

ASIAN DEVELOPMENT BANK

FEDERATED STATES OF MICRONESIA

ECONOMIC

AND

ASIAN DEVELOPMENT BANK OPERATIONS

UPDATE

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CURRENCY EQUIVALENTS

The Federated States of Micronesia uses the United States dollar as its currency.

ABBREVIATIONS

ADB	–	Asian Development Bank
FSM	–	Federated States of Micronesia
GDP	–	gross domestic product
US	–	United States
EPIC	–	Economic Policy Implementation Council
PSDP	–	Private Sector Development Program
TA	–	technical assistance

NOTE

The fiscal year (FY) of the Government ends on 30 September. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY 2000 ends on 30 September 2000.

I. THE ECONOMY

A. Introduction

1. The latest country economic review of the Federated States of Micronesia (FSM) was published by the Asian Development Bank (ADB) in November 2000. This paper presents a further update on recent economic developments and ADB operations in the FSM, and should be read in conjunction with that economic review.

B. Recent Economic Developments

2. Over the past three years, the FSM economy has stabilized and is expected to return to a level of growth nearer to its long-run average real growth rate of approximately 2 percent per annum. Stabilization followed a significant reduction of Compact funding at the onset of the third five-year period of Compact transfers. The reduction amounted to a cut equivalent to 7.1 percent of gross domestic product (GDP) in FY1997. After three years of decline in FY1996-FY1998, the economy grew at 0.9 percent in FY1999 and 2.5 percent in FY2000. Based on available data through August, real growth was projected to be 0.9 percent in FY2001. The growth potential of the FSM is significantly constrained due to the uncertain investment climate resulting from the looming threat of significantly reduced Compact economic assistance beyond FY2004. For FY2002 and FY2003, provision was made in the Compact for an increase in funding to the average levels received during the past 15 years before the renewed Compact terms (expected to be a step-down from the current level) become effective. The federal Government has committed to sterilizing 60 percent of these "bump-up" funds into a special stabilization account, and the remainder will flow through the economy and temporarily boost GDP. The economy is forecast to grow by 3.3 percent in FY2002 and 0.7 percent in FY2003.

3. Attention to public sector reforms has continued, although several factors have contributed to increases in recurrent spending in at least two states. While Pohnpei and Yap have maintained medium-term fiscal balance and constrained recurrent expenditure increases, the two other states have demonstrated less discipline. Both Chuuk and Kosrae have allowed payroll levels to creep up in the wake of the closing of the Public Sector Reform Program (PSRP). In the case of Chuuk, additional revenue efforts and the repayment of debts have actually enabled it to increase payroll without moving away from a responsible medium-term fiscal position. However, an emerging fiscal problem caused by a shortfall in projected revenues (from investments) and an increase in capital project expenditures (executed in a rush in advance of March 2001 elections) have led to a cash-flow crisis. It is imperative that Chuuk State utilize its otherwise healthy structural budget surplus to restore its fiscal position in early FY2002 to avoid a return to long-term fiscal imbalance from which the state has suffered on a recurrent basis for two decades. While Kosrae has returned to a 64-hour pay period, up by 8 hours from the second step-down level, the additional cost is being absorbed without breaking medium-term fiscal balance by compressing both recurring and nonrecurring operating costs. To qualify for the Private Sector Development Program (PSDP), Kosrae State has agreed to remove a 5 percent annual step-increase that has been eroding the fiscal position. With improved revenue performance, Kosrae will have sufficient resources to meet its commitment to set aside 50 percent of the "bump-up" funds into the stabilization or "S" account of the FSM Trust Fund. The federal Government maintains a large structural surplus; however, revenue shortfalls due to reduced fishing fee revenues and low investment returns may also put significant pressure on the federal fiscal position in the short term. The use of federal revenues for nonrecurrent expenditures under the category of public projects continues to be a source of concern to the state governments and to ADB as well being outside of formal project selection

and prioritization procedures (i.e. a Public Sector Investment Program).

4. Inflation in the FSM remains moderate. The recently established consumer price index indicates that prices fell by 1.5 percent in 1998 with the downturn in the economy and greater competition in the market place. The inflation rate rose to 1.8 percent in 1999 and peaked at 2.5 percent in 2000. From the first six-month data, inflation in consumer prices is projected to ease back to 1.3 percent in 2001. However, it should be noted that price estimates continue to be based only on a recent time series for the state of Pohnpei and on price levels in the United States (US).

5. Until the beginning of the downturn in FY1995, employment opportunities grew at an annual average of 3.6 percent during FY1987-FY1995, a rate sufficient to absorb many of the new entrants to the labor force. Employment declined over the following four years, but rebounded in both FY2000 and FY2001, returning to the levels prevailing in FY1995. However, employment has stagnated since FY1995 and failed to provide a source of gainful opportunities to the growing population and labor force. Preliminary results of the 2000 census indicate that population growth rates have fallen significantly and averaged 0.24 percent since the time of the last census in 1994. This outturn indicates that significant migration has occurred as the unemployed sought gainful employment in the neighboring Micronesian islands and the US.

6. The external debt position has improved dramatically since mid-1990s. The debt undertaken in the early period through the issue of medium-term notes in the bond market was fully secured by Compact revenues. No new borrowing in the bond market or any other nonconcessional facility has been undertaken since 1993. Nearly half of the borrowing was used by Yap State to invest in investment grade securities that have yielded a greater return than the cost of the borrowing, leaving that state with an ample surplus as a result. The ratio of FSM external debt to GDP is projected to be a relatively low 21 percent and the debt service-to-export earnings ratio is projected to be just 4.5 percent at the end of FY2002. These ratios indicate a healthy external debt position and considerable room for the FSM to undertake additional concessional borrowing. However, in light of uncertainties related to the Compact negotiation outcome and debt service capacity, the FSM has adopted a conservative external debt strategy. Both of the proposed new ADB program loans for the FSM, the Basic Social Services (BSS) and PSDP, will be secured through the establishment of matching sinking funds.

C. Current Issues

7. The Congress of the FSM seated one new senator in the May opening session of the 12th Congress and another new senator in the August 2001 session; both replaced deceased senators. The president and the vice president will continue to serve through national elections in March 2003. The Economic Policy Implementation Council (EPIC), created at the recommendation of the 2nd FSM Economic Summit in September 1999, has been established as an effective element of nationwide economic policy coordination. The EPIC includes the chief executives and presiding officers of the legislatures of the five governments and meets, at a minimum, twice yearly in conjunction with regular sessions of Congress. At the recent fourth EPIC meeting in July, the EPIC resolved that the FSM governments would save at least 60 percent of the temporary increase in Compact funding during FY2002/03 (paras. 10-11). At that meeting, the position of the state governments with respect to the two ADB loans under consideration was also clarified.

8. At the state level, the governor of Chuuk was reelected in March 2001 to serve a second and final four-year term. The state had benefited significantly from implementing rigorous

reforms in the ADB-supported PSRP. Real economic growth was 4.3 percent in FY1999 and 11.1 percent in 2000 following several years of deep recession. State gubernatorial elections will be held in November 2002 in Yap and Kosrae.

9. During the second regular session in October 2001, the FSM Congress passed bills authorizing the FSM to borrow for the ADB PSDP and BSS loans. Congress also enacted legislation to create a stabilization or "S" account of the FSM Trust Fund. The "S" account will act as a reserve that can be drawn on should the new provisions of the Compact entail a reduction in funding from the FY2001 levels. If the outcome of the negotiations is favorable, the "S" account resources will be transferred to the main corpus of the FSM Trust Fund.

10. In anticipation of potentially protracted negotiations and the US Congressional approval process, the Compact included a provision for two extra years of assistance (FY2002-FY2003) to be at the average level of funding over the 15-year Compact period. Since the Compact included steep reductions of assistance after the fifth and tenth years, this arrangement results in the FSM receiving an increased level of transfers during the next two years. It is the unrestricted (current account) portion of this clearly temporary increase that the FSM is being encouraged to save in a trust fund to avoid an increase in recurrent expenditures. This is also a condition under the proposed PSDP loan.

11. The FSM proposal calls for a steady level of assistance and separate payment by the US to a trust fund over a period of 20 years. The request is for \$84 million per year plus a \$20 million annual contribution to the trust fund that would, after 20 years, yield about \$70 million per year. The US counteroffer calls for six sector grants totaling \$61 million plus \$13 million contribution to the trust fund per annum. The reduced grant funding level, the lack of adjustment for inflation, the severely reduced level of funding for the trust fund, and the limitation to a 15-year period all combine to make the US offer significantly lower than the level proposed by the FSM.

12. In the near term, the FSM is expected to face a fiscal shock of over 10 percent of GDP in FY2004. It should also be noted that the US counter proposal is significantly weighted in favor of grant funding for the education and health sectors, while the infrastructure funding is likely to be reduced significantly. Though clearly subject to further negotiations, the infrastructure grant has been reduced by some 60 percent from the requested straight-line level.

13. The prospects for the FSM economy depend on (i) the outcome of the Compact renegotiations currently in progress, (ii) the economic management and policy environment and the attractiveness to private sector investment of the reforms currently under way, (iii) management of each state and the national Government as well as the proper coordination between the states and the national Government, (iv) prudent management of trust fund, and (v) other short-run factors. To sustain macroeconomic and financial stability, the FSM will need a Compact package that will maintain the overall assistance level comparable with the present. The FSM has also requested the US to help fund a trust fund that will provide sufficient yield to replace Compact assistance in 15-20 years. The trust fund in the long term will guarantee the independence of the economy. If successfully combined with sound economic management and maintenance of competitive policies, this strategy will provide a stable economic environment and a launching pad for future growth.

14. The immediate challenge is to ensure strong growth in the private sector. There is a need for government to divest itself of such activities and to allow the private sector to identify opportunities and take commercial risks. The labor market has remained stagnant. The

challenge is for the FSM to (i) expand private sector opportunities, (ii) provide jobs, and (iii) create a more enabling environment that promotes entrepreneurship and small business development. These objectives will be supported by the proposed PSDP loan and reinforced by ongoing policy dialogue.

15. The emphasis in public sector reform needs to be shifted to the state level. With the four states as key players, long-term improvement in terms of efficiency, effectiveness, and accountability in government must start at the state level and adequate capacity to sustain such efforts need to be built. Assistance directed to these outcomes will be through technical assistance (TA) for capacity building at state levels and coordination with other funding agencies.

II. ASIAN DEVELOPMENT BANK OPERATIONS

A. Operational Strategy

16. The ADB operational strategy in the FSM continues to reflect the Government's own development strategy presented at the fourth Consultative Meeting in Manila in February 2000. The development strategy is consistent with ADB's overall Pacific strategy for the new millennium which lists the FSM in the second category with moderate resource potential, and good long-term growth prospects. The current strategy for 2002-2004 takes into account the upcoming sector priorities that need to be strengthened, the general thrust of the ongoing Compact negotiations, and the anticipated funding to the respective sectors.

17. On the basis of the above, the operational strategy will focus on further public sector rationalization and private sector development through key reforms in land, labor, and capital markets. A major component will be improving sector efficiency and management with a view to better utilize scarce resources at both state and national levels. Given the federal Government structure in the FSM, ADB operations will give increased attention to the individual state's development needs and capacity building at the state level. While ADB's intervention is intended to promote equity between the four states on the basis of need and absorptive capacity, such intervention will be most strongly linked to FSM's overall performance and commitment to reforms.

18. For the FSM, the key parameters for Asian Development Fund (ADF) assistance will be measured by (i) progress in economic and financial management, (ii) public sector management, (iii) private sector management, and (iv) trust fund management. Economic and fiscal management will include controlling expenditure and maintaining a balanced budget across all states. Public sector management will include public sector service delivery, improved efficiency in resource utilization by sector, and capacity building. Private sector management will include private sector environment, increased private sector activities, and reduced public sector involvement. Based on initial evaluation of FSM's performance and on the assumption that the FSM will continue to meet base case performance targets, lending for the FSM from ADF resources will be about \$10.5 million for 2002-2004.

19. In determining the final program for the FSM over the next three years, special attention will be given to avoiding duplication and/or conflict with Compact assistance. Pending the final outcome of the Compact negotiations and specific modalities of Compact funding, the program for the FSM will remain tentative and subject to change in consultation with the Government. In designing any future intervention, the implications of the federal structure of the FSM Government must be taken into account. Project designs cannot assume a uniform level of

acceptance by all five governments and therefore must allow for differentiated project designs for the states.

B. Lending and Technical Assistance Operations

20. Since joining ADB in 1990, the FSM has received four loans totaling \$43.119 million from the ADF. Social infrastructure accounts for 50 percent of the total loan amount, while agriculture and natural resources and other sectors account for 25 percent each. The current loan portfolio consists of three loans (Table 1) with a net loan amount of \$25.119 million, of which \$11.909 million has been disbursed. The average annual lending level is about \$6.0 million. However, over the period 2000-2003, the average lending is likely to exceed \$7.5 million annually to assist the FSM during the transition between Compact expiry and renewal.

Table 1: Asian Development Bank Ongoing Loans to the Federated States of Micronesia

Loan No.	Project Name	Approved Loan Amount (\$ million)
1816	Basic Social Services	8.019
1459	Water Supply and Sanitation	10.600
1257	Fisheries Development	6.500
	Total	25.119

21. ADB's firm lending program includes a \$12.0 million PSDP loan in 2001, and \$6.0 million for a Basic Skills Development (BSD) loan has been replaced by an Omnibus Infrastructure Development (OID) loan in 2003. The Government felt that the BSD loan was unnecessary at this time since the education sector was expected to benefit more under the new economic provisions of the Compact. On the other hand, social infrastructure is likely to be adversely affected under the new Compact arrangements. Therefore, the Government would like ADB to consider an infrastructure loan in 2003.

22. ADB has an extensive program of grant-financed TA projects in the FSM. By end October 2001, ADB had approved 33 TA projects, for a total of \$19.2 million since 1990. Of this amount, ADB cancelled \$0.89 million provided in 1995 for two TA projects leaving a total TA amount of \$18.3 million in 1998. Of the remaining 31 TA projects, 6 were to assist in preparing loan project proposals and 25 for advisory purposes. The sector distribution of the TAs is in Table 2.

Table 2: Sector Distribution of Technical Assistance
(\$)

Sector	No. of TAs	ADB	JSF	Others	Total	Percent
Agriculture	7	1,280,000	1,969,000		3,249,000	18
Energy	2		315,000	350,000	665,000	4
Finance	4	753,000	385,000		1,138,000	6
Social Infrastructure	5	887,000	845,000		1,732,000	9
Others	13	6,082,000	3,488,000	1,998,000	11,568,000	63
Total	31	9,002,000	7,002,000	2,348,000	18,352,000	100

ADB = Asian Development Bank, JSF = Japan Special Fund, TA = technical assistance.

23. To reflect immediate priorities and to ensure that the annual TA allocation for the FSM is within the budget, a TA for \$300,000 to implement performance-based budgeting was included in the 2001 program. As a result, the TA for Public Enterprise Privatization and Corporate Governance II will slip to 2002. The TA for economic policy reform and capacity building at state level has been split into two phases to fit within the annual TA budget envelope. A project preparatory TA for the OID loan is included in 2002.

C. Project Implementation and Postevaluation Findings

24. One loan for basic social services (\$7.1 million) and two TAs were approved in 2000. As of end-October, contract awards for the year amounted to \$5.545 million, bringing the cumulative total to \$11.711 million. Two project loans are ongoing, Fisheries Development and Water Supply and Sanitation. Both loans have experienced delays in implementation and a mixed performance to date. The Government has requested an extension of the loan closing date for the Fisheries Development loan to complete the procurement of two additional boats. Under Loan 1459-FSM: Water Supply and Sanitation Project, the Kosrae State component was cancelled and funds reallocated to components of other states. Work on the other state components has satisfactorily progressed and the loan has been extended to complete the additional work.

25. The extensive and complex system of government that allows each state a high degree of autonomy is a major factor affecting project implementation. It is important that attention be given to the political realities during the project design stage to avoid delays and difficulties during implementation.

26. While counterpart funding thus far has not been a major issue, it has contributed to some implementation delays. In the context of the FSM, the issue of counterpart funding covers not only the national Government but also the four state governments, making the FSM unique. The main point of concern is the spillover effect on the fully compliant governments in the event that any one of the five governments fails to comply.