Federated States of Micronesia

Economic activity in the Federated States of Micronesia weakened further in 1995, with real GDP growth being less than the already low level achieved in 1994. Despite a small rise in exports, the trade deficit remained very large as did the fiscal deficit. External grants from the US and elsewhere to finance these deficits amounted to over 50 percent of GDP. Dealing with these two deficits in the context of a stepdown in financial support from the US under the Compact of Free Association is at the heart of the adjustment problem now faced by the FSM. Development of a strategic program for appropriate policy reform was begun in 1995 with support from ADB and others of the donor community.

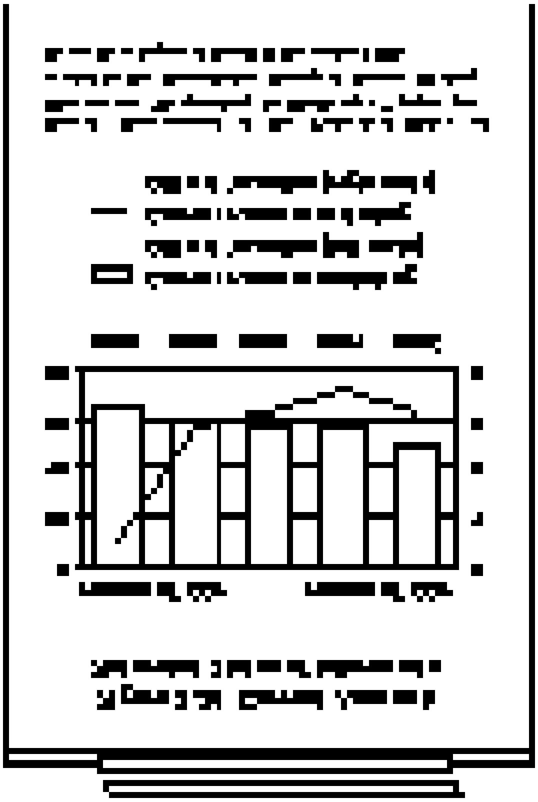
Recent Trends and Prospects

Real GDP growth in 1995 is estimated to have declined to 1 percent compared with 1.3 percent in 1994 and 5.7 percent in 1993. Sectoral data are not available but indications are that agricultural output, which is dominated by subsistence activity, stagnated. Most of the limited growth occurred in fish processing, garment manufacturing, and the services sector.

The consolidated finances of the five constituent governments in 1995 changed little from the 1994 levels. Total revenue, including external grants, declined to 73.6 percent of GDP from 77.6 percent in 1994. External grants (mostly Compact funds) were more than twice domestic tax and non-tax revenues, which together declined by over 6 percent in nominal terms to 24 percent of GDP from 27 percent in 1994. Total expenditure in nominal terms was virtually unchanged from the 1994 level, although it declined to 77.8 percent of GDP from 82 percent in 1994. The share of salaries and wages in total current expenditure, however, increased to 46 percent from 44 percent in 1994, while the share of goods and services expenditure fell from 41 percent in 1994 to 39 percent in 1995. The overall deficit declined slightly from 4.5 percent of GDP in 1994 to 4.2 percent in 1995 after allowing for grants. Excluding grants, the deficit in 1995 was 45 percent of GDP, marginally less than in 1994.

The consolidated FSM finances, however, mask some significant differences in the fiscal position of the constituent governments. The National Government, benefiting as it does from the country's fishing rights revenue, has achieved an overall budget surplus in recent years, with grants at about 35 percent of total revenue, and wages and salaries kept to about 25 percent of current expenditure. In Chuuk, the largest of the constituent states, the overall balance has been persistently in deficit over the past five years, with grants amounting to 82 percent of total revenue and salaries and wages typically about 55 percent of current expenditure.

A serious fiscal crisis developed in Chuuk in 1995 when the state government was unable to meet its expenditure obligations. A reform program was developed with the aim of achieving a greater degree of fiscal responsibility in Chuuk, but the crisis underlined the need for all constituent states to address the problems of the country as a whole and to adjust to a lower level of Compact funding in the future.



Official price data are not collected in the FSM; however, the US consumer price index modified by the Marshall Islands index is used to measure inflation. On this basis, inflation was estimated to be 4 percent in 1995, the same as in 1994.

The external position of FSM improved slightly in 1995. Exports, 90 percent of which consist of fish and garments, increased by nearly 5 percent. Although there was no growth in imports, they were still four-and-a-half times export receipts so that, while the trade deficit shrank a little, it was still very high at 51 percent of GDP compared with 54 percent in 1994. Exports have increased appreciably in recent years, rising from 3 percent of GDP in 1990 to 14 percent in 1995. The services account deficit in 1995 declined to 2.6 percent of GDP from over 7 percent in 1994. Income from fishing rights improved, as did net income from interest and dividends; freight and insurance payments were lower. While private transfers increased slightly, official transfers, mainly comprised of Compact funds, were down by nearly 8 percent; however, they were still substantial at over 47 percent of GDP. Allowing for these official transfers, the current account deficit contracted to 0.2 percent of GDP compared with 1.2 percent in 1994 (Figure 2.28). The overall deficit, allowing for capital movements, also contracted, moving from 8 percent of GDP in 1994 to 2.3 percent in 1995. Reserves declined by some $5 million compared with a fall of over $16 million in 1994 and were the equivalent of 55 percent of GDP at the end of 1995. External debt, most of which had been incurred during 1990–1993 for fisheries development and telecommunications, stood at 35 percent of GDP in 1995.

The prospects in the short term for the FSM economy are not encouraging. GDP growth in 1996 is likely to fall below that of 1995 and could become negative. The private sector, limited in scope as it is, is unlikely to show any growth momentum, especially since measures already being taken to restrict hiring and wage growth in the public sector will impact on consumer spending. The consolidated public budget for 1996 provides for a modest reduction of public expenditure although not by as much as what the emerging fiscal situation would appear to demand.

Policy and Development Issues

The critical problem facing the FSM is that of adjusting its economy to the progressive decline in financial support from the US. The National Government, with support from the states, has built an institutional mechanism to enable the design and implementation of the necessary reforms. Reducing reliance on external funds is a main objective and will require, in particular, a substantial reduction in the size of the public sector wage bill; that, in turn, will require efforts to increase employment opportunities through increasing the size and competitiveness of productive sectors. Another objective is to diversify sources of external funding and investment. A stable macroeconomic environment and a transparent and stable regulatory framework are essential for this purpose. The success of any program will, however, depend critically on the readiness of the state governments and the people of the FSM to accept the necessity of some radical decisions. Inevitably, there will be severe social impacts from the reduction in expenditure on wages and consumer subsidies and the increase in unemployment. The National Governmen t will need to address these issues in its policy reform program.