

(DRAFT)

Joint Annual Report

2003

**European Commission/
Federated States of Micronesia**

1. Executive Summary

Article 5, Annex IV of the Cotonou Agreement requires that the National Authorising Officer and Head of Delegation shall annually undertake an operational review of the indicative programme and, within 30 days of completion of review, draw up and submit a report to the Development Finance Committee.

This Joint Annual Report for 2003 fulfils this reporting requirement.

The Country Strategy Paper and National Indicative Programme (NIP) for the Federated States of Micronesia (FSM) were signed in Pohnpei on 1st April 2003.

The NIP provides for an indicative financial allocation for FSM of € 4.8m for the "A" Envelope, and € 1.4m for the "B" envelope. The focal area of EC-FSM cooperation is the energy sector, to which 85% of the A envelope (€ 4.08m) is to be allocated. A further € 0.72m (15% of the A envelope) is to be allocated to support the work of Non-State Actors in the areas of conservation and environmental protection.

The preparation of project proposals to be financed under the Cotonou Agreement began in 2003 and the status of proposals in the focal and non-focal sectors by end 2003 was as follows :

In the latter half of 2003, a draft Financing Proposal of the proposed focal sector programme on Energy (covering 5 of the new PACP countries, including FSM) was developed, in concert with beneficiary countries and with the Forum Secretariat (which is to manage the project). The Proposal was submitted to the N.A.O. of the Federated States of Micronesia (FSM) in December 2003 for consideration and comment.

The Financing Proposal was expected to be reviewed by the EDF Committee in the second half of 2004, and implementation expected to begin in early 2005.

As regards the non-focal sector, a draft financing proposal with NSAs in the area of conservation and environment protection was being prepared, with consultations still ongoing at the country level. The expectation at the end of 2003 was that the draft proposal would be approved by the NAO by the first half of 2004, with EDF committee approval obtained by second half of 2004, followed by implementation soon after signing of the Financing Agreement.

2. The Federated States of Micronesia National Policy Agenda

2.1 National Development Strategy

For the past 15 years, the United States has provided considerable financial assistance to the Federated States of Micronesia (FSM) under the Compact of Free Association. With the progressive reduction of U.S. grants, the Government of FSM began to implement a comprehensive adjustment programme in 1996. It was mainly designed to correct substantial imbalances in the public sector and external accounts and to increase the economy's self-

reliance by reducing the role of the public sector in economic activity. The reform programme focuses in particular on government expenditure reductions and on structural measures aimed to promote private sector activities.

2.1 The National Development Strategy

The FSM Planning Framework (PF) document for 1999-2002 contains a comprehensive set of policies and strategies for achieving the overall economic goal of the Government, which is "to strengthen the economy and make it more resilient to changes in the world economy". The main objectives and strategies outlined in the FSM PF document are (a) to reduce reliance on external aid funds (through reducing the size of the public sector and increasing public and private savings and investment); (b) to diversify sources of external funding and investment (by attracting additional sources of foreign aid, accessing finance from multilateral agencies and attracting foreign private investment), and (c) Increasing the size and competitiveness of the productive sectors (by providing incentives to productive activities, improving efficiency of land use and focussing on human resource development investments in productive sectors.

3. ANALYSIS OF THE POLITICAL, ECONOMIC AND SOCIAL SITUATION

3.1 Political Situation

The Federated States of Micronesia (FSM) became an independent nation in 1986 under an agreement with the United States, known as the Compact of Free Association, which set out the economic and political ties between the two countries over the period 1986-2001. A two-year extension to the original Compact Agreement (to September 2003) was later agreed, as of which time a new 20-year Agreement came into force. A stated aim of the new Compact assistance is to advance economic self-reliance and complete the transition from U.S. dependence. Emphasis is placed on greater accountability in the use of Compact funds – a development which some regard as calling into question the country's political independence.

FSM has maintained a stable government since independence. However, geographic dispersion and the linguistic, cultural and historical differences between the 4 states tends to make national consensus difficult. Each state is bound to be concerned by the demands of its own population centre and the unique requirements of its own outer islands. The traditional chiefly systems are amongst the most critical factors underpinning community cohesion. The divergence of living standards between the states is also a source of some resentment. Given the strong cultural and social systems, the role of government is much larger than would normally be the case in most market economies and will be slow to change.

3.1.1. Democratic participation

At municipal level, traditional village leaders play an active role in government in some of the states. Heads of local government are mostly traditional chiefs or other prominent members of the community. The Council of Chiefs has veto power over legislation affecting traditional customs.

The Congress of the FSM (unicameral, with 14 senators, one from each state elected for a four-year term, and ten serving two-year terms and elected on the basis of population

apportionment. The President and Vice President (who cannot be from the same state) are elected to four-year terms by the Congress, from among the four-year senators, and the vacant seats are then filled in special elections. Election outcomes generally hinge on *peneinei* (family) and *keinek* (clanship).

Each of the four states has a high degree of autonomy with its own constitution. There are three layers of government, with the legislative, executive and judicial branches replicated at national and state levels. Traditional leaders (in Pohnpei and Yap) also continue to exert political influence.

3.1.2. Human rights

All essential freedoms are respected in FSM under the Constitution.

3.2 Economic and social situation

While the original Compact agreement was successful in meeting the political goals of establishing independence and a stable democratic government, it was less successful in stimulating economic development and self-sustaining growth in the country. Over the last decade, and despite more than US\$ 1 billion worth of U.S. assistance, real GDP per capita (€ 2,079) has stagnated.

Economic data

GDP per capita	€ 2,079
GDP growth rate (2000)	2.5 %
Inflation rate (2000)	3.2 %
Current expenditure (2000 est.)	€ 141.3 million
Current expenditure as % of GDP	54 %
Fishing access revenue (2000 est.)	€ 19 million
Total exports to the EU (1999)	€ 0.8 million
Total imports from the EU (2000)	€ 1.1 million

The economic assistance provided by the U.S. exerts an enormous influence on the economy. Although this assistance has diminished in both absolute and relative terms over the past decade, it remains an extremely important factor to FSM's economic well-being. Although accountability is stressed under the new Compact arrangements, the onus of achieving results lies entirely with GoFSM.

Compact funding has resulted in the development of the government as the core influence on the economy. Almost half of total Compact assistance has been spent to support government operations (wages, salaries and benefits). Public sector growth combined with relatively high wages paid to public servants have crowded out private sector initiatives and removed incentives for individuals to contribute to the productive base of the economy. Private sector activity comprises largely services and distribution and there is little indigenous private commercial production or investment.

A money economy with modern communications, transport and utilities has developed, but is limited to the population centres of the main islands.

The FSM economy is dominated by three types of economic activity: 1) subsistence farming and onshore fisheries, 2) wholesale/retail trade, 3) the provision of government services. FSM has rich fisheries resources. The main source of income from offshore fishing is from annual licences granted to foreign vessels. Traded goods and services (agriculture, fisheries and tourism) represent only 1 – 2% of GDP.

In recent years FSM has designed and implemented an economic reform programme aimed at achieving long-term stability and security ; improved economic, and environmentally sustainable, growth and development ; improved efficiency and effectiveness of social services and self-reliance.

3.2.1. Economic situation, structure and performance

Reducing the size of the public sector is a stated policy aim, and a prerequisite of improved economic performance.

Detailed, up-to-date information with relation to the economy's performance in 2003 is not available.

3.2.1. Economic growth sectors

Opportunities for private sector development are believed to exist in the areas of fisheries, tourism and agriculture, in particular. Significant wage differentials between the public and private sector tend to discourage private sector initiatives, however.

3.2.2. Social aspects

3.3. Social situation

The external support provided to FSM has produced a standard of living, especially in the urban centres, that is generally higher than elsewhere in the region. Income per capita and literacy rates are somewhat above the regional average, with most health indicators comparable to the average for other Pacific Island countries. The relative position of FSM can be expected to decline in the near future as the reduction in external funding and associated budget constraints reduce income levels and the quality of health and education services.

FSM has a young and rapidly growing population, with some 50% under 18 years of age. Unemployment rates among youth will increase and career opportunities diminish in the public sector as a result of the reform process. The working-age population is under-employed and underpaid, especially as regards women. Wage differentials remain a critical labour market issue. Average public sector wages are close to double those of the private sector, which acts as a disincentive for participation in the private sector. As the reform process implies a major reduction in public sector wages at all levels, migration may continue to be significant.

POPULATION AND SOCIAL INDICATORS 1998

POPULATION INDICATORS	1998
Total population	114.1
Annual population growth rate (% change)	2.1
SOCIAL INDICATORS	
Total fertility rate (births per woman)	5.0
Maternal mortality rate (per 100 live births)	-
Infant mortality rate (below 1 year, per '000 live births)	46.0
Life expectancy at birth (years)	67.0
Female	67.0
Male	63.0
Adult literacy (%)	71.0
Primary school enrolment (% of school age)	83.0
Secondary school enrolment (% of school age)	44.0
Child malnutrition (% age under 5 years)	15.0
Population with access to safe water (%)	44.0
Population with access to sanitation (%)	51.0
Human Poverty Index	26.7

3.2.3. Structure of the public sector and recent developments

No information available on recent developments.

3.3. External Environment

3.3.1. Balance of payments

No information available for 2003.

3.3.2. Merchandise Trade

No information available for 2003.

3.4. Sustainability of Current Policies

3.4.1. Economic development

Compact assistance is scheduled to last for another two decades, but in order to advance the cause of economic self-reliance, and to reduce the increasing social problems associated with the high unemployment, or under-employment rate, it is vital that the authorities successfully implement policies capitalising on the potential for economic growth. This is likely to involve a degree of privatising of areas at present in the public sector and, more generally, to create a more enabling environment for private sector development.

3.4.2. Unemployment

As in many Pacific Island countries, unemployment and underemployment are areas of considerable concern. As reform of the public sector progresses, unemployment figures are likely to rise further.

3.4.3. Gender issues

In FSM women lag significantly behind males in almost every respect. They have a smaller share of the job market, are mainly employed in subordinate, low-paid jobs, are weakly organised and under-represented in the policy-making process at state and national levels.

The government, recognising the need to improve the status of women and to include them in the development policy-making process, has incorporated women's issues within planning and operations practices. A Women's Coordination Unit has been established within the Department of Health, Education and Social Affairs. At state levels, Women's Interest Officers have been appointed which have broad responsibilities for input into policy-making, especially for the social sectors.

3.4.4. Environment

3.4 Environment and Resource Management: Natural Resources

High birth rates, limited land and migration to state capitals have contributed to growing environmental problems. Proper waste management and sewage disposal are required. Policies to restrict pollution, to effectively manage coastal water resources and preserve the country's bio-diversity need to be further developed. Appropriate national and state environmental regulations exist, but enforcement is hindered by limited institutional capacity. Sustainable management of resources such as aggregate, offshore minerals and renewable energy are other issues in the quest for development in the FSM. (See also Annex 1)

With recent budget cuts diminishing the government's ability to manage and protect the nation's natural resources, non-governmental organizations and community-based organisations have begun to assume resource management responsibilities. Capacity building for Non-State-Actors (NSAs) is a stated aim of both national and state governments. The national government has recently given its support to the establishment of a national NGO network, FSMANGO, and is encouraging government-NGO-private sector resource management partnerships to enhance conservation and environmental protection.

3.5 Energy

FSM relies mostly on imported fossil fuels for its energy generation. This places an increasing strain on the economy, as diesel fuel is expensive to import and diesel-generated electricity expensive to produce. Moreover, oil imports have increased in recent years due to a steady growth of the urban population and an increase in the load on power stations. A priority objective of the government is the provision of an adequate and secure supply of energy to meet the needs of households, commerce and industry and considered to be crucial for the sustainable growth and equitable development of the country.

The shortage of energy supply to the rural areas and outer islands is contributing to the lop-sided development of urban centres. Part of the urban drift and migration in FSM is the result of a bias towards power and water supply infrastructure in favour of the urban areas. The government, recognising the need to redress national disparities, considers the development of indigenous energy sources in the outer islands as crucial for the sustainable and equitable development of the country.

3.4.5. Governance : Sound Development Management

Greater accountability in the use of Compact funds should ensure their more sound management, provided that attention is paid to the impact of funds and not merely to questions of financial probity.

4. OVERVIEW OF ONGOING COOPERATION IN THE REGION

The 9th EDF Regional Programme foresees an allocation of €29 million and includes three focal sectors "Economic Integration and Trade" (€9 million), "Human Resource Development" (€8 million) and "Fisheries" (€5 million) and € 7 million for a non-focal sector, destined for the extension of a number of 8th EDF programmes to the 6 new ACP countries, including RMI. The Regional Programme was signed in 2002 by Commissioner Poul Nielson, during his first visit to the Pacific.

- "Regional Economic Integration Programme" (REIP) - €9.2 million

The programme aims to assist the region in strengthening its capacity to implement PICTA (the proposed free trade area among the Pacific island countries), negotiate trade agreements with developed partners (e. g. an Economic Partnership Agreement with the EU) ; to participate in multilateral trade negotiations (WTO) and to assist the private sector in addressing supply-side constraints.

The EDF approved the programme at its November 2003 meeting and at the end of the year the Financing Agreement (FA) had been finalised. The FA was scheduled to be officially signed by the RAO and by the Commissioner during the latter's visit to Fiji in February 2004.

- "Human Resources Development" (HRD) – PRIDE programme - €8 million

The objective of the programme is two-pronged: to assist Pacific island countries (PICs) in developing a sector-wide strategy for Education and subsequently to finance the implementation of some parts of that strategy. Most PICs have identified Education as a focal sector in their National Indicative Programmes, and a number of other donors are very active in the sector in all of them. Therefore, the parts of the strategies that have a more national character will be implemented with national funding (both governments' own resources and that of donors) and those that have the capacity to be shared by the region can be selected for funding by this programme. The programme is implemented by the Institute of Education of the University of the South Pacific (USP).

The Financing Proposal was finalised in 2003 and approved by the EDF Committee in September. Both the Financing Agreement and Contribution Agreement were signed in Suva in November 2003.

A very positive development occurred during 2003: at the invitation of the Pacific Island Countries, led by Samoa, and with the consent of the Commission, NZAid agreed to provide funding for PRIDE, to the tune of NZD 5 million for three years, with the possibility of additional funding after that. This allowed USP to proceed with the recruitment of the project management team during the second half of 2003. At the end of the year all but one element

of the team have been selected and all have either ACP or EU nationality. USP is also finalizing works in the PRIDE office building. The team will start working in February 2004.

Implementation of this programme went faster than expected: implementation had been forecast to start in early 2004, but at the end of 2003 almost all the team has already been selected and works in the office were almost completed.

- "Fisheries" - €5 million

Two programmes are being funded in this sector :

- Extension of PROCFISH to the 6 new ACPs - €1.997 million
The complementary Financing Proposal was approved in late 2003, and the Financing Agreement was to be signed in February 2004, during Commissioner Nielson's visit to Fiji, for immediate implementation (cf. 8th EDF, below, for further details on PROCFISH).
- DEV FISH, a programme to be managed by the Forum Fisheries Agency (FFA) in collaboration with the Secretariat of the Pacific Community (SPC) - € 3 million

The objective of the programme is to increase the benefits received by PICs from sustainable use of marine resources, by increasing the capacity of PICs to directly participate in the tuna fishing and processing industry, and reinforcing national and regional policies and strategies for the sector.

By end-2003, the Financing Proposal was being finalised by EC headquarters, with a view to a decision by mid-2004. Implementation should start immediately after.

- Non-focal sector - € 7 million

The non-focal sector is composed of extensions of existing programmes to the new 6 ACP countries, and support to the Palau Festival of Arts:

- All extensions refer to the participation of the 6 new Pacific ACP countries (Cook Islands, Federated States of Micronesia, Nauru, Niue, Palau and the Republic of the Marshall Islands), which cannot benefit from 8th EDF funding, in projects/programmes recently approved and financed under the 8th EDF. Three extension proposals were approved during 2003 and one other is being finalised, as per the table below.

PROJECT	EURO Millions	EDF SOURCE	STATUS
SPC/DSAP ext.	1.981	9th EDF	Approved. FA to be signed by Com. Nielson in Feb 2004
SPC/PPP ext.	1.512	9th EDF	Approved. FA to be signed by Com. Nielson in Feb 2004
SOPAC ext.	2.55	9th EDF	Approved. FA to be signed during the first quarter of 2004
SPREP/PIEN ext.	0.56	9th EDF	being finalised by HQ in view of a decision by mid-2004

- The Palau Festival of Arts is a co-financing project with the Pacific OCT, consisting of € 330,000 from the 9th EDF RIP (including balances of previous EDFs, transferred into

the 9th) and € 250,000 from the OCTs. The RIP part will finance the purchase of sound and light equipment, its installation and the training of Festival staff for its operation. The OCT part will finance accommodation, local transport and catering for the participants from the French Pacific territories. The Festival will take place in Palau in July 2004 and the organisation wanted to start tendering for the sound and light equipment in November 2003.

The Financing Proposal was presented to the Delegation in May 2003 and, after further processing, to AIDCO at the end of the same month. Changes in staff in headquarters and difficulties in coordinating funding from different sources resulted in serious delays to the programme. Approval was expected at the end of the first quarter of 2004.

4.1 NIP Focal sectors

4.1.1 9th EDF NIP Focal sector – Energy

As a result of a mission by the Delegation to FSM in March 2003, which allowed for consultations with various energy stakeholders and discussions with the government on the implementation of the cooperation programme, progress was made with the drafting of a Financing Proposal for the interventions in the renewable energy sector. Agreement on the final Financing Proposal was sought from 5 different NAOs in December 2003, since the programme is to be implemented at a sub-regional level, together with the Marshall Islands, Nauru, Niue and Palau. The Financing Proposal was expected to be presented to the EDF Committee in the second half of 2004, with a Financing Agreement signed soon thereafter.

4.2. Projects and programmes outside focal sectors

As regards the non-focal sector, a draft financing proposal with NSAs in the area of conservation and environment protection was being prepared, with consultations still ongoing at the country level. The expectation at the end of 2003 was that the draft proposal would be approved by the NAO by the first half of 2004, with EDF committee approval obtained by second half of 2004, followed by implementation soon after signing of the Financing Agreement.

5. Programming perspectives for the following years

9 th EDF NIP	2004	2005	2006	2007	2008
Commitments (in € million)					
Energy Programme (€ 4.08m)	4.08				
NSA programme (€ 0.72m)	0.72				
	4.8				
Disbursements (in € million)					
Energy Programme	-	750,000	1,250,000	1,250,000	830,000
NSA programme	-	200,000	320,000	200,000	-
Total (cumulative)	-	950,000	1,570,000	1,450,000	830,000

6. 2003 Annual Operational Reviews – specific themes

6.1 The speeding up of the use of old EDF Resources

(Not applicable).

6.2 Setting indicators and targets for measuring poverty reduction and results in focal sectors

6.2.1 Indicators for measuring poverty reduction

No information available.

6.2.2. Indicators for measuring results in focal sectors

Indicators to measure results of the focal sector programme would be the number of renewable energy initiatives running in the country and/or the share of energy consumption derived from renewable sources.

6.3. Dialogue in-country with the Office of the NAO and non-State actors

Dialogue in-country with the Office of the NAO has been limited, and is hampered by the distances separating the Delegation and FSM. FSM's unfamiliarity with EDF procedures and requirements has affected the efficiency of dialogue – a situation which should improve as mutual familiarity improves. The opening of an EC Office in FSM should greatly improve contacts and facilitate programme implementation.

The NIP includes a component for NSAs (15% of the A envelope), which has been allocated for NSA support in the area of conservation and environmental protection. Good NSA contacts have been established by the Delegation with the FSM Association of NGOs (FANGO) and Micronesian Conservation Trust (MCT).

7. Conclusions

(One-page resume of the foregoing, to be written when the rest of the text is complete/agreed.)

Federated States of Micronesia : Country Environmental Profile

Land

The Federated States of Micronesia is a young, independent nation created from part of the former United Nations Trust Territory of the Pacific Islands following conclusion of a Compact of Free Association with its former colonial administrator, the United States of America in November 1986. The FSM comprises four states which are, in geographic sequence from west to east, Yap, Chuuk, Pohnpei and Kosrae. FSM's land area is only 271 square miles, made up of mainly large and mountainous islands and more than 200 islets and atolls.

Water

Most of the states population are on 24-hour water service while rural areas have a few community systems such as a filtration and chlorination process which precedes the distribution network. Many, though, rely on individual roof catchments and storage tanks.

Climate & Forestry

The climate of the Federated States of Micronesia is typical of many tropical islands and on most islands there is a pronounced wet season and dry season. All states except Chuuk have large forested areas. Micronesians developed traditional forest resource management systems that provided for the sustainable management of forestry resources, however, a growing population, a decline in traditional knowledge and the desire for participation in the cash economy have led to increasingly unsustainable use of forest resources in the FSM. Landowners and policy makers alike need to be made more aware of the important ecological functions and benefits that the forests of Micronesia provide.

Marine

The most economically significant natural resources of the Federated States of Micronesia are those associated with the marine environment. Although the land resources of the FSM are small, the Exclusive Economic Zone is vast. The marine area within the FSM's 200 mile Exclusive Economic Zone (EEZ) totals over one million square miles and includes abundant and varied resources. The coastal zone has particular significance as this is both the zone in which the majority of the population lives and the area most sensitive to environmental disturbance. The marine resources are extensive and in many ways central to the future economic prospects of the FSM. Tuna is the primary fisheries resource, including both surface schooling and deep-water species. Marine resource officials believe that the catch of skipjack tuna can be increased greatly without any significant risk of depleting that resource.

Minerals

The mineral resources of potential interest are gold and phosphate deposits in Yap, however, early results indicate little economic potential for the gold deposits. Deep ocean resources of manganese and cobalt crusts have been identified but their extent has not been determined.

Tourism

Tourism is a significant contributor to the FSM economy in terms of employment, exports and income. All state economic development plans foresee considerable expansion of tourism activities for the coming decade. A precursor to realisation of the great potential for growth of the tourism sector is investment in tourist infrastructure, including additional accommodation, better transport connections and improved recreational activities.

Waste Management

The small size of islands in the FSM greatly limits the availability of sites for waste disposal. Mangrove areas have been used in all islands as it has been assumed that the result of the in-filling will be additional precious land.

In the urban centres, the lack of suitable landfill sites for dumps is a major pollution issue. Existing dump sites are generally not adequately maintained nor do any of the sites have specific areas set aside for the disposal of hazardous material. In rural areas, garbage is sometimes dumped in the mangrove zone to create land for community use, but if not contained and properly managed, this is an eyesore and causes marine pollution. There is a clear need to emphasize composting of biodegradable rubbish at both the household and community levels.

Environmental Management

Effective long term environmental management in the Federated States of Micronesia will require an informed and supportive public. The need for increased awareness is particularly apparent at the "grass-roots" or village community level. It is the resource owners who decide what activities will occur on their land, and it is therefore they who have the greatest potential effect on the environment of the FSM. Another important issue is the need for traditional knowledge to be integrated into environmental awareness programs. In many instances traditional use practices ensured the long term protection of natural resources. Inhibiting factors to these traditional practices include the focus today on economic development and individual material well-being without due attention to the long term sustainability of the resource base.