lower recoverable values, the registry is mostly used for small commercial loans and has not led to a significant increase in business financing. To enhance its effectiveness, STR-backed lending should be used to help small businesses access their first, lower-value loans, enabling them to establish a track record. Alongside digital transactions and tax

¹ Prepared by Nur M. Adhi Purwanto

² A regional technical assistance program backed by the Governments of Australia, New Zealand, and the Asian Development Bank

records, STR-backed loans can support their gradual qualification for larger loans, assessed with more advanced, data-driven credit-evaluation methods.

4. Digital infrastructure is a critical enabler for improving financial inclusion and overcoming FSM’s geographic dispersion. The recent completion of the submarine fiber optic cable landing in Kosrae marks a major milestone—now all four FSM states (Yap, Chuuk, Pohnpei, and Kosrae) have access to fast, reliable international broadband. Rollout of satellite-based internet connection to outer islands is in progress, with the support of the World Bank. This greater connectivity, along with lower cost of broadband service, removes physical barriers to financial access laying the foundation for digital credit expansion. Commercial banks are already leveraging this infrastructure to roll out digital services that enhance financial inclusion. The Bank of FSM (BFSM) has launched a Consumer Internet Banking platform and mobile app offering mobile check deposits, peer-to-peer (P2P) payments, and fund transfers. Similarly, the Bank of Guam (BoG) provides comprehensive digital banking services. Authorities are piloting digital provision of inter-island ferry booking, which will also support take-up of digital payments.

5. Data from digital banking platforms is a powerful tool for expanding access to credit. Transactional data, such as mobile check deposits, P2P payments, and digital fund transfers, offers real-time, objective insights into the financial behavior of businesses. This data significantly enhances credit scoring accuracy, allowing banks to assess creditworthiness and cash flow for businesses that lack formal financial records or credit histories. By leveraging these digital footprints, financial institutions can tailor lending products to underserved segments, helping to unlock new pathways for inclusive finance and economic growth.

B. Addressing Demand-Side Constraints: Literacy, Tax Reform, and Cooperation

6. Expanding financial literacy and formal business practices among SMEs is critical to unlocking credit demand and reducing perceived lending risks. A key constraint on the demand side is the widespread informality of SMEs, many of which lack the financial management skills and accounting systems needed to produce verifiable financial statements required by lenders. This gap in financial literacy leads commercial banks to view these businesses as high-risk, limiting their access to credit and hindering private sector growth. To address this challenge, the FSM Development Bank (FSMDB) established the Development and Finance Training Institute (DFI) in 2014. The DFI offers targeted courses such as “Financial Accounting for Non-Accountants and Competitive Business Strategy for Entrepreneurs and Small Businesses”, designed to help SME owners formalize operations, improve financial recordkeeping, and meet the documentation standards of prudent lenders. The authorities should expand the reach and curriculum of the DFI, integrate financial literacy into broader entrepreneurship and vocational training programs, and incentivize participation by linking training completion to loan eligibility. Collaborating with development partners and financial institutions to co-deliver training, mentorship, and certification programs can accelerate SME formalization, enhance credit readiness, and foster inclusive private sector development.

7. Modernizing tax administration through digital infrastructure can support formalization and improve financial data quality. The government's public financial management (PFM) roadmap is aligned with this goal, supported by the launch of the World Bank-backed Revenue Management System (RMS). The RMS is designed to create a verifiable, end-to-end digital audit trail of business activity, directly addressing financial informality. However, its full potential is constrained by FSM's outdated tax structure. The current Business Gross Receipts Tax requires minimal reporting offering limited insight into business performance. Introducing a value-added tax (VAT), which compels firms to track inputs and outputs, would generate more granular profitability data critical for credit-risk modeling and enable the RMS to better support credit expansion. Strengthening complementary legal frameworks, such as those governing electronic transactions, data protection and privacy, cybercrime, and online consumer protection, would further reinforce confidence in digital financial systems and enable the safe and effective use of tax and transactional data in credit assessment.

8. Establishing a regulated data-sharing protocol is critical to unlocking the value of financial and tax data for credit expansion. While the RMS and digital platforms generate rich transactional and compliance data, this information remains largely inaccessible to lenders. The absence of a secure, regulated mechanism for data exchange between the tax authority (RMS) and financial institutions (BFSM, BoG, FSMDB) is a key institutional barrier. The design and implementation of legal and technical measures to transform tax compliance history and commercial payment data into formalized, shared credit assets should be prioritized. This will enable data-driven lending and accelerate access to finance for underserved segments. However, any mechanism for data exchange must adhere to data privacy and data protection principles. The authorities should mandate that data be shared only with the explicit consent of the taxpayer (the business or individual) seeking a loan, ensuring the borrower retains complete control over their financial footprint during the credit application process. Experiences in India—where a consent-based data-sharing framework allows tax information to be securely provided to lenders—illustrate how clear legal foundations can support safe and effective use of such data in credit decisions.

9. Strengthening institutional collaboration and regulatory oversight is essential to expand credit access for SMEs. Credit unions with deep local knowledge and a strong presence in remote areas are well-positioned to support micro-lending. However, their potential is constrained by the absence of regulatory oversight. Currently, credit unions operate outside the supervision of the FSM Banking Board (FSMBB), which creates disincentives for commercial banks from entering formal co-lending partnerships involving risk-sharing. Legislative action is needed to bring both credit unions and the FSMDB under FSMBB supervision. This would establish the governance, risk management, and reporting standards necessary for safe inter-institutional cooperation and consumer protection. With appropriate oversight in place, innovative cooperation models like agency banking can be introduced and can leverage credit union local networks for efficient loan origination, monitoring, and collection. This would ensure that financial inclusion efforts reach the last mile.

Annex VII. Investing in Climate Adaptation¹

The Federated States of Micronesia stands at the frontline of climate and disaster risk, with its small size, remote islands, and heavy reliance on U.S. grants shaping both its vulnerabilities and opportunities. Limited domestic revenues and investment bottlenecks make building resilience a challenge. Using the DIGNAD model, this analysis spotlights how smarter public investment, grant support, and bold reforms—like a new VAT—can help FSM strengthen its fiscal position, boost climate adaptation, and secure a more sustainable future.

A. The FSM's Climate Vulnerabilities

1. The Federated States of Micronesia (FSM) is highly vulnerable to the adverse impacts of climate change. It faces heightened risks from extreme weather events such as sea-level rise, typhoons, storm –wave surges, king tides, droughts, ocean acidification, and rising sea temperatures. Their likely impact includes the destruction of housing and infrastructures and damages to crops and livestock. Average annual losses from tropical cyclones are estimated at USD 8 million. The FSM is expected to incur a severe tropical cyclone every 20 years which results in losses and damages of 10 percent of GDP². The FSM ranks among the most at-risk Pacific Island Countries in the Global Climate Risk Index and fourth in losses per unit of GDP, while the Notre Dame Global Adaptation Initiative which considers food, water, health and infrastructure shows vulnerability has increased over the past decade.

2. Intensifying climate shocks highlight the pressing need for FSM to accelerate and deepen its adaptation efforts. Climate adaptation in the FSM remains at an early stage and well below what is required, as the country's heightened exposure to natural disasters and climate change continues to outpace its limited adaptive capacity. Despite ongoing efforts to integrate climate considerations into national planning tools—such as the Infrastructure Development Plan—the FSM's climate readiness has improved only marginally over the past decade and still lags behind most Pacific Island peers, reflecting persistent weaknesses in public financial management, investment planning, and coordination across agencies. Frequent and increasingly severe natural disasters place additional strain on fiscal planning, requiring large and repeated recovery efforts that the FSM's constrained fiscal space cannot easily accommodate. These shocks often force the reallocation of funds away from existing development priorities, an approach that undermines long-term resilience and raises future fiscal risks. Together, these challenges underscore the urgency of scaling up and better prioritizing adaptation investments—supported by stronger institutions and more effective use of grant financing—to safeguard fiscal sustainability while enhancing resilience to climate risks.

¹ Prepared by Kavita Ram and Frank Zhang

² [PCRAFI FSM Country Risk Profile](#)

B. Investment Needs and Challenges

3. Adaptation costs to protect FSM against natural disasters and climate shocks are substantial and rising over time, reflecting the country's unique geographic characteristics. According to discussion with authorities integrating climate adaptation into investment projects is extremely costly—often double or triple standard investment costs—due to reliance on imported raw materials, elevated transportation and freight costs, and shipment difficulties. These factors weigh on project pricing, implementation, and completion timelines. Currently there is no official estimate of adaptation needs as work on the National Adaptation Plan is ongoing. However, the Green Climate Fund-aligned work program provides an order of magnitude indication of adaptation spending requirements, identifying climate related investment needs of around USD 1.1 billion.

4. Structural weaknesses constrain investment effectiveness. Weak public investment management—limited capacity to implement high-quality projects, inadequate planning, and procurement delays—has muted the growth impact of public investment. Limited private sector participation and high adaptation costs further exacerbate these challenges. Strengthening public financial management and raising investment efficiency are preconditions for successful scaling-up.

5. External shocks compound vulnerabilities. As in other PICs, the FSM's small and undiversified economy is highly exposed to external shocks, including volatile global commodity prices. Inflationary pressures from high imported food and fuel prices deepen hardship and add to fiscal strains, reinforcing the case for social protection. Similarly, price shocks affecting construction materials, underscore the need for resilient infrastructure.

C. Financing Options

6. The COFA agreements have been very instrumental in shaping the FSM as they face unique development, economic, and social challenges. The FSM have persistent financing gaps between domestic revenues and relatively high public expenditure needs, partly reflecting its remoteness and dispersed population. The fiscal gap is generally financed by COFA sector grants and other US grants. Grants make a sizeable contribution to supporting the delivery of essential services such as health, education, infrastructure, and U.S. contributions to the COFA Trust Fund, which is a long-term financing mechanism for the FSM.

7. Additional resources are needed to close the climate financing gap. Additional financing will be required to meet the FSM's increasing climate-adaptation needs. While the renewed COFA provides USD 2.8 billion over 20 years and a USD 0.5 million contribution to the CTF, these resources alone will not fully address the scale of investment required to build climate-resilient infrastructure, as they are mainly used to support core public services such as health and education. The renewal of the COFA has elevated the fiscal space to spend in priority sectors and has also dedicated financing for climate, there is a need to improve the efficiency and effectiveness of how these additional resources will be utilized. Strengthening domestic revenue mobilization—

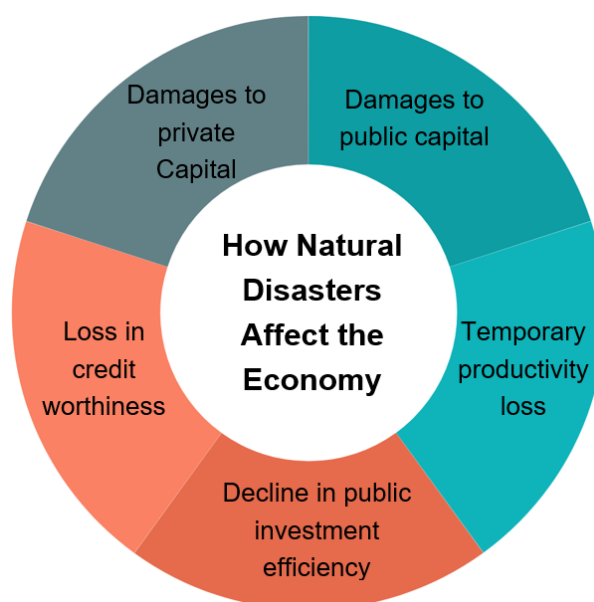
particularly through the introduction of a Value-Added Tax (VAT) and enhanced compliance—would broaden the tax base and support more predictable funding for priority adaptation measures. Access to external climate-finance sources, including the Green Climate Fund (GCF), remains important; however, effective utilization of the GCF, and other financing instruments, will depend on continued efforts to bolster institutional capacity, streamline project preparation and execution, and improve public investment management practices to ensure timely and high-quality delivery of climate-resilient projects.

D. DIGNAD Model

8. Model-based scenarios are used to analyze the macro-fiscal impact and resilience outcomes of various investment financing options. To compare financing mixes and policy packages, we use DIGNAD scenarios that consider combinations of grants, concessional borrowing, domestic revenue mobilization (VAT), and public investment efficiency (PIE) reforms. These scenarios assess macro-fiscal trade-offs and resilience outcomes under alternative investment paths and shock realizations.

9. The Debt, Investment, Growth, and Natural Disasters (DIGNAD) model is a dynamic general equilibrium model designed to analyze the impact of investing in climate-resilient capital on economic growth and debt sustainability under various scenarios especially in small open economies.

The DIGNAD model (Marto, Papageorgiou and Klyuev, 2018) accounts for climate shocks by assuming that natural disasters affect the economy through five channels: (i) damages to public capital; (ii) damages to private capital; (iii) a temporary productivity loss; (iv) reduced public investment efficiency; and (v) a loss in creditworthiness. Additionally, it assesses debt sustainability risks following a natural disaster and evaluates the effects of ex-ante policies, such as investing in climate-resilient infrastructure versus non-resilient infrastructure and building fiscal buffers. The model also considers public investment inefficiency and limitations posed by absorptive capacity constraints. The model captures the challenges of closing infrastructure gaps in developing countries that frequently face natural disasters and captures the linkages between public investment, growth, and debt, such as the investment- growth nexus, the fiscal adjustment and the private sector response.



10. The model is calibrated to represent the economy of the FSM and simulates a hypothetical natural disaster consistent with the historical severity of major tropical cyclones. Using available data from Graduate School USA, the debt bulletin, and the national government's audit report, the model's initial conditions are calibrated to match key macroeconomic and fiscal indicators of the FSM in 2024, including the levels of grants and public debt. The simulation assumes that a severe natural disaster strikes the FSM in 2030, affecting both tradable and non-tradable sectors, with disproportionately larger damage to the tradable sector (e.g., fisheries) and to private capital, consistent with observed impacts of typical tropical cyclones.³ These shocks are consistent with those assumed in the customized stress test for natural disasters in the Debt Sustainability Analysis.

Definition	Value
Grants to GDP ratio	28.2
Public domestic debt to GDP ratio	1.0
Public concessional debt to GDP ratio	9.1
Public external commercial debt to GDP ratio	0.5
Return to standard infrastructure	25.0
Return to climate-resilient infrastructure	30.0
Public standard infrastructure investment to GDP ratio	11.0
Depreciation rate of standard public infrastructure	7.5
Depreciation rate of resilient public infrastructure	3.0
Public investment efficiency	50.0
Share of capital in tradable sector	40.0
Share of capital in non-tradable sector	55.0

Source: IMF staff calculations.

E. Policy Scenario Analysis

11. With these calibrations, the following section presents a scenario-based analysis to evaluate the macroeconomic and fiscal impacts of alternative investment and financing strategies for FSM in response to the assumed natural disaster in 2030. The economy is assumed to recover from the disaster by 2033.

Scenario 0: Baseline Scenario

12. The baseline assumes additional public investment of 0.9 percent of GDP in standard infrastructure and 0.1 percent of GDP in resilient infrastructure annually from 2026 to 2030, all financed by grants. In 2030, a natural disaster strikes, and reconstruction is financed through concessional debt. This scenario reflects the continuation of current policies with moderate investment in resilience and relies on external grants for development and concessional borrowing for post-disaster recovery.

³ It is assumed that tradable and non-tradable output decline by 13 and 4 percent, respectively, in the year of the shock, as suggested by Davies et al. (2019).

Scenario 1: Scale-Up with Concessional Borrowing

13. This scenario increases public investment to 0.9 percent of GDP in standard infrastructure and 1.1 percent of GDP in resilient infrastructure from 2026 to 2030, with additional investment financed by concessional borrowing. After the natural disaster in 2030, reconstruction is also financed by concessional debt. This approach boosts resilience but results in higher public debt compared to the baseline, as financing relies more on borrowing than grants.

Scenario 2: Scale-Up with Grants

14. Scenario 2 mirrors the investment scale-up of Scenario 1 (0.9 percent of GDP in standard and 1.1 percent in resilient infrastructure from 2026 to 2030) but finances all additional public investment with grants. Reconstruction after the 2030 disaster is still financed by concessional debt. This scenario demonstrates the benefits of grant financing, which supports higher investment and resilience without increasing public debt, compared to scenarios relying on borrowing.

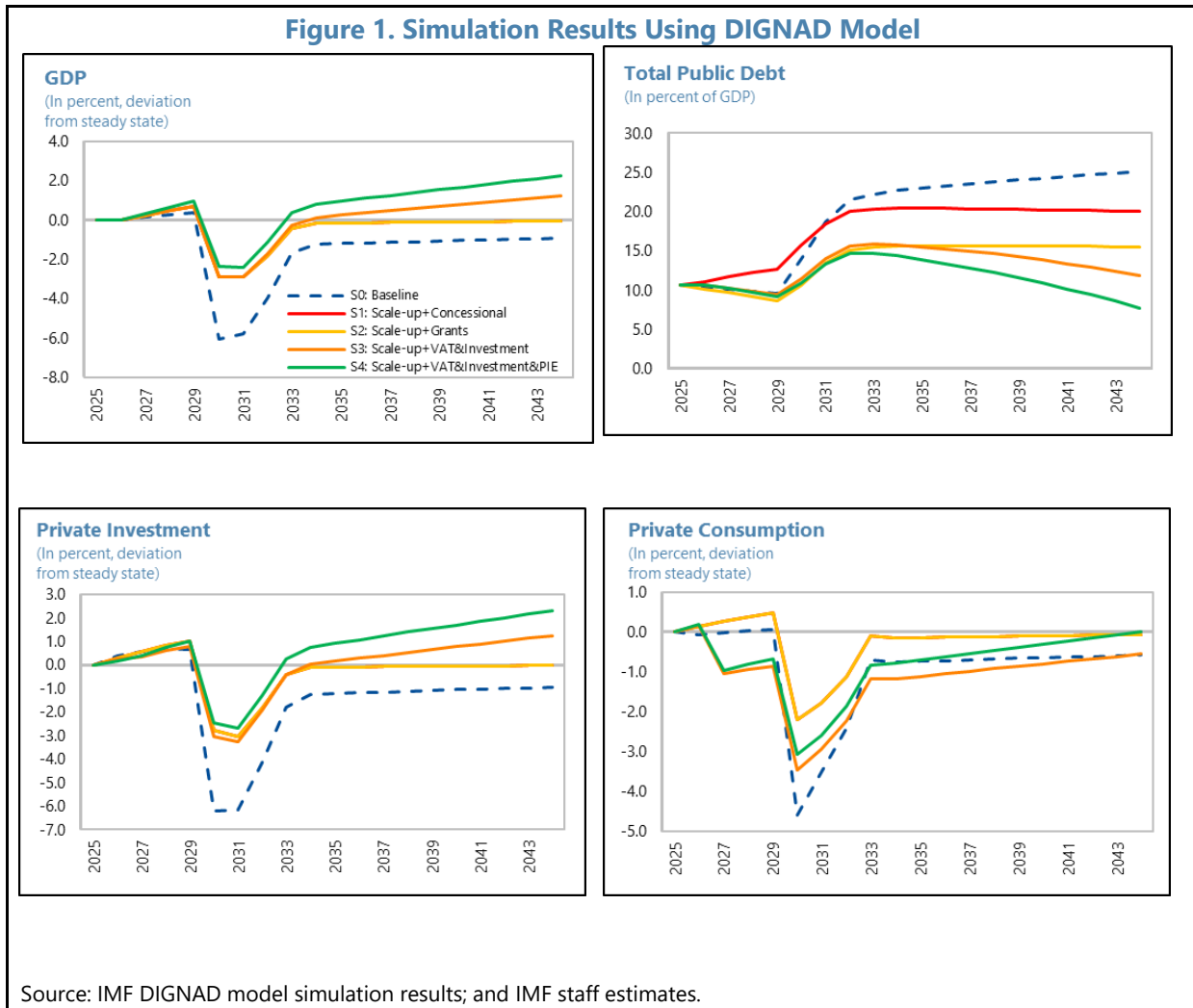
Scenario 3: VAT Reform with Extra Resilient Investment

15. Scenario 3 features the same scale-up in infrastructure investment as scenario 1, but considers permanent investment in resilient infrastructure after 2030 at 1 percent of GDP. In this scenario, investment is financed using domestic revenue mobilization – via a permanent value added tax (VAT) reform starting in 2027 – that raises an additional 1.5 percent of GDP in revenue⁴. Part of this additional revenue (0.5 percent of GDP) is given back to the households as transfers, while the remaining 1 percent of GDP finances the permanent resilient investment. Reconstruction after the disaster is financed by concessional debt.

Scenario 4: VAT & PIE Reform with Extra Resilient Investment

16. Scenario 4 builds on Scenario 3 by combining VAT reform (as in Scenario 3) with a public investment efficiency (PIE) reform that raises efficiency from 50 percent to 70 percent. All extra public investment is financed by VAT revenue, and reconstruction is financed by concessional debt. This scenario demonstrates the compounded benefits of both domestic revenue mobilization and improved investment efficiency, resulting in stronger economic recovery, greater resilience, and improved public debt dynamics.

⁴ The revenue estimates do not include any gains in compliance. However, in other countries, introducing a VAT has led to revenue gains from better compliance with other taxes (Mullins, 2025)



17. Preemptive public investment in resilient infrastructure mitigates the economic damage from natural disasters and strengthens long-term debt sustainability. Figure 1 illustrates the macroeconomic responses of real GDP, total public debt, private investment, and private consumption across all scenarios. Relative to the Baseline Scenario, scaled-up resilient investment in Scenarios 1 and 2 substantially reduces the real GDP loss caused by the natural disaster, from 6.1 percent to 2.9 percent⁵. Although financing additional resilient investment through concessional borrowing results in a higher initial public debt level in Scenario 1, public debt is better contained over the long run. These findings underscore the critical role of resilient investment in reducing post-disaster reconstruction financing needs and preserving public debt sustainability.

⁵ The simulations assume zero real interest rates on concessional borrowing, hence scenarios 1 and 2 yield the same real outcomes but different debt levels.

18. VAT reform creates additional fiscal space for resilient investment and supports investment-led growth over the long run. Although the higher tax rate dampens private consumption in the short run, the benefits of VAT reform are twofold. First, it generates fiscal space that enables the authorities to finance resilient investment while reducing reliance on external grants and concessional borrowing. As a more permanent policy change, VAT allows the authorities to better secure financing for longer-term public investment. Second, sustained investment in resilient infrastructure crowds in private investment, lifting economic growth above its initial level. As shown in Figure 1, persistent public investment in Scenario 3 leads to a strong recovery in real GDP and private investment, with both remaining about 1 percent above their 2025 levels ten years after the natural disaster. Debt sustainability is also enhanced under VAT reform: relative to Scenario 2, the public debt-to-GDP ratio is around 1.8 percentage points lower in 2040 and follows a declining trajectory as the economy grows. Finally, the improvement in GDP growth and partial distribution of VAT revenues as transfers eventually bring back consumption to reach baseline levels in the long run.

19. Public investment efficiency (PIE) reform further amplifies the economic gains from resilient investment and VAT reform. As a combined reform package, Scenario 4 in Figure 1, illustrates an ideal policy response to natural disaster shocks. Higher public investment efficiency enhances the formation of resilient capital and further mitigates economic losses from natural disasters. As a result, real GDP growth and private investment rise to around 2 percent above their initial levels in the long run; the public debt-to-GDP ratio remains fully contained and declines below its 2025 level; and private consumption not only faces a muted impact of the shock relative to the baseline, but also recovers to be above its initial level.

F. Policy Implications

20. FSM's rising climate related vulnerabilities and structural investment constraints highlight the need for a balanced strategy that strengthens resilience while safeguarding fiscal sustainability.

- **Scaling up climate resilient infrastructure** should remain a top priority. Although upfront costs are higher, resilient investment substantially reduces future disaster related losses and limits reconstruction spending. Embedding climate proofing standards in all new public projects would help improve long-term value for money.
- **Improving public investment management (PIM)** is essential to enhance the impact of both domestic and grant-financed spending. Strengthening project preparation, procurement processes, and coordination between national and state authorities would improve implementation timelines and absorptive capacity. Gains in investment efficiency can meaningfully raise growth dividends and support debt sustainability.
- **Domestic revenue mobilization**, particularly the introduction of a VAT, can create predictable fiscal space for priority investments and reduce reliance on external grants. A well-designed

VAT—accompanied by improvements in compliance and administration—would strengthen fiscal buffers while allowing FSM to maintain essential services and scale up adaptation efforts.

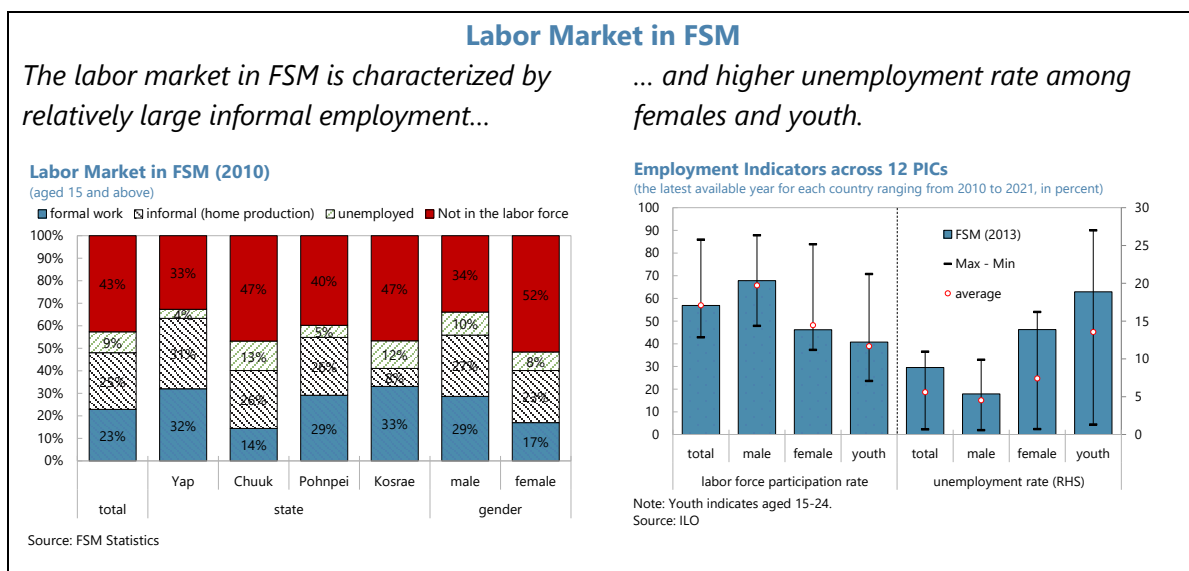
- **Maintaining a prudent mix of grants and concessional financing** will be important. Concessional borrowing should remain reserved for high impact, climate resilient infrastructure and post disaster recovery, while maximizing access to external climate finance facilities. Strengthening PFM and fiduciary systems will help FSM better prepare projects and utilize climate funds effectively.
- Finally, **broader structural reforms**—including improving the business environment, addressing land related constraints, and advancing digitalization—are needed to encourage private sector activity and support long term, resilient growth.-related constraints, and advancing digitalization.

Together, these reforms would help the FSM close critical infrastructure gaps, strengthen disaster resilience, and maintain fiscal stability while leveraging the opportunities created by grants and the COFA agreement.

Annex VIII. Labor Market and Migration¹

The labor market in the FSM can be characterized by relatively large informal employment and high unemployment rates among females and youth, although heterogeneity exists across the states. Due to skills shortages, the FSM relies on foreign workers to fill gaps. The pandemic and elevated cost of living could have exacerbated the brain drain in FSM, as more people across different skill levels migrate to the US to search for higher salaries. Revitalizing the private sector, enhancing employability by improving the quality of the education system can improve labor market outcomes and stem the tide of emigration.

1. The labor market in the FSM can be characterized by relatively large informal employment and high unemployment rates among females and youth. The availability of labor market data in FSM is severely limited, but based on the Population Census 2010, the labor force participation rate (LFPR) in FSM was about 57 percent². More than half of those who were employed were working in the informal sector, participating in home production. Even among formal workers, about 26 percent engaged in home production. Across the four states, the labor market situation was particularly concerning in Chuuk, where the state had a relatively low LFPR (53 percent), the largest share of informal workers among employed persons (64 percent), and a high unemployment rate (25 percent). There are also gender gaps in the labor market, including a low ratio of female to male LFPR (73 percent) and a larger share of informal employment (58 percent). The available data across 12 Pacific Island countries (PICs) reveals that LFPR in FSM is about the average of PICs, but the unemployment rate is higher than the average, particularly among females and youth.



¹ Prepared by Salote Cirikisuva and Shinya Kotera

² A population census was conducted in 2023, but the results have not been published.

2. The FSM has experienced a decline in total employment mostly in the private sector.

Preliminary estimates reveal a reduction in population over the last decade owing to outmigration, with the population even lower than the level in 1989. Subsequently, the pool of available workers is lower. The private sector has experienced the most loss, registering a decline of about 11 percent from 2010-2024. In 2024, losses in the private sector were almost equal to the gains made in the public sector which suggests that workers may have moved to work for the public sector following the wage hike. The public sector remains the single largest employer while in the private sector, most workers are employed in the wholesale and retail trade and repairs, transport storage, communications and education sectors (WB 2022). Despite being the largest employer, the scope for job creation in the public sector is limited. Besides migration, a mismatch of skills between domestic training offerings and the requirements for advertised roles also explain the slow growth in employment. In addition, current health and education outcomes reflect persistent gaps that constrain labor productivity.

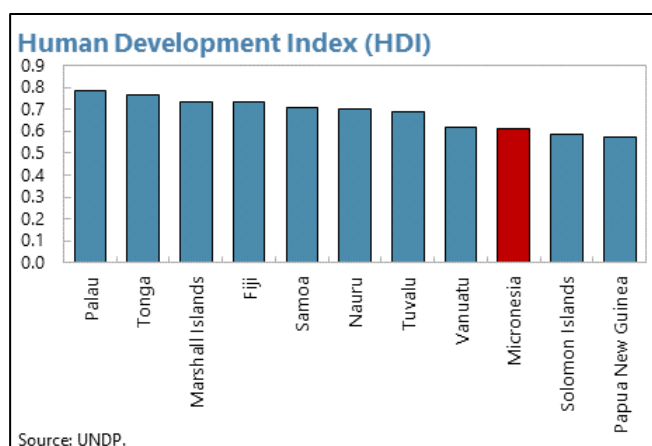
3. The FSM relies on foreign workers due to persistent skill gaps. Most foreign work permits are for workers in the private sector (76 percent) – employed as professionals, craft and trade workers, skilled agriculture, forestry and fishery workers – who generally have higher educational qualifications than FSM citizens. About 15 percent and 4 percent of employment in the private and public sectors are foreign workers, respectively, with most being from neighboring Pacific Islands (27 percent) and the Philippines (26 percent) with others from China and other Asian countries (WB, 2022). The Philippines government initiated a ban on sending new workers to the FSM in 2018 due to complaints of labor abuse by local employers, which resulted in a shortage of skilled migrants in the labor market. The ban was lifted in 2023 which has eased foreign labor supply.

4. Wages in the FSM are low. While the average national wage in the FSM has increased over the years, it has been gradual and uneven across sectors, with a large disparity between the public and private sector. As a retention strategy in response to migration and to combat cost of living pressures, civil service wages were increased by 45 percent at the national level, and states followed with similar increases. Salaries and minimum wages differ across the four autonomous states leading to migration within the FSM as well. Notably, many FSM citizens who migrate abroad for labor-intensive jobs can earn up to twice the average wage available at home.

5. Various data suggest an increasing trend of outward migration, which could have accelerated after the pandemic. Although the actual number of Micronesians migrating varies across databases, all sources point to the increasing trend of Micronesians living in the US, as the Compact allows Micronesians to work in the US without a visa. The OECD reports that the number of FSM citizens residing in the US grew by around 53 percent between 2020 and 2023. These migrants can be characterized as relatively young and more educated than the general population in FSM (but less educated than other migrants from PICs). The departure of these skilled individuals has had a significant impact on the education, healthcare and technology sectors. Many FSM migrants in the US are employed in labor-intensive industries, such as hospitality, trade, and manufacturing, likely due to lower skill requirements in these fields. In addition, FSM citizens are

permitted to study in the US under the Compact, but those who earn a degree in the US tend not to return to the FSM, as suitable jobs reflecting their qualifications are scarce in FSM. This ongoing trend of outward migrations is contributing to a brain drain, which may reduce productivity and limit the potential growth rate.

6. A confluence of factors explains the push to outward migration. Compared to other PICs, where migration is gradual and circular due to the design of the labor migration schemes that they participate in, migration in FSM has led to more permanent diasporas³. An assessment on skills and employability revealed that FSM youths view migration as a permanent solution rather than a temporary opportunity (WB 2022). The accessibility of the US labor market, together with limited economic opportunities at home, makes migration both easier and attractive for FSM citizens. Many migrants from Compact countries relocate for better economic and educational opportunities, improved healthcare and family reunification (GAO, 2020). The pandemic and recent cost of living crisis may have accelerated outward migration from the FSM, as migrants search for employment opportunities with higher salaries, including those with relatively low skill levels.



7. Invigorating the private sector and enhancing employability of citizens through improving education quality – including vocational training – can help stem the tide of emigration. Revitalizing the private sector by accelerating structural and financial reforms will be critical to providing better employment opportunities in the FSM; helping to retain workers and attract skilled returnees. Introducing active labor market programs will be essential to enhance opportunities for technical and vocational training and address existing skill gaps (ADB, 2019). Supporting vocational training for fostering green jobs can be beneficial in FSM, considering the vulnerability to climate disasters (IOM and ILO, 2022). Strengthening the quality of the education system remains one of the biggest challenges in FSM, and schools require more teachers with higher education backgrounds. Scholarships for foreign universities are provided with the condition of returning to the FSM. However, mechanisms to enforce these requirements need to be strengthened. In these respects, the recent project by the World Bank to enhance skill development

³ Circular migration refers to a pattern where workers temporarily move abroad for employment and then return to their home country, often repeating this cycle. For example, unskilled workers from Vanuatu and Fiji participate in Australia's PALM (Pacific Australia Labor Mobility) scheme. These workers travel to Australia for seasonal or short-term jobs—mostly in agriculture—and then return home when their contracts end. The design of the PALM program encourages this temporary, repeat migration by setting clear time limits and providing pathways for workers to return for future employment. As a result, migration from these countries tends to be more temporary and cyclical, rather than leading to permanent settlement abroad.

is welcome, and active engagement of authorities will be required.⁴ Raising female labor force participation in FSM could help alleviate labor shortages, though addressing associated structural and social challenges remains essential (Zhang and Zhou, 2025). The International Organization for Migration is also supporting the FSM government through a multisectoral migration task force led by the Department of Justice. The taskforce aims to address key areas of concern to FSM citizens (i.e., drivers of migration) including those living abroad (e.g., reintegration).

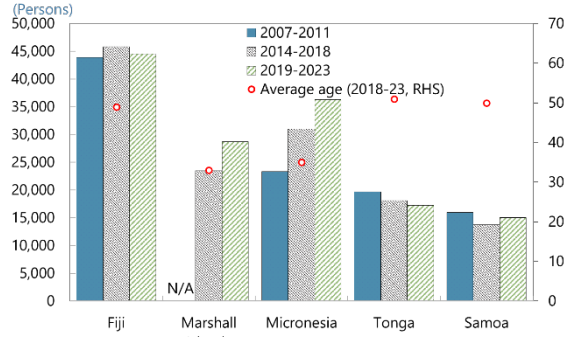
8. Better engagement with the diaspora can support economic development. Given its institutional and social fragilities as well as exposure to climate change, outward migration and labor market challenges are expected to continue over the short term. Hence it would be important to establish strategies to engage the diaspora in building the FSM economy. Despite having one of the highest emigration rates amongst PICs at 39.2 percent, the level of inward remittances is relatively low, highlighting permanent diasporas and concentration of migrants in low-wage sectors abroad. While most PICs prioritize reintegration programs, the FSM's strategy should focus on diaspora engagement. For instance, Samoa has a dedicated Diaspora Relations Unit to foster ties and investment, and New Zealand's 'Return to Roots' program had seen some success during its introduction. For the FSM, improving digital and financial infrastructure is essential for such initiatives to succeed.

⁴ <https://projects.worldbank.org/en/projects-operations/project-detail/P176965>

Figure 1. Labor Market and Migration in FSM

The number of Micronesians living in the US has increased...

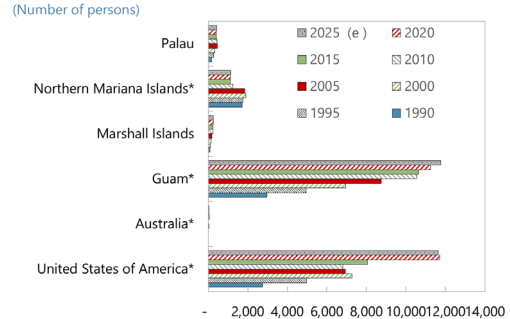
Foreign-Born Population in the US by Place of Birth



Sources: ACS 5-Year estimate and IMF staff estimation.

...with others choosing to relocate to Guam and the Northern Mariana Islands

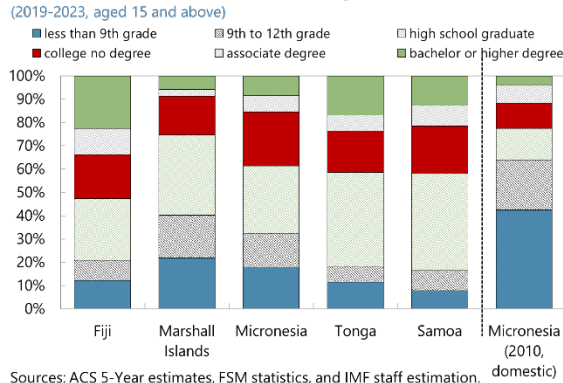
Stock of FSM Migrants



Source: United Nations.

FSM migrants to the US tend to have higher education than general FSM citizens...

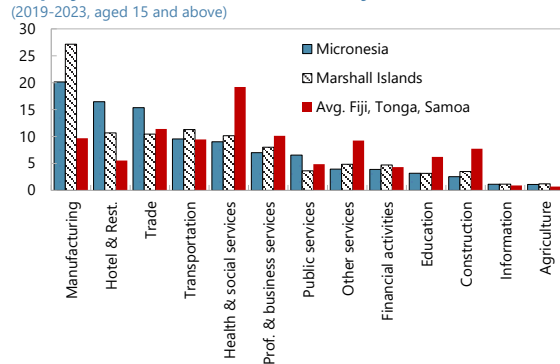
Educational Attainment in the US by Place of Birth



Sources: ACS 5-Year estimates, FSM statistics, and IMF staff estimation.

... and work at companies in hospitality, trade, and manufacturing

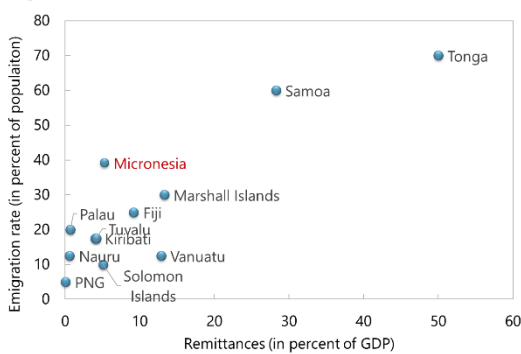
Employment Distribution in the US by Place of Birth



Sources: ACS 5-Year estimate and IMF staff estimation.

Despite a high emigration rate, remittances are relatively low

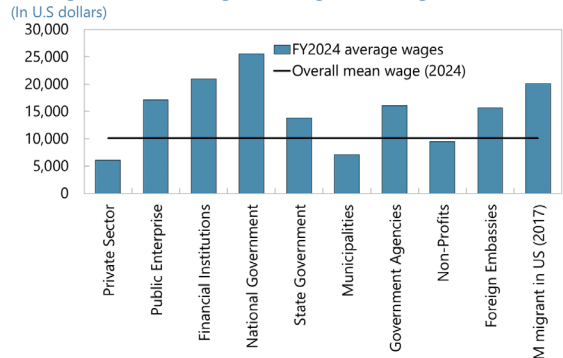
Migration Rate and Remittance Received



Sources: Authorities; and IMF staff calculations.

Average earnings in FSM are low, far below those earned by migrants in labor-intensive jobs overseas.

Average Domestic Wages vs. Migrants' Wages



Sources: FSM Statistics Division; and GAO Report, 2020.

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Annex IX. Data Adequacy Assessment

Table 1. Micronesia: Data Adequacy Assessment for Surveillance							
Data Adequacy Assessment Rating 1/							
C							
Questionnaire Results 2/							
Assessment	National Accounts	Prices	Government Finance Statistics	External Sector Statistics	Monetary and Financial Statistics	Inter-sectoral Consistency	Median Rating
	D	C	C	D	C	C	C
Detailed Questionnaire Results							
Data Quality Characteristics							
Coverage	D	B	C	C	C		
Granularity 3/	C		B	C	C		
Consistency			C	D	C	C	
Frequency and Timeliness	D	C	C	D	B		
<p>Note: When the questionnaire does not include a question on a specific dimension of data quality for a sector, the corresponding cell is blank.</p> <p>1/ The overall data adequacy assessment is based on staff's assessment of the adequacy of the country's data for conducting analysis and formulating policy advice, and takes into consideration country-specific characteristics.</p> <p>2/ The overall questionnaire assessment and the assessments for individual sectors reported in the heatmap are based on a standardized questionnaire and scoring system (see IMF <i>Review of the Framework for Data Adequacy Assessment for Surveillance</i>, January 2024, Appendix I).</p> <p>3/ The top cell for "Granularity" of Government Finance Statistics shows staff's assessment of the granularity of the reported government operations data, while the bottom cell shows that of public debt statistics. The top cell for "Granularity" of Monetary and Financial Statistics shows staff's assessment of the granularity of the reported Monetary and Financial Statistics data, while the bottom cell shows that of the Financial Soundness indicators.</p>							
A	The data provided to the Fund are adequate for surveillance.						
B	The data provided to the Fund have some shortcomings but are broadly adequate for surveillance.						
C	The data provided to the Fund have some shortcomings that somewhat hamper surveillance.						
D	The data provided to the Fund have serious shortcomings that significantly hamper surveillance.						
<p>Rationale for staff assessment. Like other COFA countries, the FSM receives support from Graduate School USA (GSUSA) to compile economic statistics, through the EconMAP program. Substantial time lags and gaps in coverage somewhat hamper surveillance. While there are serious shortcomings for the National Accounts and External Sector statistics, the economy is dominated by the public sector and hence the quality of government financial reporting has a heavier weight for surveillance. National Accounts: National accounts data is usually provided on an annual basis. However, challenges in sharing administrative tax data between government departments has delayed compilation in recent years. Administrative data are available only through FY2023. National Accounts data for FY2024 are estimates since data for the non-fishing private sector is not available. Sectoral data is available, but a disaggregation by expenditure is not. The benchmark year is outdated (2004) and the treatment of the informal sector, deflation method and derivation of industry value added can be improved. Data from the 2013-14 Household Income and Expenditure Survey could be better incorporated into the compilation methodology. Prices: Quarterly CPI data is available by states, including a demarcation of imported and domestic inflation. Data however is available with at least a six-month lag. Government Finance Statistics: Fiscal data covers the budgetary central government and four state governments, but not government agencies or local governments (municipalities). The GFS contains detailed statistics on revenues, expenses, and changes in net worth, and the granularity of this data is generally suitable for surveillance in the years for which they are available. The most recent GFS data is for FY2024. Government debt statistics, which have been available in the debt bulletin published by the Department of Finance and Administration (DOFA), additionally cover debt by State Owned Enterprises and provide relatively detailed data, including information on creditors, borrowers, debt service schedule, and repayment schedule. The most recently published debt bulletin was for December 2024. The debt data for FY2025 is estimated based on partial debt data provided by the authorities, as well as the debt repayment schedule in the national government's financial reports. External Sector Statistics: International Merchandise Trade Statistics is available up to 2021 with a significant delay (CY2021 provisional data published in 2023). The Balance of Payments is available up to FY2023 and is planned to be published in early 2026 after a significant hiatus in publishing since FY2018. Monetary and Financial Statistics: Quarterly data on the assets and liabilities of commercial banks are available with a lag of six months. Data for the superannuation fund and credit unions are less readily available, however commercial banks dominate the financial sector. Quarterly financial soundness indicators are available with a lag of six months.</p>							
<p>Changes since the last Article IV consultation. The debt bulletin was published quarterly from December 2021 until September 2023. However, since then, only one issue has been published in December 2024 due to staff turnover.</p>							
<p>Corrective actions and capacity development priorities. In the near term, efforts are directed toward producing National Accounts, government finance statistics, and public sector debt reporting. The compilation of External Sector Statistics will be the focus of medium-term capacity development. Authorities and GSUSA recently restarted National Accounts compilation. PFTAC have fielded several missions in 2025 to develop the authorities' capacity to anonymize the Business Gross Revenue Tax data so that it can be securely shared with the Statistics Department and GSUSA. Progress on the CD supporting Public Debt Statistics (PDS) has been limited. Missions to assist the DOFA in improving and expanding the compilation and dissemination of PDS have either remained in the planning stage or been canceled. The new information management systems, such as the Revenue Management System, ASYCUDA and IFMIS provides scope to automate data collection and improve timeliness of data releases. Staff are working with the authorities to improve the NA methodology. Closing data gaps and reducing publication lags would require additional hands-on capacity development from the Fund and other development partners, as well as additional resources for the Statistics Department.</p>							
<p>Use of data and/or estimates in Article IV consultations in lieu of official statistics available to staff. Staff does not use any data and/or estimates in the staff report in lieu of official statistics</p>							
<p>Other data gaps. Given labor market challenges and significant outward migration, improving labor market and migration statistics would help monitor the latest developments and help inform policy design. Staff encourage authorities to publish the 2023 Population Census as it can help fill some of these data gaps</p>							
Table 2. Micronesia: Data Standards Initiatives							
<p>Micronesia participates in the Enhanced General Data Dissemination System (e-GDDS) and publishes the data on its National Summary Data Page since July 2017.</p>							

Table 3. Micronesia: Table of Common Indicators Required for Surveillance

As of February 10, 2026

	Data Provision to the Fund				Publication under the Data Standards Initiatives through the National Summary Data Page			
	Date of Latest Observation	Date Received	Frequency of Data ⁶	Frequency of Reporting ⁶	Expected Frequency ^{6,7}	Micronesia ⁸	Expected Timeliness ^{6,7}	Micronesia ⁸
Exchange Rates ¹	NA	NA	NA	NA	D	M	...	1M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	NA	NA	NA	NA	M	M	1M	1M
Reserve/Base Money ¹	NA	NA	NA	NA	M	M	2M	2M
Broad Money ¹	NA	NA	NA	NA	M	Q	1Q	21M
Central Bank Balance Sheet ¹	NA	NA	NA	NA	M	M	2M	2M
Consolidated Balance Sheet of the Banking System	2025Q3	Jan-26	Q	Q	M	Q	1Q	21M
Interest Rates ²	FY2025	Jan-26	A	A	M	A	...	12M
Consumer Price Index	2025Q2	Nov-25	Q	Q	M	A	2M	12M
Revenue, Expenditure, Balance and Composition of Financing ³ –General Government ⁴	FY2024	Nov-25	A	A	A	A	3Q	12M
Revenue, Expenditure, Balance and Composition of Financing ³ –Central Government	FY2024	Nov-25	A	A	Q	A	1Q	12M
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	2025Q3	Jan-26	Q	Q	Q	A	2Q	12M
External Current Account Balance	FY2023	Jan-26	A	A	Q	A	1Q	12M
Exports and Imports of Goods and Services	FY2023	Jan-26	A	A	M	A	12W	12M
GDP/GNP	FY2024	Nov-25	A	A	Q	A	1Q	12M
Gross External Debt	FY2022	Jan-26	A	A	Q	A	2Q	12M
International Investment Position	FY2022	Jan-26	A	A	A	A	3Q	12M

¹ The U.S. dollar is legal tender and the official currency. FSM does not have a central bank.
² Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
³ Foreign, domestic bank, and domestic nonbank financing.
⁴ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
⁵ Including currency and maturity composition.
⁶ Frequency and timeliness: ("D") daily; ("W") weekly or with a lag of no more than one week after the reference date; ("M") monthly or with lag of no more than one month after the reference date; ("Q") quarterly or with lag of no more than one quarter after the reference date; ("A") annual; ("SA") semiannual; ("I") irregular; ("NA") not available or not applicable; and ("NLT") not later than.
⁷ Encouraged frequency of data and timeliness of reporting under the e-GDDS and required frequency of data and timeliness of reporting under the SDDS and SDDS Plus. Any flexibility options or transition plans used under the SDDS or SDDS Plus are not reflected. For those countries that do not participate in the IMF Data Standards Initiatives, the required frequency and timeliness under the SDDS are shown for New Zealand, and the encouraged frequency and timeliness under the e-GDDS are shown for Eritrea, Nauru, South Sudan, and Turkmenistan.
⁸ Based on the information from the Summary of Observance for SDDS and SDDS Plus participants, and the Summary of Dissemination Practices for e-GDDS participants, available from the IMF Dissemination Standards Bulletin Board (<https://dsbb.imf.org/>). For those countries that do not participate in the Data Standards Initiatives, as well as those that do have a National Data Summary Page, the entries are shown as "...".



FEDERATED STATES OF MICRONESIA

STAFF REPORT FOR THE 2026 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

April 6, 2026

Approved By
**Rahul Anand, Cemile
Sancak (IMF), Manuela
Francisco and Lalita M.
Moorty (IDA)**

Prepared by the staff of the International Monetary Fund
and the International Development Association (IDA)^{1,2}

Risk of external debt distress	Moderate
Overall risk of debt distress	Moderate
Granularity in the risk rating	Substantial space
Application of judgment	Yes: The forecast horizon is extended to 20 years to take account of a continuous upward trajectory of debt indicators in stress tests.

The Federated States of Micronesia (FSM) remains at moderate risk of debt distress under the Low-Income Country Debt Sustainability Framework (LIC DSF). While mechanical ratings on a 10-year horizon indicate low risk, the risk rises to moderate for the 20-year horizon as stress tests show that natural disaster and export shocks could increase the present value (PV) of external debt-to-GDP and debt-to-exports above the threshold. As such, both external and overall debt distress risks are assessed as moderate, with substantial space to absorb shocks. FSM's Trust Fund and Compact Trust Fund offer strong safeguards for debt repayment and fiscal resilience. However, large climate adaptation needs cannot be met through domestic resources alone without risking debt sustainability, necessitating grants and concessional financing. Strengthening public financial and debt management, including developing medium-term strategies and prioritizing climate-resilient investments, is essential.

¹ The FSM's Composite Indicator of 1.76 indicates a weak debt-carrying capacity, based on the October 2025 IMF's World Economic Outlook (WEO) and the 2024 World Bank's Country Policy and Institutional Assessment (CPIA).

² This DSA has been prepared jointly by the IMF and World Bank, following the 2018 Guidance Note on the Bank-Fund Debt Sustainability Framework for Low Income Countries.

PUBLIC SECTOR DEBT COVERAGE

1. This Debt Sustainability Analysis (DSA) covers debt owed by the national and state governments of the FSM (Text Table 1). As of September 2025, debt is primarily external and includes guaranteed debt from strategically important state-owned enterprises (SOEs). The FSM authorities report on both guaranteed and on-lent debt by SOEs in debt bulletins.³ Nevertheless, the coverage of the analysis can be improved by including other elements in the government (e.g. social security fund⁴). There is no non-guaranteed SOE debt. Against this background, the shock for SOE’s debt is set to zero in the contingent liability stress test. There are no Public Private Partnerships (PPP). The FSM uses the U.S. dollar as the legal tender and does not have a central bank. The external debt is defined based on the residency criteria.

Text Table 1. Federated States of Micronesia: Coverage of Public Debt

Subsectors of the public sector	Sub-sectors covered
1 Central government	X
2 State and local government	X
3 Other elements in the general government	
4 o/w: Social security fund	
5 o/w: Extra budgetary funds (EBFs)	
6 Guarantees (to other entities in the public and private sector, including to SOEs)	X
7 Central bank (borrowed on behalf of the government)	
8 Non-guaranteed SOE debt	

1 The country's coverage of public debt	The central, state, and local governments, government-guaranteed debt		
	Default	Used for the analysis	Reasons for deviations from the default settings
2 Other elements of the general government not captured in 1.	0 percent of GDP	0.0	
3 SoE's debt (guaranteed and not guaranteed by the government) 1/	2 percent of GDP	0.0	SOEs' debt guaranteed by the government already included in debt coverage
4 PPP	35 percent of PPP stock	0.0	
5 Financial market (the default value of 5 percent of GDP is the minimum value)	5 percent of GDP	5.0	
Total (2+3+4+5) (in percent of GDP)		5.0	

1/ The default shock of 2% of GDP will be triggered for countries whose government-guaranteed debt is not fully captured under the country's public debt definition (1.). If it is already included in the government debt (1.) and risks associated with SoE's debt not guaranteed by the government is assessed to be negligible, a country team may reduce this to 0%.

BACKGROUND ON DEBT

2. The FSM’s public sector debt declined to 8.9 percent of GDP at end-September 2025, from a peak of 31.1 percent of GDP in FY2009 (Text Table 2).⁵ Because the FSM has generally been running budget surpluses, public sector debt has been on a downward trajectory since FY2009. Most of the debt is concessional and is contracted with official lenders. As of September 2025, 69.7 percent of the debt is from the Asian Development Bank (ADB), while the share of the U.S. Department of Agriculture stood at 12.9 percent. The remaining debt (17.4 percent of total) comprises the European Investment Bank (EIB), a commercial private lender, and domestic entities. All loans except from the EIB (4.2 percent of total) are

³ To enhance debt transparency, since December 2021 the Government has been publishing debt bulletins, which include public and publicly guaranteed (PPG) debt, with breakdown by level of government, domestic and external debt, creditor, government guarantees, and debt servicing schedule.

⁴ The size of the social security fund assets was USD 56.7 million in 2023 and its liabilities are less than 0.1 percent of GDP.

⁵ Fiscal Year in FSM is from October to September. This DSA is prepared on FY basis, unless stated otherwise. For example, FY2025 represents the period from October 2024 to September 2025.

denominated in U.S. dollars. Total external debt service reached 5.3 percent of exports in FY2025 and is expected to decrease in the medium term.

Text Table 2. Federated States of Micronesia: Stock of Debt owed by the National and State Governments

	Sep-25		
	In millions of U.S. dollars	As a share of total debt	In percent of GDP
Total public debt	44.5	100.0	8.9
External	40.2	90.3	8.0
Multilateral	32.9	73.8	6.5
Asian Development Bank	31.0	69.7	6.2
European Investment Bank	1.9	4.2	0.4
Bilateral	5.7	12.9	1.1
U.S. Department of Agriculture	5.7	12.9	1.1
Commercial	1.6	3.6	0.3
Domestic	4.3	9.7	0.9
Memorandum item:			
of which: SOE debt 1/	20.9	47.1	4.2

Source: FSM authorities and IMF staff estimates and calculations.
1/ SOE debt comprises guaranteed (\$10.0 million) and on-lent (\$10.9 million) debts.

BACKGROUND ON MACROECONOMIC FORECASTS

3. Economic growth is expected to remain subdued due to structural and capacity constraints; the fiscal balance is projected to deteriorate over time (Box 1). Real GDP growth is estimated to slow to 1.1 percent in FY2025 as factors which drove the rebound in FY2024 dissipate (i.e., jump in fishing output, high bank profitability and the public sector wage increase). Growth is expected to moderate to 0.7 percent in FY2026 as real income compression and higher import costs, particularly for the relatively fuel intensive fishing sector, weigh on activity. At the same time, growth is bolstered by the gradual pickup in public investment funded by the Compact of Free Association (COFA). An increase in project-related grants from multilateral financial institutions (MFIs) and the Yap airport expansion by the US Department of War will support a growth uptick in FY2027 and FY2028. However, in the medium term, growth is projected to decline to 0.7 percent due to structural and capacity constraints including labor shortages. Headline inflation is projected to remain elevated at 3.2 percent in FY2026 and rise to 4.0 percent in FY2027, reflecting higher oil and food prices due to the conflict in the Middle East (these projections are subject to uncertainty and depend on the duration and depth of the shock). It is projected to fall to 2 percent in the long term. The fiscal balance is expected to weaken as fishing fees gradually fall due to a climate-change driven decrease in tuna biomass and state government spending accelerates. The current account is projected to shift into a long-term deficit of around 2 percent of GDP due to high public spending. The fiscal balance is expected to turn into a deficit in FY2027, financed by new concessional debt. From FY2031,

the financing mix envisages a combination of external concessional borrowing and partial drawdown of financial assets, as withdrawals from the FSM trust fund (FSMTF) become available.⁶

4. The issues flagged by the realism tools primarily reflect recent changes in the economic environment (Figure 3 and 4). The negative 5-year historical change in debt is mainly the result of improvements in current account and primary deficit. These improvements were driven by large corporate income tax gains from foreign firms and higher fishing fee revenues. The residuals are high because the authorities contributed a substantial portion of the fiscal surplus to the FSMTF during this time. The differences in projected public investment patterns between the current and previous DSAs reflect changes in planned project-related grants from MFIs.

Box 1. Federated States of Micronesia: Key Macroeconomic Assumptions

- Under **the new COFA**, which took effect in March 2024, the FSM has access to USD 140 million per year (29 percent of GDP in FY2024) in sector grants until FY2043, with an additional USD 500 million in US contributions to the Compact Trust Fund (CTF) in FY2024 and FY2025. This is a significant increase in grants compared to the previous compact (19 percent of GDP). The amended Compact indicates the possibility of renewal beyond FY2043 and this is assumed to be the case under the baseline.
- **Real GDP growth** is expected to remain subdued. Economic growth is estimated to slow to 1.1 percent in FY2025 as factors which drove the rebound in FY2024 dissipate (i.e., jump in fishing output, high bank profitability and the public sector wage increase). In FY2026, growth is expected to moderate to 0.7 percent as real income compression and higher import costs, particularly for the relatively fuel intensive fishing sector, weigh on activity. At the same time, growth is bolstered by a gradual pickup in public investment funded by COFA. An increase in project-related grants from MFIs and the Yap airport expansion by the US Department of War will support a growth uptick in FY2027 and FY2028. However, the economy is projected to return to 0.7 percent growth due to structural and capacity constraints, including labor shortages.
- **Inflation** is projected to remain relatively high and only fall gradually in the medium term. Although headline inflation in FY2025 eased to 3.2 percent from 5.4 percent in the previous year, it remains elevated. Inflation is projected to remain high at 3.2 percent in FY2026 and rise to 4.0 percent in FY2027, reflecting higher oil and food prices due to the conflict in the Middle East. However, these projections are subject to uncertainty and depend on the duration and depth of the shock. Inflation will gradually converge to 2 percent in the long term in line with US inflation (the US dollar is the FSM's legal tender). The GDP deflator is assumed to move in tandem with inflation.
- **The fiscal balance** is projected to weaken. In FY2025, the fiscal surplus narrowed to 0.4 percent of GDP, as revenues from corporate income taxes and fishing fees fell while the wage bill increased. The fiscal balance will deteriorate as fishing fee revenues gradually fall due to a climate-change driven decrease in tuna biomass and state government spending accelerates. A fiscal deficit is expected from FY2027 onwards. Support from MFIs transitioned from purely grants to a blend of grants and concessional loans due to an upgraded debt distress rating. Nevertheless, project-related grants from the World Bank (WB) and ADB will continue until 2031, as they were committed prior to the upgrade. These commitments increase each year from approximately USD 30 million in FY2026 to a peak of

⁶ By law, withdrawals from FSMTF are restricted until FY2030 and they will be capped at a level that preserves the fund's real value after they become available. The FSMTF is a sovereign savings fund built from prior fiscal surpluses and contributions by the government. Therefore, withdrawals from the FSMTF are domestic financing from accumulated assets, not grants.

Box 1. Federated States of Micronesia: Key Macroeconomic Assumptions (Concluded)

approximately USD 70 million in FY2028 and FY2029 – driven by a jump in planned disbursements from the World Bank – before declining to zero by FY2031.

- **The current account balance** is projected to deteriorate, resulting in a deficit of around 2 percent of GDP in the long run. The deterioration is mainly driven by elevated public consumption and investment aligned with the FSM's development needs, despite large grants inflow mainly from the US.
- **The FSM Trust Fund** has accumulated large financial assets thanks to revenues from fishing license fees, revenue windfalls, and foreign grants. The trust fund's balance stood at USD 577 million, or about 115 percent of GDP, at the end of FY2025. A partial drawdown of investment gains to finance the fiscal deficit is assumed to commence from FY2031. Despite this plan, the fund's balance is projected to increase to around 146 percent of GDP by end-FY2046, with the assumption that the rate of investment return is higher than the nominal GDP growth rate, and that any drawdown from the FSMTF can only be made in a manner that maintains the real value of the fund. 1/
- **Financing mix.** It is assumed that new external concessional loans from development partners will be incurred starting in FY2027 when the fiscal balance is expected to turn into a deficit, given that the lending terms of these loans are generally more favorable than domestic loans. Beyond this, the paths of external and public debt are determined by projected fiscal deficits, GDP growth, interest rates for new debt, and the financing mix for fiscal gross financing needs (GFNs). From FY2031, liquid assets, mainly the FSMTF drawdown, are assumed to be used to partially fill GFNs, with external concessional loans financing the remaining GFNs. As of end-FY2025, around 70 percent of public debt is owed to the ADB. As this debt is repaid and new concessional borrowing is concentrated in IDA credit, the World Bank is projected to become the largest creditor over the medium term. FSM is an IDA-only small state with a moderate risk of debt distress. Accordingly, FSM will receive IDA financing on a 50/50 split between grants and credits on Small Economy Terms under IDA21 with a total indicative IDA21 allocation of SDR 48.8 million, equivalent to USD 67.1 million as of end-February 2026. The indicative FY27 and FY28 allocations exclude the SDFP incentive, which will be applied annually for countries satisfactorily implementing all Performance and Policy Actions (PPAs).

Macroeconomic Assumptions

	Current DSA (2026 Article IV)				Previous DSA (2023 Article IV)			
	2025	2026	2027-28	2029-46	2025	2026	2027-28	2029-43
Real GDP (y/y growth)	1.1	0.7	1.3	0.7	1.7	1.1	0.8	0.7
Inflation (y/y growth)	3.2	3.2	2.9	2.0	3.0	2.5	2.1	2.0
Fiscal balance (percent of GDP)	0.4	0.4	-0.5	-3.6	-0.4	-1.0	-1.1	-2.5
Current account balance (percent of GDP)	3.8	1.1	-0.6	-1.9	0.8	0.6	0.3	-1.1

Sources: FSM authorities and IMF staff estimates and calculations.

1/ The annual nominal net return rate of the FSMTF is assumed at 5 percent, which is the same as the rate applied to the Compact Trust Fund (CTF). The historical average net return rates of the FSMTF and the CTF are 7.6 percent and 7.5 percent, respectively, as of end-FY2025.

COUNTRY CLASSIFICATION AND DETERMINATION OF SCENARIO STRESS TEST

5. **The FSM’s debt carrying capacity is assessed as weak.** The country’s Composite Indicator (CI) index is 1.76, based on October 2025 WEO and 2024 CPIA (Text Table 3). The CI indicates a weak debt-carrying capacity, similar to the previous vintage classification. The DSA thresholds applicable for the FSM are: 30 percent for the present value (PV) of external debt-to-GDP ratio, 140 percent for the PV of external debt-to-exports ratio, 10 percent for the external debt service-to-exports ratio, 14 percent for the external debt service-to-revenue ratio, and 35 percent for the PV of public debt-to GDP ratio.

Text Table 3. Federated States of Micronesia: Composite Indicator and Applicable Thresholds

Calculation of the CI Index

Components	Coefficients (A)	10-year average values (B)	CI Score components (A*B) = (C)	Contribution of components
CPIA	0.385	2.798	1.08	61%
Real growth rate (in percent)	2.719	0.390	0.01	1%
Import coverage of reserves 1/ (in percent)	4.052	3.198	0.13	7%
Import coverage of reserves^2 (in percent)	-3.990	0.102	0.00	0%
Remittances (in percent)	2.022	6.771	0.14	8%
World economic growth (in percent)	13.520	3.035	0.41	23%
CI Score			1.76	100%
CI rating			Weak	

Applicable Thresholds

Applicable	
External debt burden thresholds	
PV of debt in % of Exports	140
GDP	30
Debt service in % of	
Exports	10
Revenue	14

Applicable	
Total public debt benchmark	
PV of total public debt in percent of GDP	35

1/ FSM Trust Fund and Compact Trust Fund are excluded from reserves.

6. **Among the six standardized stress tests in the DSF, five were applied to analyze external and public debt sustainability.** These tests simulate shocks to real GDP growth, the primary fiscal balance, exports, other external flows such as transfers and FDI, exchange rate depreciation, and a combined shock scenario. The scenario with exchange rate depreciation is not

considered as the U.S. dollar is the FSM's legal tender. In each test, the affected variable is set to its historical average minus one standard deviation, or the baseline projection minus one standard deviation, whichever is lower, in the second and third years of the projection period.

7. Given the severity and frequency of natural disasters in the FSM, a customized stress test for a natural disaster shock is added to the standard set of stress test scenarios. In the natural disaster scenario, a one-off shock of 10 percentage points to debt-GDP ratio in FY2027 is assumed, with real GDP growth and exports growth lowered by 9.2 and 13 percentage points, respectively, in the year of the shock. The size of the shock to the public debt-to-GDP ratio is the same as that assumed in the tailored stress tests.⁷ The size of the shocks to real GDP and export growth is based on the estimated impacts of a large disaster on tradable output (13 percent) and non-tradable output (4 percent) as suggested by Davies et al. (2019), and the share of value added in the non-tradable sector (42 percent) in 2024.⁸ These shocks are consistent with those assumed in Annex VII of the Staff Report. Financial market shocks are considered for contingent liabilities, using the default shock parameters.⁹

DEBT SUSTAINABILITY

A. External Debt Sustainability Analysis

8. Under the baseline scenario, there are no breaches in any external debt indicators vis-à-vis indicative thresholds over the extended 20-year horizon (Table 1 and Figure 1). The external debt stock is projected to decrease from 8.0 percent of GDP in FY2025 to 6.7 percent in FY2027, followed by an increase to 38.7 percent of GDP in FY2046. Repayment of the external debt is expected to occur according to schedule, while a continued decline in fishing fee revenues and an increase in public investment are expected to cause the debt level to rise after FY2027. However, thanks to large grant inflows from the new COFA, all external debt stock and liquidity indicators remain below their thresholds through FY2046. The debt trajectory under the historical scenario differs significantly from that of the baseline scenario (Figure 1), this is mainly because the historical scenario reflects a period of high fiscal surplus.

9. Stress tests point to the vulnerability of the FSM's external debt dynamics to shocks from natural disasters and exports during the extended 20-year period (Figure 1 and Table 3). In the customized stress test for a natural disaster shock, the PV of external PPG debt-to-GDP ratio and the PV of external PPG debt-to-exports ratio are projected to be on a continuous upward trajectory, breaching the

⁷ This is based on the median change in the public debt to GDP ratio one year after the natural disaster from its pre-shock level, across all episodes with measured economic losses of at least 5 percent of GDP, using data from Emergency Events (EM-DAT) database. (Guidance Note on the Bank-Fund Debt Sustainability Framework for Low Income Countries, February 2018)

⁸ Davies *et al.* (2019), 'Federated States of Micronesia: Climate Change Policy Assessment', IMF Country Report No. 19/292.

⁹ Following the DSA guideline, shocks of SOE's debt and PPP stock are set to zero.

threshold starting in FY2039 and FY2038, respectively. The PV of external PPG debt-to-exports ratio also breaches the threshold starting in FY2039, if there is an exports shock.

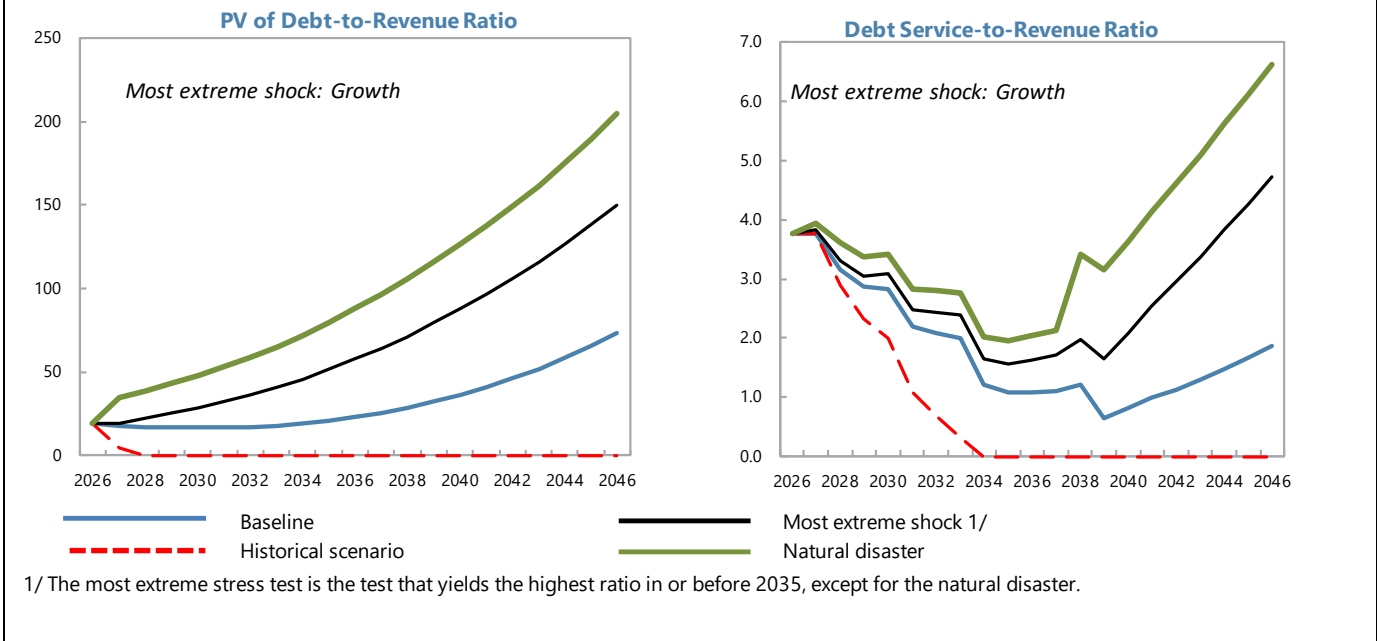
B. Public Sector Debt Sustainability Analysis

10. Public sector debt follows closely the dynamics of external debt. The ratio of public debt to GDP is projected to decrease to 7.3 percent of GDP in FY2027, after which it is expected to increase to 38.7 percent of GDP in FY2046 (Table 2). The higher terminal public debt-to-GDP ratio relative to the 2023 DSA reflects updated assumptions of increased development and climate change adaptation needs, alongside the authorities' willingness to contract new concessional loans to address these priorities in support of long-term resilience and growth. The PV of the public debt-to-GDP ratio does not breach the benchmark under the baseline through the 20-year projection horizon.

11. Domestic debt is estimated to be minimal (Figure 5). The domestic debt-to-GDP ratio and the ratio of domestic debt service to revenues, including grants, are both less than 1 percent in FY2026 and are projected to converge to zero around FY2036. This is primarily because no new domestic debt is expected after FY2026. The ratio of domestic debt service to revenues, excluding grants, remains below 1 percent in FY2026 and follows a similar pattern.

12. Stress tests indicate overall debt dynamics is also vulnerable to natural disasters and growth shocks (Figure 2 and Table 4). The PV of overall debt-to-GDP ratio is projected to increase, breaching the benchmark in response to a natural disaster shock starting from FY2040 and a growth shock starting from FY2045, respectively. Excluding grants from revenues increases the PV of public-debt-to-revenue ratio and the debt service-to-revenue ratio to 204 percent and 6.6 percent, respectively, in FY2046, when a natural disaster hits (Text Figure 1).

Text Figure 1. Federated States of Micronesia: PV of Public Debt-to-Revenue (excluding grants) Ratio and Debt Service-to-Revenue (excluding grants) Ratio under Alternative Scenarios, 2026-2046



RISK RATING AND VULNERABILITIES

13. The risk of external debt distress is assessed at moderate with substantial space to absorb shocks (Figure 6). The DSA’s mechanical rating indicates low risk, as none of the DSA thresholds are breached in either baseline or stress tests during the standard 10-year horizon. Nevertheless, the horizon for the FSM is extended to 20 years due to longer term effects on debt from some shocks. While there is still no breach in the baseline within a 20-year forecast, the projected breach of the threshold in stress tests warrants an assessment of moderate risk of external debt distress. External debt dynamics are especially vulnerable to the natural disaster and exports shocks.

14. The risk rating of overall debt distress is also assessed at moderate. The mechanical rating indicates low risk with no breach in both baseline and stress tests within 10 years. Extending the forecast horizon to 20 years, however, the risk of overall debt distress is assessed as moderate, as the external debt distress risk rating is moderate and the benchmark for the PV of the overall public debt-to-GDP ratio is breached in the stress test with the natural disaster and growth shocks.

15. The FSMTF and the CTF provide an additional safeguard for debt repaying capacity and debt sustainability. At the end of FY2025 the balance of the FSMTF and the CTF are 115 percent of GDP and 395 percent of GDP, respectively. The new Compact agreement allows for greater flexibility regarding the use of resources. The CTF was originally created to accumulate resources to be distributed after the expiration of the fiscal support under COFA, but now a distribution of the CTF is possible even during the grant period (until FY2043). In addition, unused infrastructure funds and economic assistance grants from the previous COFA are available to be utilized. As regards the FSMTF, the baseline scenario assumes that a

partial drawdown from the FSMTF will commence from FY2031. Drawdowns are capped at a level that maintains the real value of the Fund, but this condition is not breached in the baseline. This strategy implies that the trust funds can facilitate the authorities' capacity to repay public debt and respond to shocks, helping keep debt on a sustainable path. The balance of the FSMTF and CTF is projected to exceed 140 percent of GDP and 500 percent of GDP, respectively by the end of the projection period.

16. Fiscal risks from SOEs are mainly concentrated in state utility corporations. Part of SOE's weak financial performance is reflected in the analysis, as some SOEs receive budgetary and non-budgetary transfers. In FY2026, budgeted transfers from the national government to SOEs amount to USD 0.3 million, allocated entirely to Caroline Islands Air. At the state level, the Pohnpei State Government provided USD 0.8 million to the Pohnpei Utilities Corporation (PUC) in FY2023, which is also the beneficiary of state guarantees on loans from the ADB. Following PUC's past debt service shortfalls, the national government withheld approximately USD 0.6 million of Pohnpei State's revenue shares in FY2023 to meet these obligations. The Yap State Government paid USD 0.8 million in FY2023 to cover the principal and interest of the ADB loan owed by the Yap State Public Service Corporation. Although these transfers are modest in size, ranging from 0.1 to 0.2 percent of GDP, their recurrent nature and the weak operating performance of these SOEs, including instances of operating losses even after support, suggest that associated fiscal risks remain.

17. FSM has substantial climate change adaptation needs. While the baseline reflects the FSM's current capacity to implement public investment projects, the country's climate change adaptation needs are much larger. Frequent and intensifying natural disasters, including typhoons, droughts, flooding, and rising sea levels, make the FSM one of the most vulnerable amongst Pacific Island countries. Key sectors such as agriculture, fisheries, and tourism are highly vulnerable, and annual adaptation costs are estimated at one-third of the FSM's GDP. Furthermore, the cost of addressing potential oil spills from over 60 WWII-era shipwrecks could weigh on FSM's fiscal condition. A national emergency was declared in late September 2025 following a significant leak. The cost of extracting oil from each wreck is estimated at 2-7 percent of GDP. Analysis based on the debt, investment, growth, and natural disasters (DIGNAD) model indicates that greater preemptive public investment in climate-resilient infrastructure can substantially reduce the macroeconomic costs associated with natural disasters and improve long-term debt sustainability, irrespective of the financing strategy employed.¹⁰ These findings highlight the importance of scaling up resilient investment while preserving debt sustainability through an appropriate combination of grants, concessional financing, and strengthened domestic revenue mobilization. However, financing the entirety of adaptation needs – without sufficient grant and concessional support – would jeopardize debt sustainability, particularly given the limited capacity of the private sector.

18. Macroeconomic data gaps and long lags in data availability can affect the robustness of the macroeconomic projections. Balance of Payments and GDP statistics are available until FY2023. Complete debt data is available up to December 2024, and the debt data as of end-FY2025 is estimated based on partial data provided by the authorities, as well as the debt repayment schedule in the national

¹⁰ Agrawal, Ram, and Zhang (2026), 'Building Resilience to Natural Disaster Shocks in Federated States of Micronesia', IMF Staff Report.

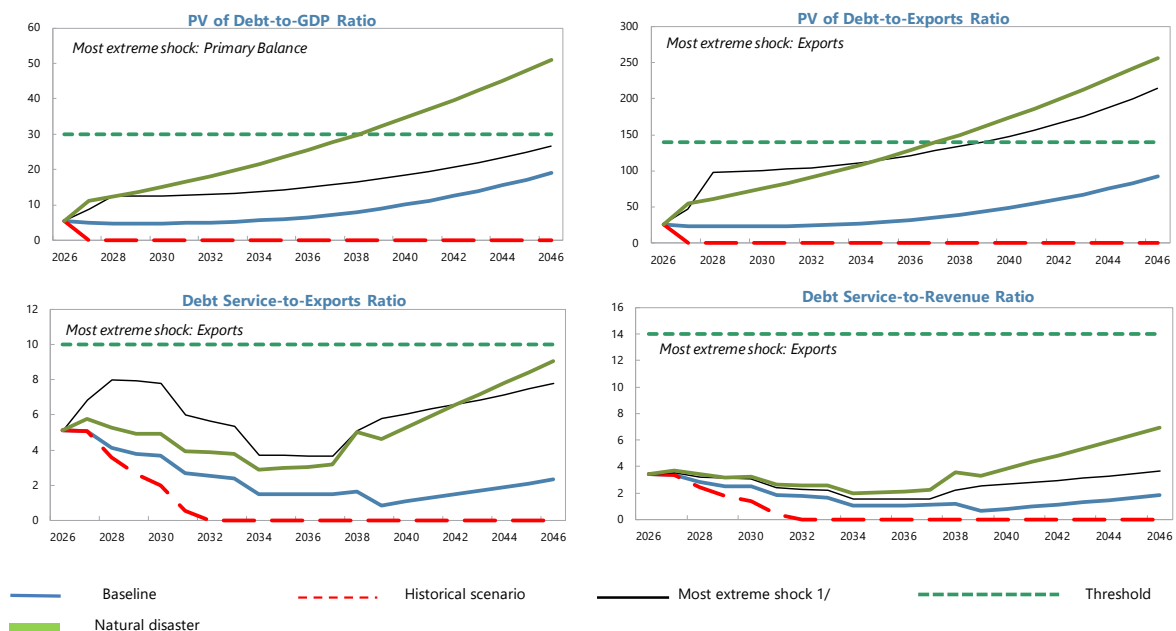
government's financial reports. The authorities are actively working to close data gaps by improving interdepartmental data sharing with support from PFTAC and reviewing the national accounts methodology in collaboration with development partners. To enhance the timeliness and coverage of economic statistics, authorities are leveraging newly launched systems like automated systems for customs data (ASYCUDA), the revenue management system (RMS), and the financial management information system (FMIS).

19. Concerted efforts are needed to improve public financial management and debt management, which would help support growth and better manage risks. A medium-term fiscal framework to guide budgets toward long-term goals and promote fiscal discipline and sustainability is needed. Enhancing capacity to plan and implement public spending is crucial for effective implementation of public investment. Strengthening debt management would benefit from regularly publishing a debt bulletin to improve transparency and accountability and over time developing a medium-term debt strategy. It is also crucial to ensure that new borrowing remains concessional and well-targeted. Building resilience to climate change is essential, given the vulnerability of debt dynamics to natural disaster shocks. Prioritizing climate-resilient infrastructure investments helps reduce disaster-related economic losses and enables faster recovery (see Annex VII of the 2026 Article IV). For FSM, early and targeted adaptation investments supported by grants, concessional financing, and potential tax reforms can protect fiscal space and improve long-term debt sustainability.

AUTHORITIES' VIEWS

20. The authorities broadly concurred with staff's assessment of the overall risk of debt distress, but with caveats regarding the risk rating. The authorities noted that the results of the customized stress test reflect only a natural disaster shock and does not reflect the slow-moving effects of climate change, such as rising temperature and drought, and hence underestimates the impact of climate change on the economy and debt sustainability. They also expressed concerns over treating trust funds as an additional safeguard for debt sustainability, given that their purpose is also to ensure intergenerational equity. They acknowledged the need to contract new concessional loans to finance development needs, but emphasized their intention to proceed in a prudent manner, citing concerns about the capacity to repay. While noting that the national government can withhold tax revenue transfers to states that do not meet debt obligations, they stressed that such measures may constrain states' ability to provide essential public services.

Figure 1. Federated States of Micronesia: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2026-2046



Customization of Default Settings			Borrowing assumptions on additional financing needs resulting from the stress tests*		
	Size	Interactions		Default	User defined
Standardized Tests	Yes	Yes	Shares of marginal debt		
Tailored Stress			External PPG MLT debt	100%	
Combined CL	Yes		Terms of marginal debt		
Natural disaster	n.a.	n.a.	Avg. nominal interest rate on new borrowing in USD	0.8%	0.8%
Commodity price	n.a.	n.a.	USD Discount rate	5.0%	5.0%
Market financing	n.a.	n.a.	Avg. maturity (incl. grace period)	40	40
			Avg. grace period	10	10

Note: "Yes" indicates any change to the size or interactions of the default settings for the stress tests. "n.a." indicates that the stress test does not apply.

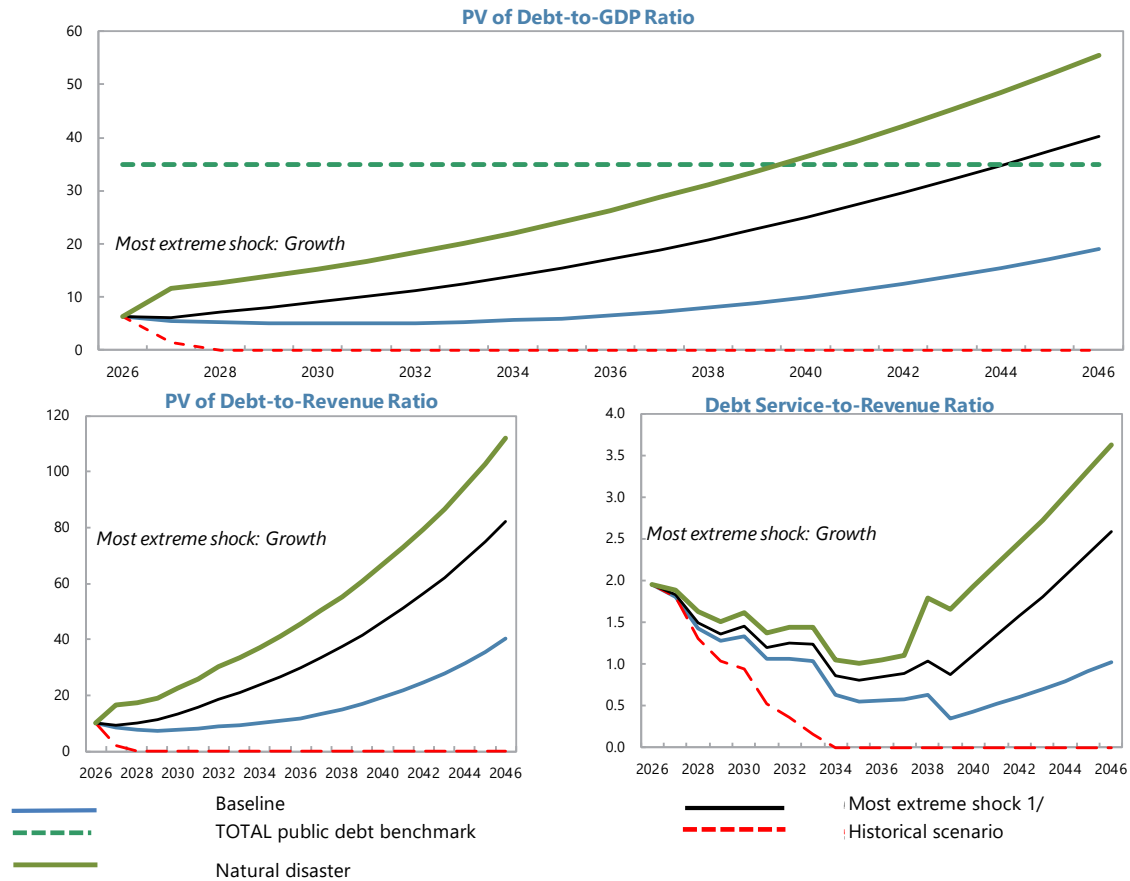
* Note: All the additional financing needs generated by the shocks under the stress tests are assumed to be covered by PPG external MLT debt in the external DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2035, except for the natural disaster. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most extreme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

2/ The magnitude of shocks used for the commodity price shock stress test are based on the commodity prices outlook prepared by the IMF research department.

Figure 2. Federated States of Micronesia: Indicators of Public Debt under Alternative Scenarios, 2026-2046



Borrowing assumptions on additional financing needs resulting from the stress tests*	Default	User defined
Shares of marginal debt		
External PPG medium and long-term	100%	100%
Domestic medium and long-term	0%	0%
Domestic short-term	0%	0%
Terms of marginal debt		
External MLT debt		
Avg. nominal interest rate on new borrowing in USD	0.8%	0.8%
Avg. maturity (incl. grace period)	40	40
Avg. grace period	10	10
Domestic MLT debt		
Avg. real interest rate on new borrowing	10.4%	10.4%
Avg. maturity (incl. grace period)	4	4
Avg. grace period	1	1
Domestic short-term debt		
Avg. real interest rate	-0.2%	-0.2%

* Note: The public DSA allows for domestic financing to cover the additional financing needs generated by the shocks under the stress tests in the public DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2035, except for the natural disaster. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most extreme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

Figure 3. Federated States of Micronesia: Drivers of Debt Dynamics—Baseline Scenario

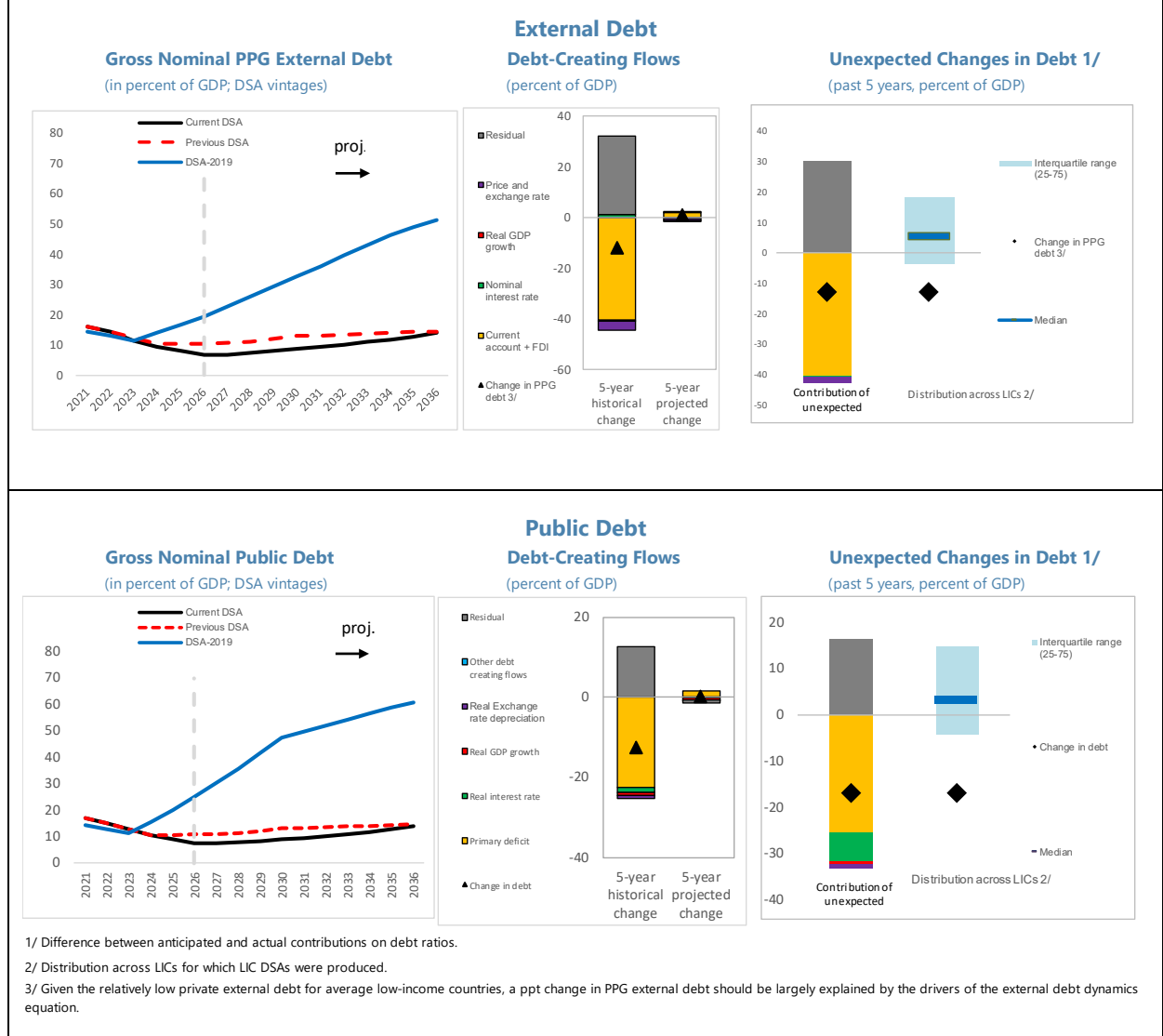
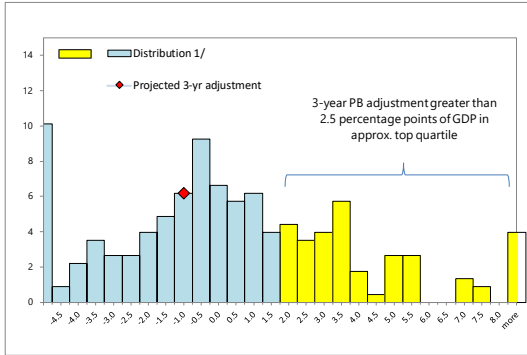


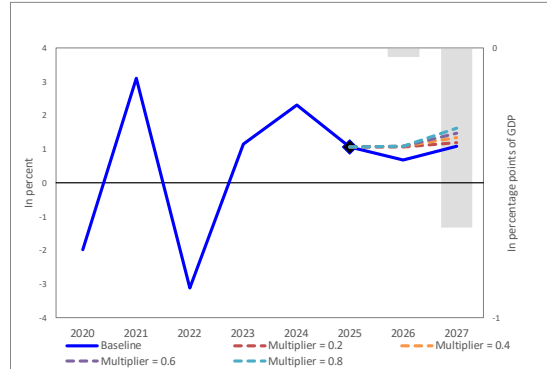
Figure 4. Federated States of Micronesia: Realism Tools 1/

**3-Year Adjustment in Primary Balance
(Percentage points of GDP)**



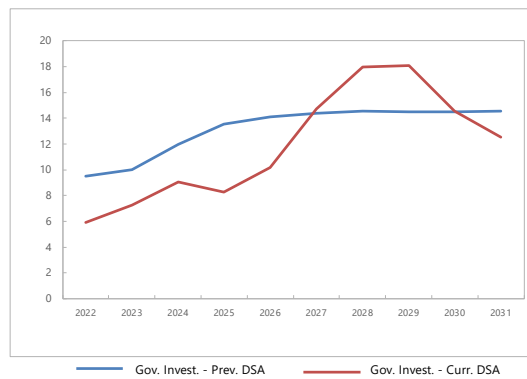
1/ Data cover Fund-supported programs for LICs (excluding emergency financing) approved since 1990. The size of 3-year adjustment from program inception is found on the horizontal axis; the percent of sample is found on the vertical axis.

Fiscal Adjustment and Possible Growth Paths 1/



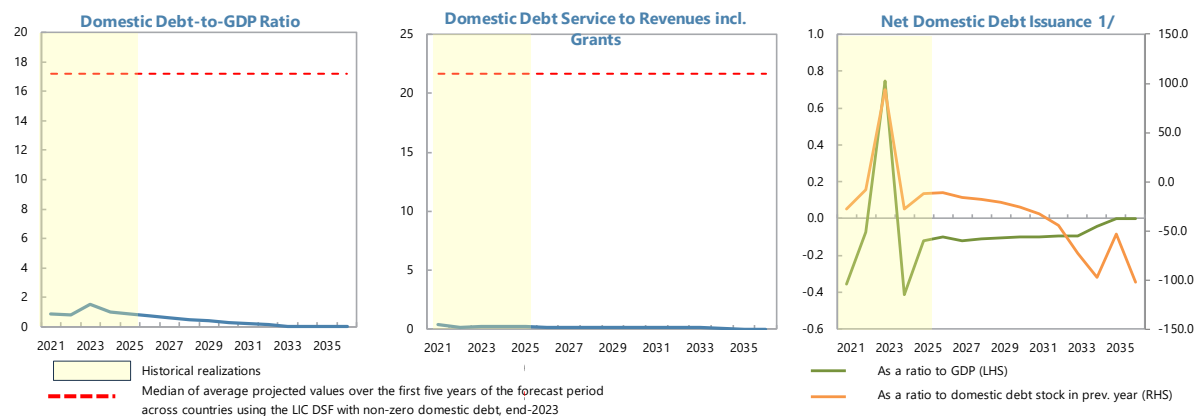
1/ Bars refer to annual projected fiscal adjustment (right-hand side scale) and lines show possible real GDP growth paths under different fiscal multipliers (left-hand side scale).

**Public and Private Investment Rates
(percent of GDP)**



1/ The data needed to conduct the investment growth tool is not available for the DSA exercise.

Figure 5. Federated States of Micronesia: Indicators of Domestic Debt, 2021-2036
(Percent)

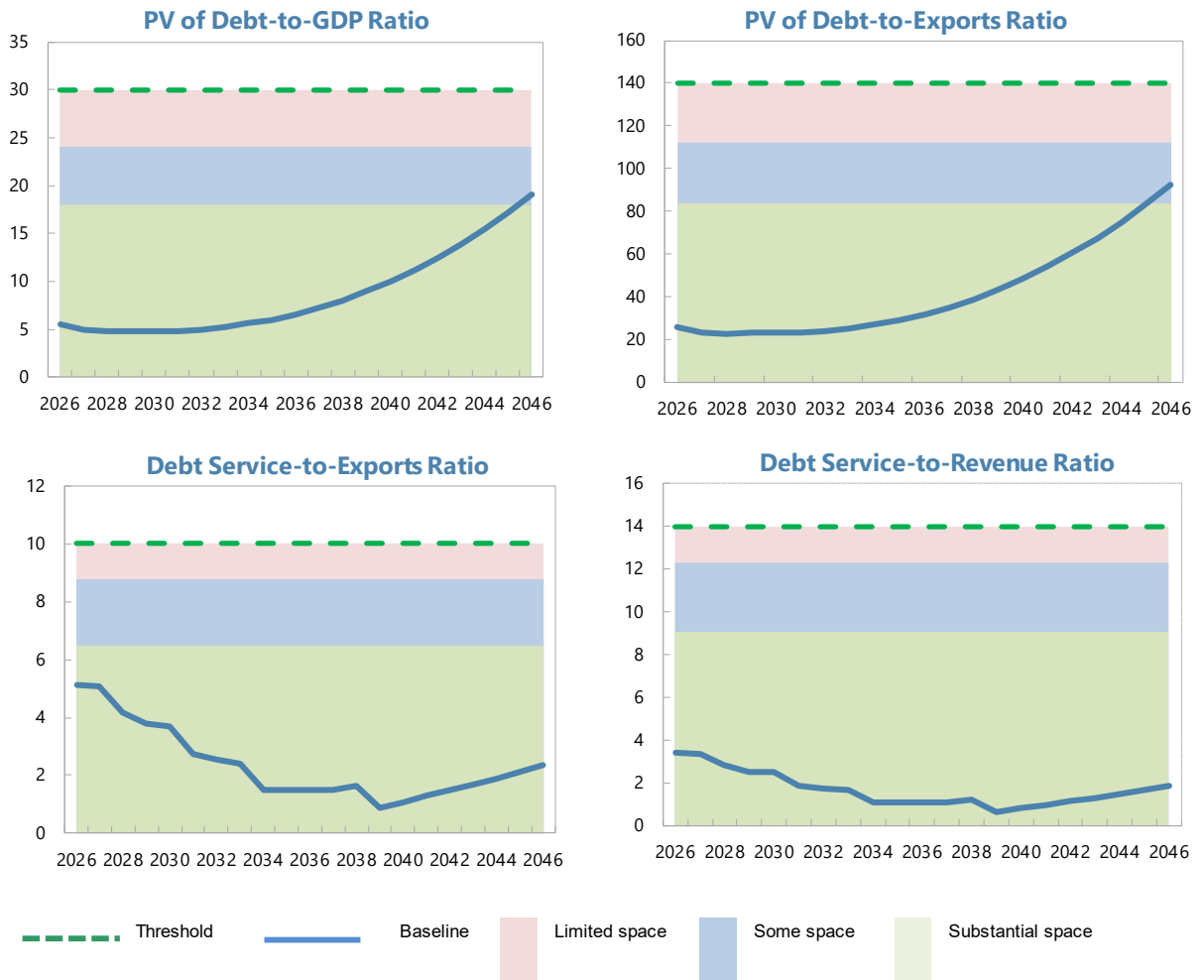


Borrowing Assumptions (average over 10-year projection)	Value
Shares in new domestic debt issuance	
Medium and long-term	0%
Short-term	0%
Borrowing terms	
Domestic MLT debt	
Avg. real interest rate on new borrowing	10.4%
Avg. maturity (incl. grace period)	4
Avg. grace period	1
Domestic short-term debt	
Avg. real interest rate	-0.2%

Sources: Country authorities; and staff estimates and projections.

1/ Net domestic debt issuance is an estimate based on the calculated public gross financing need net of gross external financing, drawdown of assets, other adjustments and domestic debt amortization. It excludes short-term debt that was issued and matured within the calendar year.

Figure 6. Federated States of Micronesia: Qualification of the Moderate Category, 2026-2046 1/



Sources: Country authorities; and staff estimates and projections.

1/ For the PV debt/GDP and PV debt/exports thresholds, x is 20 percent and y is 40 percent. For debt service/Exports and debt service/revenue thresholds, x is 12 percent and y is 35 percent.

Table 1. Federated States of Micronesia: External Debt Sustainability Framework, Baseline Scenario, 2025-2046
(In percent of GDP, unless otherwise indicated)

	Actual		Projections							Average 8/	
	2025	2026	2027	2028	2029	2030	2031	2036	2046	Historical	Projections
External debt (nominal) 1/ of which: public and publicly guaranteed (PPG)	8.0	6.7	6.7	7.2	8.0	8.8	9.3	13.9	38.7	16.5	9.6
Change in external debt	-1.4	-1.3	0.0	0.5	0.7	0.8	0.6	1.2	3.5		
Identified net debt-creating flows	-4.1	-1.1	0.4	0.7	1.1	1.1	1.0	1.2	3.7	-13.3	0.7
Non-interest current account deficit	-3.9	-1.2	0.3	0.7	1.1	1.0	0.9	1.1	3.6	-13.0	0.7
Deficit in balance of goods and services	49.0	51.8	54.3	55.5	55.3	52.9	51.4	47.5	43.2	44.7	51.1
Exports	22.1	21.6	21.3	21.2	20.8	20.7	20.7	20.7	20.7		
Imports	71.0	73.4	75.6	76.7	76.1	73.6	72.1	68.2	63.8		
Net current transfers (negative = inflow)	-42.4	-42.4	-44.0	-45.2	-45.0	-42.8	-41.7	-38.6	-33.1	-45.9	-41.5
of which: official	-30.6	-30.8	-32.4	-33.6	-33.3	-31.1	-29.9	-26.8	-21.1		
Other current account flows (negative = net inflow)	-10.5	-10.6	-10.0	-9.6	-9.3	-9.1	-8.8	-7.8	-6.4	-11.7	-8.9
Net FDI (negative = inflow)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0
Endogenous debt dynamics 2/	-0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0
Contribution from nominal interest rate	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.3		
Contribution from real GDP growth	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2		
Contribution from price and exchange rate changes	-0.3	...	...	...	...	...	...	...	...
Residual 3/	2.7	-0.2	-0.4	-0.2	-0.4	-0.3	-0.4	0.0	-0.2	11.5	-0.2
of which: exceptional financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Sustainability indicators											
PV of PPG external debt-to-GDP ratio	6.6	5.5	5.0	4.8	4.8	4.8	4.9	6.5	19.0		
PV of PPG external debt-to-exports ratio	29.8	25.6	23.4	22.7	23.0	23.2	23.5	31.7	92.1		
PPG debt service-to-exports ratio	5.3	5.1	5.1	4.2	3.8	3.7	2.7	1.5	2.4		
PPG debt service-to-revenue ratio	3.6	3.4	3.4	2.8	2.5	2.5	1.9	1.1	1.9		
Gross external financing need (Million of U.S. dollars)	-13.5	-0.4	7.8	8.9	11.0	10.9	9.2	10.2	37.7		
Key macroeconomic assumptions											
Real GDP growth (in percent)	1.1	0.7	1.1	1.4	1.0	0.7	0.7	0.7	0.7	1.0	0.8
GDP deflator in US dollar terms (change in percent)	3.2	3.2	4.0	1.7	2.0	2.0	2.0	2.0	2.0	4.0	2.3
Effective interest rate (percent) 4/	1.8	1.7	1.6	1.3	1.2	1.0	1.0	0.8	0.8	2.4	1.1
Growth of exports of G&S (US dollar terms, in percent)	2.7	1.7	3.7	2.6	1.1	2.4	2.6	2.7	2.7	5.4	2.5
Growth of imports of G&S (US dollar terms, in percent)	0.2	7.4	8.3	4.6	2.3	-0.7	0.5	2.3	2.7	4.1	2.7
Grant element of new public sector borrowing (in percent)	...	...	59.4	59.4	59.4	59.4	59.4	59.4	57.4	...	59.4
Government revenues (excluding grants, in percent of GDP)	32.9	32.4	31.9	31.3	30.9	30.5	30.2	28.6	25.9	40.8	30.3
Aid flows (in Million of US dollars) 5/	139.0	156.0	197.7	223.3	232.6	215.2	204.5	198.4	238.2		
Grant-equivalent financing (in percent of GDP) 6/	...	...	35.5	38.9	39.3	35.3	32.8	27.6	24.1	...	32.3
Grant-equivalent financing (in percent of external financing) 6/	...	...	98.5	98.5	98.3	98.1	98.5	97.5	92.5	...	98.1
Nominal GDP (Million of US dollars)	502	521	548	565	583	598	614	702	917		
Nominal dollar GDP growth	4.3	3.9	5.2	3.1	3.1	2.7	2.7	2.7	2.7	5.0	3.1
Memorandum items:											
PV of external debt 7/	6.6	5.5	5.0	4.8	4.8	4.8	4.9	6.5	19.0		
In percent of exports	29.8	25.6	23.4	22.7	23.0	23.2	23.5	31.7	92.1		
Total external debt service-to-exports ratio	5.3	5.1	5.1	4.2	3.8	3.7	2.7	1.5	2.4		
PV of PPG external debt (in Million of US dollars)	33.0	28.9	27.3	27.2	27.8	28.8	29.9	45.9	174.6		
(PVt-PVt-1)/GDPt-1 (in percent)	-0.8	-0.8	-0.3	0.0	0.1	0.2	0.2	0.7	2.4		
Non-interest current account deficit that stabilizes debt ratio	-2.5	0.0	0.3	0.2	0.4	0.2	0.3	-0.1	0.1		

Sources: Country authorities; and staff estimates and projections.

1/ Includes public sector external debt. There is no available data on private sector external debt. Due to the underdeveloped private sector and its limited access to the international financial market, the private sector external debt is estimated to be minimal.

2/ Derived as $[r - g - p(1+g) + E\alpha(1+r)] / (1+g+p+gp)$ times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate; p = growth rate of GDP deflator in U.S. dollar terms; E = nominal appreciation of the local currency, and α = share of local currency-denominated external debt in total external debt.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Current-year interest payments divided by previous period debt stock.

5/ Defined as grants, concessional loans, and debt relief.

6/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

7/ Assumes that PV of private sector debt is equivalent to its face value.

8/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

Definition of external/domestic debt	Residency-based
Is there a material difference between the two criteria?	Yes

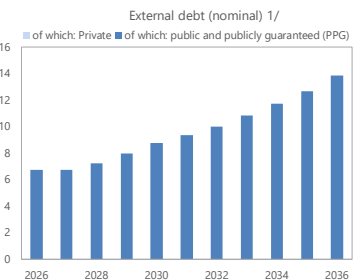
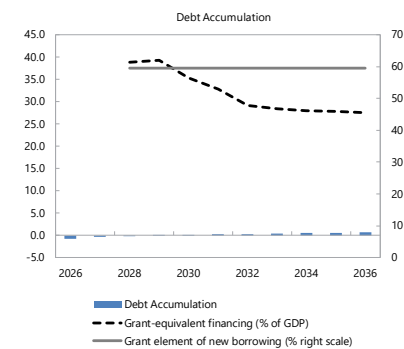


Table 2. Federated States of Micronesia: Public Sector Debt Sustainability Framework, Baseline Scenario, 2025-2046
(In percent of GDP, unless otherwise indicated)

	Actual		Projections								Average 8/	
	2025	2026	2027	2028	2029	2030	2031	2036	2046	Historical	Projections	
Public sector debt 1/	8.9	7.5	7.3	7.7	8.4	9.1	9.5	13.9	38.7	17.2	9.9	
of which: external debt	8.0	6.7	6.7	7.2	8.0	8.8	9.3	13.9	38.7	16.5	9.6	
Change in public sector debt	-1.5	-1.4	-0.1	0.4	0.6	0.7	0.5	1.2	3.5			
Identified debt-creating flows	-0.8	-0.7	-0.1	0.4	0.6	0.7	0.5	1.2	3.5	-9.9	0.5	
Primary deficit	-0.6	-0.6	0.1	0.5	0.7	0.8	1.1	2.5	7.1	-9.5	1.1	
Revenue and grants	60.6	62.4	66.6	69.3	69.2	64.8	62.2	55.2	47.4	70.5	61.6	
of which: grants	27.7	29.9	34.7	38.0	38.3	34.3	32.0	26.5	21.5			
Primary (noninterest) expenditure	60.0	61.8	66.8	69.8	69.9	65.6	63.3	57.7	54.5	61.0	62.7	
Automatic debt dynamics	-0.2	-0.1	-0.2	-0.1	-0.1	-0.1	-0.1	-0.2	-0.6			
Contribution from interest rate/growth differential	-0.2	-0.1	-0.2	-0.1	-0.1	-0.1	-0.1	-0.2	-0.6			
of which: contribution from average real interest rate	-0.1	-0.1	-0.1	0.0	0.0	0.0	-0.1	-0.1	-0.4			
of which: contribution from real GDP growth	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2			
Contribution from real exchange rate depreciation	-0.1	...	...	...	...	...	...	...	...
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	-0.5	-1.1	-3.0	0.0	-0.4	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0			
Recognition of contingent liabilities (e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0			
Debt relief (HIPC and other)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0			
Other debt creating or reducing flow 2/	0.0	0.0	0.0	0.0	0.0	0.0	-0.5	-1.1	-3.0			
Residual 3/	-0.7	-0.7	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	8.2	-0.1	
Sustainability indicators												
PV of public debt-to-GDP ratio 4/	7.4	6.3	5.6	5.3	5.2	5.1	5.1	6.5	19.0			
PV of public debt-to-revenue and grants ratio	12.3	10.1	8.4	7.7	7.5	7.9	8.2	11.9	40.2			
Debt service-to-revenue and grants ratio 5/	2.1	2.0	1.8	1.4	1.3	1.3	1.1	0.6	1.0			
Gross financing need 6/	0.7	0.7	1.3	1.5	1.6	1.7	1.3	1.7	4.6			
Key macroeconomic and fiscal assumptions												
Real GDP growth (in percent)	1.1	0.7	1.1	1.4	1.0	0.7	0.7	0.7	0.7	1.0	0.8	
Average nominal interest rate on external debt (in percent)	1.8	1.7	1.6	1.3	1.2	1.0	1.0	0.8	0.8	2.4	1.1	
Average real interest rate on domestic debt (in percent)	-1.1	-0.8	-1.3	1.4	1.6	2.3	3.5	2.9	2.9	-1.2	2.4	
Real exchange rate depreciation (in percent, + indicates depreciation)	-0.7	...	...	...	...	...	...	...	...	-1.1	...
Inflation rate (GDP deflator, in percent)	3.2	3.2	4.0	1.7	2.0	2.0	2.0	2.0	2.0	4.0	2.3	
Growth of real primary spending (deflated by GDP deflator, in percent)	1.8	3.6	9.2	6.0	1.2	-5.5	-2.9	0.2	0.0	2.0	0.5	
Primary deficit that stabilizes the debt-to-GDP ratio 7/	1.0	0.8	0.2	0.1	0.1	0.1	0.6	1.3	3.7	1.8	0.7	
PV of contingent liabilities (not included in public sector debt)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0			

Sources: Country authorities; and staff estimates and projections.

1/ Coverage of debt: The central, state, and local governments, government-guaranteed debt. Definition of external debt is Residency-based.

2/ Withdrawals from FSM Trust Fund beyond 2031.

3/ The residuals are high in 2025 and 2026 because the fiscal surplus is assumed to be deposited into the government account.

4/ The underlying PV of external debt-to-GDP ratio under the public DSA differs from the external DSA with the size of differences depending on exchange rates projections.

5/ Debt service is defined as the sum of interest and amortization of medium and long-term, and short-term debt.

6/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period and other debt creating/reducing flows.

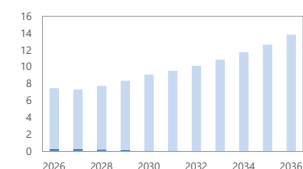
7/ Defined as a primary deficit minus a change in the public debt-to-GDP ratio (i.e., a primary surplus), which would stabilize the debt ratio only in the year in question.

8/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

Definition of external/domestic debt	Residency-based
Is there a material difference between the two criteria?	Yes

Public sector debt 1/

■ of which: local-currency denominated
■ of which: foreign-currency denominated



■ of which: held by residents

■ of which: held by non-residents

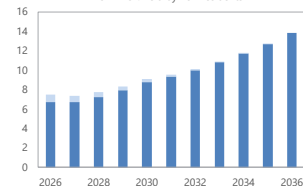


Table 3. Federated States of Micronesia: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2026-2046
(In percent)

	Projections 1/											
	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036	2046
PV of Debt-to-GDP Ratio												
Baseline	6	5	5	5	5	5	5	5	6	6	7	19
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2026-2036 2/	6	0	0	0	0	0	0	0	0	0	0	0
A2. Alternative Scenario :Natural disaster	6	11	12	14	15	17	18	20	22	24	26	51
B. Bound Tests												
B1. Real GDP growth	6	5	5	5	5	5	5	6	6	6	7	21
B2. Primary balance	6	9	12	12	13	13	13	13	14	14	15	27
B3. Exports	6	8	12	12	12	12	13	13	14	14	15	26
B4. Other flows 3/	6	7	9	9	9	9	9	10	10	10	11	22
B5. Depreciation	6	5	5	5	5	5	5	5	6	6	7	19
B6. Combination of B1-B5	6	8	8	8	9	9	9	9	10	10	11	23
C. Tailored Tests												
C1. Combined contingent liabilities	6	7	7	7	7	7	7	8	8	8	9	22
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	30	30	30	30	30	30	30	30	30	30	30	30
PV of Debt-to-Exports Ratio												
Baseline	26	23	23	23	23	24	24	25	27	29	32	92
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2026-2036 2/	26	0	0	0	0	0	0	0	0	0	0	0
A2. Alternative Scenario :Natural disaster	26	54	60	68	76	83	91	99	109	118	128	257
B. Bound Tests												
B1. Real GDP growth	26	23	23	23	23	24	24	25	27	29	32	92
B2. Primary balance	26	41	59	60	61	62	63	64	67	69	72	129
B3. Exports	26	47	98	100	101	102	104	107	111	116	121	215
B4. Other flows 3/	26	33	42	43	43	44	45	46	48	51	53	108
B5. Depreciation	26	23	23	23	23	24	24	25	27	29	32	92
B6. Combination of B1-B5	26	40	38	52	52	53	54	56	59	62	65	139
C. Tailored Tests												
C1. Combined contingent liabilities	26	33	33	33	34	34	35	36	38	40	43	106
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	140	140	140	140	140	140	140	140	140	140	140	140
Debt Service-to-Exports Ratio												
Baseline	5	5	4	4	4	3	3	2	2	2	2	2
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2026-2036 2/	5	5	4	3	2	1	0	0	0	0	0	0
A2. Alternative Scenario :Natural disaster	5	6	5	5	5	4	4	4	3	3	3	9
B. Bound Tests												
B1. Real GDP growth	5	5	4	4	4	3	3	2	2	2	2	2
B2. Primary balance	5	5	4	4	4	3	3	3	2	2	2	5
B3. Exports	5	7	8	8	8	6	6	5	4	4	4	8
B4. Other flows 3/	5	5	4	4	4	3	3	2	2	2	2	4
B5. Depreciation	5	5	4	4	4	3	3	2	2	2	2	2
B6. Combination of B1-B5	5	6	6	5	5	4	4	4	2	2	2	4
C. Tailored Tests												
C1. Combined contingent liabilities	5	5	4	4	4	3	3	3	2	2	2	2
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	10	10	10	10	10	10	10	10	10	10	10	10
Debt Service-to-Revenue Ratio												
Baseline	3	3	3	3	2	2	2	2	1	1	1	2
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2026-2036 2/	3	3	2	2	1	0	0	0	0	0	0	0
A2. Alternative Scenario :Natural disaster	3	4	3	3	3	3	3	3	2	2	2	7
B. Bound Tests												
B1. Real GDP growth	3	4	3	3	3	2	2	2	1	1	1	2
B2. Primary balance	3	3	3	3	3	2	2	2	1	2	2	4
B3. Exports	3	4	3	3	3	2	2	2	2	2	2	4
B4. Other flows 3/	3	3	3	3	3	2	2	2	1	1	1	3
B5. Depreciation	3	3	3	3	2	2	2	2	1	1	1	2
B6. Combination of B1-B5	3	3	3	3	3	2	2	2	1	1	1	3
C. Tailored Tests												
C1. Combined contingent liabilities	3	3	3	3	3	2	2	2	1	1	1	2
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	14	14	14	14	14	14	14	14	14	14	14	14

Sources: Country authorities; and staff estimates and projections.

1/ A bold value indicates a breach of the threshold.

2/ Variables include real GDP growth, GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

3/ Includes official and private transfers and FDI.

Table 4. Federated States of Micronesia: Sensitivity Analysis for Key Indicators of Public Debt, 2026-2046
(In percent)

	Projections 1/											
	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036	2046
PV of Debt-to-GDP Ratio												
Baseline	6	6	5	5	5	5	5	5	6	6	7	19
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2026-2036 2/	6	1	0	0	0	0	0	0	0	0	0	0
A2. Alternative Scenario :Natural disaster	6	12	13	14	15	17	18	20	22	24	26	55
B. Bound Tests												
B1. Real GDP growth	6	6	7	8	9	10	11	12	14	15	17	40
B2. Primary balance	6	9	13	13	13	13	13	13	14	14	15	27
B3. Exports	6	8	12	12	12	12	12	12	13	13	14	24
B4. Other flows 3/	6	8	9	9	9	9	9	10	10	10	11	22
B5. Depreciation	6	6	5	5	5	5	5	5	6	6	6	19
B6. Combination of B1-B5	6	10	10	6	6	6	6	6	6	7	7	20
C. Tailored Tests												
C1. Combined contingent liabilities	6	8	7	7	7	7	7	7	8	8	9	22
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
TOTAL public debt benchmark	35	35	35	35	35	35	35	35	35	35	35	35
PV of Debt-to-Revenue Ratio												
Baseline	10	8	8	7	8	8	9	9	10	11	12	40
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2026-2036 2/	10	2	0	0	0	0	0	0	0	0	0	0
A2. Alternative Scenario :Natural disaster	10	17	17	19	22	26	30	34	37	41	46	112
B. Bound Tests												
B1. Real GDP growth	10	9	10	11	14	16	19	21	24	27	30	82
B2. Primary balance	10	14	19	18	20	21	22	23	24	26	27	56
B3. Exports	10	12	17	17	18	19	20	21	22	23	25	51
B4. Other flows 3/	10	11	14	13	14	15	16	17	18	19	20	47
B5. Depreciation	10	8	8	7	8	8	9	9	10	11	12	40
B6. Combination of B1-B5	10	15	14	9	9	9	10	11	11	12	13	42
C. Tailored Tests												
C1. Combined contingent liabilities	10	11	11	11	11	12	13	13	14	15	16	46
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Debt Service-to-Revenue Ratio												
Baseline	2	2	1	1	1	1	1	1	1	1	1	1
A. Alternative Scenarios												
A1. Key variables at their historical averages in 2026-2036 2/	2	2	1	1	1	1	0	0	0	0	0	0
A2. Alternative Scenario :Natural disaster	2	2	2	2	2	1	1	1	1	1	1	4
B. Bound Tests												
B1. Real GDP growth	2	2	1	1	1	1	1	1	1	1	1	3
B2. Primary balance	2	2	2	1	2	1	1	1	1	1	1	2
B3. Exports	2	2	1	1	2	1	1	1	1	1	1	2
B4. Other flows 3/	2	2	1	1	1	1	1	1	1	1	1	2
B5. Depreciation	2	2	1	1	1	1	1	1	1	1	1	1
B6. Combination of B1-B5	2	2	1	1	1	1	1	1	1	1	1	1
C. Tailored Tests												
C1. Combined contingent liabilities	2	2	1	1	1	1	1	1	1	1	1	1
C2. Natural disaster	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Country authorities; and staff estimates and projections.

1/ A bold value indicates a breach of the benchmark.

2/ Variables include real GDP growth, GDP deflator and primary deficit in percent of GDP.

3/ Includes official and private transfers and FDI.



FEDERATED STATES OF MICRONESIA

April 6, 2026

STAFF REPORT FOR THE 2026 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

Asia and Pacific Department
(In consultation with other departments)

CONTENTS

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FUND RELATIONS

(As of January 31, 2026)

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

General Resources Account:

	SDR Million	Percent Quota
Quota	7.20	100.00
Fund holdings of currency	6.68	92.71
Reserve tranche position	0.53	7.30

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	11.71	100.00
Holdings	12.81	109.38

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to Fund¹

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	<u>2026</u>	<u>2027</u>	<u>2028</u>	<u>2029</u>	<u>2030</u>
Principal					
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

Exchange Rate Arrangement

The de jure and de facto exchange rate arrangement is an arrangement with no separate legal tender. The U.S. dollar is legal tender and the official currency. The Federated States of Micronesia (FSM) maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions and multiple currency practices.

Article IV Consultation

The Federated States of Micronesia is on a 24-month consultation cycle. The 2023 Article IV consultation discussions were held during November 28 – December 11, 2023. The Executive Board discussed the staff report and concluded the consultation on February 23, 2024.

Technical Assistance: PFTAC, FAD, and STA have provided technical assistance on tax policy, financial supervision and regulation, national accounts and government finance statistics.

Resident Representative: The IMF Regional Resident Representative Office based in Suva, Fiji covers 12 IMF member countries in the Pacific, including the FSM. Mr. Neil Saker is the current Resident Representative.

¹ When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

RELATIONS WITH OTHER INTERNATIONAL FINANCIAL INSTITUTIONS AND PACIFIC FINANCIAL TECHNICAL ASSISTANCE CENTER

Relations with other International Financial Institutions:

- World Bank Group: http://projects.worldbank.org/search?lang=en&searchTerm=&countrycode_exact=FM
- Asian Development Bank: <https://www.adb.org/countries/micronesia/main>

Relations with Pacific Financial Technical Assistance Center:

- Pacific Financial Technical Assistance Center: <https://www.pftac.org/content/PFTAC/en1.html>

**Statement by Mr. Jiyoung Choi, Mr. Mark Blackmore, and Mr. Meson Tumsok on
Federated States of Micronesia
April 27, 2026**

On behalf of the Federated States of Micronesia (FSM) authorities, we thank the Mission Chief, Ms. Dinar Prihardini, and her team for the constructive and candid policy discussions during the Article IV consultation mission. The authorities broadly agree with the staff's assessment and welcome the policy recommendations presented in the report.

Context

FSM is a small island developing state in the North Pacific, comprising four states (Yap, Chuuk, Pohnpei, and Kosrae) spread across more than 600 islands. Its small and geographically dispersed population presents significant service delivery and infrastructure challenges. The economy remains narrow and highly dependent on external support, particularly under the Compact of Free Association (COFA) with the United States. Economic activity is largely public sector-driven, while private sector development remains limited. Growth has been persistently weak, reflecting structural constraints, limited diversification, and low productivity, with high emigration constraining the labor market. Like many Pacific island countries, FSM remains highly vulnerable to climate change and natural disasters. Recent developments have underscored these vulnerabilities. A tropical typhoon disrupted livelihoods and infrastructure in the Chuuk island of FSM in April 2026, placing additional strain on already limited fiscal and implementation capacity. At the same time, global developments—notably the Middle East conflict—are likely to contribute to higher fuel and imported food prices, exacerbating inflationary pressures in a highly import-dependent economy. This will further increase the cost of service delivery and disaster mitigation efforts. These shocks reinforce the urgency of strengthening resilience to external and climate-related risks.

Recent Economic Development, Outlook and Risk

Economic growth moderated to 1.1 percent in FY2025 from 2.3 percent in FY2024, reflecting weak public investment, subdued private sector activity, and labor market pressures from emigration. Inflation eased from 5.4 percent in FY2024 to 3.2 percent in FY2025 on the back of declining global commodity prices and moderating U.S. inflation, a key import source. Fiscal performance remains broadly prudent with the fiscal surplus narrowing from 1.7 percent of GDP in FY2024 to 0.4 percent in FY2025, mainly reflecting lower fishing revenues. The current account surplus increased slightly to 3.8 percent of GDP, supported by a reduced trade deficit and higher corporate income tax inflows, which more than offset the decline in fishing revenues.

Growth is expected to moderate further to 0.7 percent in FY2026, reflecting weaker real incomes and higher import costs, particularly fuel inputs in the fishing sector. In FY2027 – FY2028, growth is anticipated to temporarily strengthen, supported by higher external grants including COFA-funded public investment, expansion of Yap airport, and housing construction for foreign workers. Over the medium term, growth is projected to remain subdued at around 0.7 percent, reflecting persistent structural constraints, including capacity limitations, labor shortages from emigration, and climate-related impacts. The fiscal balance and current account are projected to be in deficit over the medium term as the government resorts to external concessional borrowing to support increased development spending and as fishing revenue declines due to climate change effects.

The authorities agree that risks to growth prospects are tilted to the downside. These include delays in infrastructure implementation, ongoing emigration and skills shortages, weaker-than-expected fishing revenues, climate-related disruptions to food production, and more frequent natural disasters. In addition, the authorities stress that although the COFA funding has increased, limited implementation capacity could potentially result in large unspent grants. Further, the clean-up and containment cost of the recent oil spillage from WWII shipwrecks in the Chuuk area are assessed to be substantial and this may exert additional strain on the budget, coastal ecosystem and tourism activity-given the fact that there are about sixty shipwrecks in the area. Prolonged geopolitical tensions could further elevate oil prices, worsening inflation, fiscal pressures, and external balances. Upside risks stem from effective reform implementation that could unlock private sector activity, generate employment, and reduce dependence on external aid.

Fiscal Policy

The authorities remain committed to maintaining prudent fiscal management while addressing substantial development and climate-related spending needs. The increase in COFA grants will support priority investments in infrastructure and build resilience, while placing public debt on a sustainable path. Efforts are underway to strengthen public financial management, including the rollout of digital revenue and expenditure systems. The authorities have implemented the automated system for customs data, the revenue management system, and partially rolled out the financial management information system. As part of improving long-term infrastructure planning and prioritization, the authorities have recently approved the Infrastructure Development Plan (IDP) 2025-2034 which presents a 10-year roadmap for FSM's capital development needs.

Looking ahead, fiscal pressures are expected to rise as a result of declining fishing revenues, higher spending needs, and climate-related costs. The authorities are advancing tax reforms, including the introduction of a VAT and a net profits tax, to enhance domestic revenue mobilization and support private sector development. With fishing revenues now shared with the states, the national authorities have taken steps to reallocate resources, including reducing transfers to the FSM Trust Fund and scaling back congressional projects, while emphasizing the need to strengthen state-level planning and implementation capacity. Continued support from the IMF and development partners will be critical to improving public investment management, including integrating climate change considerations into infrastructure planning, strengthening medium-term fiscal frameworks, and building debt management capacity across all levels of government. The authorities remain committed to maintaining fiscal sustainability and emphasize the importance of preserving financial resources in the trust fund for future generations.

Financial Sector

The authorities welcome the assessment that the banking sector remains broadly sound, supported by strong capital and liquidity buffers. While they note that non-performing loans have increased, systemic risks remain contained due to limited macro-financial linkages and low levels of domestic lending. The authorities have taken meaningful steps to strengthen financial sector resilience while laying the groundwork for deeper financial sector development. They have continued to enhance regulatory and supervisory frameworks through the FSM Banking Board, including efforts to expand its mandate to cover non-bank financial institutions such as the FSM Development Bank and credit unions. The authorities continue to closely monitor rising non-performing loans and maintain ongoing efforts to improve risk management practices to safeguard financial system stability. At the same time, the authorities are promoting digital financial services—including digital payments and banking platforms—to improve financial inclusion and generate better financial data to support lending decisions. Progress has also been made in strengthening the FSM Development Bank’s operations, including loan restructuring to improve asset quality and accreditation with international climate financing institutions to expand access to funding. These reforms, supported by continued technical assistance from the IMF and development partners, will be important to strengthen supervision, enhance financial inclusion, and support financial deepening.

Structural Reforms

The authorities note that addressing critical structural bottlenecks is essential to support private sector activity, create job opportunities, and sustain long-term growth. The authorities continue to advance structural reforms under the Strategic Development Plan 2024-2043 (SDP), with a focus on private sector development and economic diversification. Efforts to improve the business environment, streamline regulations across states, and expand digitalization are ongoing. The authorities also agree that reforms in education and formal sector job creation are also critical to address persistent emigration, which reflects limited domestic employment opportunities. However, key constraints remain. Land tenure issues continue to limit investment, and while the authorities recognize the need for reform, progress requires broad consensus across states and stakeholders, as well as adequate financial resources. Due to the complicated governance structure, it has been difficult to gain support from the states, resulting in slow progress toward fully implementing the reforms. Continued support from development partners will be essential to strengthen institutional capacity, build human capital, and unlock private sector potential.

Climate Change

The authorities have taken steps to strengthen climate change resilience and mainstream adaptation into national policy frameworks. They are advancing the development of the National Adaptation Plan to guide sectoral priorities and have committed under NDC 3.0 to ambitious mitigation and adaptation targets, including achieving net-zero emissions by 2050, scaling up renewable energy, and strengthening climate resilience and food security, especially for coastal communities. Efforts to enhance disaster risk management have progressed, including participation in regional risk financing mechanisms such as the Pacific Catastrophe Risk Insurance Company and strengthening the Disaster Assistance Emergency Fund to provide timely response to shocks. The authorities are also working to integrate climate resilience into public investment planning, including infrastructure development, while promoting climate-smart agriculture through donor-supported research into resilient crops for vulnerable atoll and coastal communities. In parallel, they are improving coordination and institutional frameworks to better access climate finance and operationalize resilience-building projects, including through engagement with international climate funds and accreditation of national institutions to channel financing for adaptation initiatives.

Despite ongoing progress, spending requirements remain substantial, and demands of implementation of adaptation initiatives remain complex, hindering progress. Continued external support from the IMF and development partners will play a key role in helping the authorities mobilize climate finance, build resilience, and safeguard long-term development outcomes.