

ASIAN DEVELOPMENT BANK

**COUNTRY ASSISTANCE PLAN
2001 – 2003**

FEDERATED STATES OF MICRONESIA

December 2000

CURRENCY EQUIVALENTS

(As of 30 November 2000)

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

ABBREVIATIONS

ADB	-	Asian Development Bank
ADF	-	Asian Development Fund
BSSP	-	Basic Social Services Program
EMPAT	-	Economic Policy Reform and Management
FSM	-	Federated States of Micronesia
GDP	-	Gross Domestic Product
PDMC	-	Pacific Developing Member Country
PIER	-	Pacific Islands Economic Report
PRC	-	People's Republic of China
PSRP	-	Public Sector Reform Program
RETA	-	Regional Technical Assistance
SPREP	-	South Pacific Regional Environment Programme
TA	-	technical assistance
UNDP	-	United Nations Development Programme
US	-	United States

NOTES

- (i) The fiscal year (FY) of the Government ends on 30 September.
- (ii) In this report, "\$" refers to US dollars.

FOREWORD

The Country Assistance Plan describes the planned program of assistance by the Asian Development Bank (ADB) for the Federates States of Micronesia, covering the three-year period 2001-2003. It includes loan and technical assistance projects, as well as possible cofinancing from other donors. The CAP was prepared by the ADB between April and June 2000, in close consultation with the Government of FSM, and other stakeholders, including non-government organizations. The CAP was discussed with the Board of Directors in October 2000 and has been revised by the ADB to incorporate recent developments. The assistance plan described in the CAP is only indicative and may be revised to reflect more recent developments.

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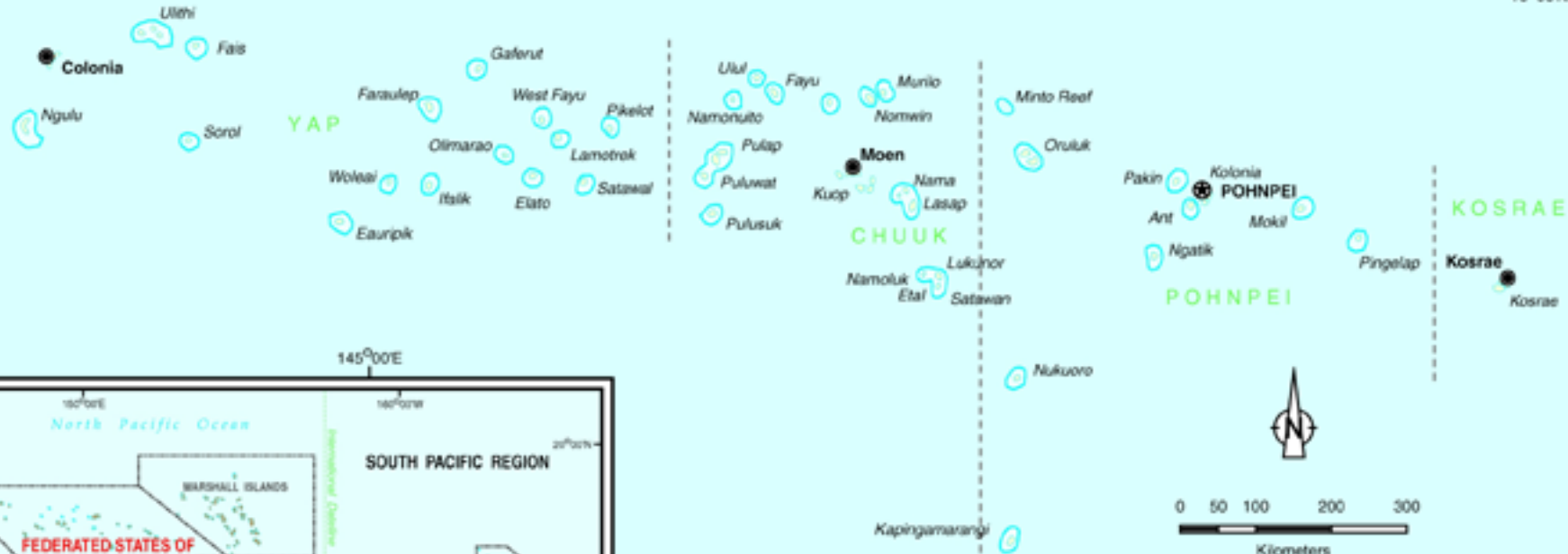
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FEDERATED STATES OF MICRONESIA

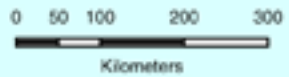
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-  National Capital
 -  State Capital
 -  Reef
 -  State Boundary
 -  International Boundary
- Boundaries are not necessarily authoritative.

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FEDERATED STATES OF MICRONESIA

I. Country Performance Assessment

A. Economic Performance Assessment

1. The real Gross Domestic Product (GDP) of the Federated States of Micronesia (FSM) rose by an estimated 0.2 percent in the fiscal year ending 30 September 1999. This slight increase in the aggregate level of economic activity ended three years of recession, but was not evenly spread across the four states. Indeed, the rise in GDP was entirely attributable to an increase in economic activity in Chuuk, where the private sector expanded strongly enough to more than offset a further decline in the contribution of government. Real GDP was stagnant in Kosrae and Pohnpei, and declined in Yap, although in the latter two cases private sector activity increased¹.

2. In spite of the preliminary encouraging signs, the country's medium-term economic outlook remains fragile due to possible reductions in Compact of Free Association² (Compact) grant funding. An overall balance of payments surplus of 8 percent of GDP was recorded in 1998. The financial holdings of the state and national governments, which serve as a measure of external reserves, increased to \$61.7 million, which was sufficient for almost nine months cover of imports at the much-reduced 1998 level. The external debt level at the end of 1997 was \$111.4 million, or 52.3 percent of GDP. The national and state governments had undertaken massive borrowing in the early nineties, but since then have refrained from new foreign borrowings except for loans from the ADB. Lately, the external debt burden has dropped sharply and will continue to drop until 2001 when the borrowings of the early nineties will have been repaid.

3. Projections of the consolidated general government accounts for 1998 showed a substantial increase in the current budget surplus to 11.3 percent of GDP, and an overall budget surplus of 0.7 percent (see Appendix 1, page 1). Exclusive of separation payments, the overall surplus rose to 9 percent of GDP. This represents an important step toward greater fiscal self-reliance, but further adjustments will be required. In 1998, domestic revenue of \$69 million still only accounted for 62 percent of current expenditure. Combined with the modest economic growth and increased tax efforts, there appears to be clear improvement in tax revenue in FY99. Besides a relatively low tax level and a need for reinforcing the tax collection efforts, the remaining critical issues are reforming the existing gross revenue tax into a more equitable, comprehensive, and export-friendly tax such as value-added tax; more equitable share of fishery fees and financial revenue between the national and state governments; improving weak implementation capacity; and achieving more effective and efficient use of resources through newly-introduced performance-based budget processes.

4. No data are available on the inflation rate, but it will have tracked the US rate of 2.6 percent, as the US dollar is the currency in circulation and the United States is the dominant source of imports. Commercial banking deposits and loans changed little from the levels recorded since 1993. Deposits dropped and both consumer and commercial loans increased

¹ In 1996, GDP per capita in Chuuk was estimated at \$1,005 while the other three states were at the level of over \$2,300 (Kosrae at \$2,302, Pohnpei at \$2,784, and Yap at \$3,197).

² The Compact of Free Association (the Compact) between the FSM and the United States came into effect in 1986. Under the Compact, the FSM receives financial and technical assistance over a 15-year period until 2001.

marginally, with the former loans (mostly to public servants) dominating bank portfolios. The loans to deposits ratio fell to 43 percent at the end of the 1999 fiscal year, as banks continued to invest offshore because of the ongoing lack of domestic commercial lending opportunities. The latter reflected a specific limitation on mortgage secured lending caused by a legal prohibition of land ownership by foreign banks. It also reflected a combination of constraints to private sector development in general, most notably high wage costs, inadequate economic infrastructure, and an inadequate regulatory framework and its application. Under the Public Sector Reform Program (PSRP)¹, a start has been made in the easing of these and other constraints through public service downsizing, public enterprise reform, support services, and attempts at improving land titling and leasehold arrangements.

5. The aid-dependent, public sector-dominated nature of the FSM economy is well documented. This has altered some with the cutbacks in government expenditure forced by reductions in transfer grants under the Compact with the United States. Staff retrenchment and wage reductions have brought about a reduction in national and state government expenditures from 80 percent of GDP in 1993 to 70 percent in 1998. Simultaneously, they have caused a decline in private sector activity (excluding subsistence production) since historically this sector largely evolved as a subsidiary goods and services provider to public servants, centering on importing, wholesaling, and retailing, rather than on export-oriented agriculture, fisheries, and tourism. The public expenditure reductions have contributed substantially to a strengthening of state government finances, but expenditure remains high, with wages and travel accounting for 85 percent of operating expenditure. The external debt level continued to decline in 1999, reaching 28 percent of GDP (compared with a high of 66 percent in 1993). The debt service ratio was estimated at 25 percent of exports. Official projections indicated that the country was on track to achieve a debt to GDP ratio of 21 percent and a debt service ratio of 3 percent by 2002.

6. The extent of the long-term economic adjustment required if large aid flows are not continued is indicated by the fact that, in 1998, Compact transfers still accounted for 47 percent of total government revenue. Tax collections provided just 14 percent. Major reform to improve efficiency and effectiveness is required if taxation revenue is to rise without jeopardising private sector development. This will involve consideration of a value-added tax as a replacement for the current gross revenue tax, greater efficiency in collection, and greater use of service charges and user fees. The issue of revenue-sharing between state and national governments needs to be addressed. Any reductions in external grants demand further fiscal adjustments that will impact negatively, and relatively quickly, on living standards. The private sector development that must be relied upon to generate employment and income will be slow in coming if many of the conditions, which are essential for investment and economic growth, are not addressed with increased vigor. At the 4th Consultative Group meeting held at the ADB headquarters in February 2000, the Government presented its plan for private sector-led growth of the FSM economy, which was consistent with ADB and other donors' proposed strategy for FSM.

7. The obvious uncertainty confronting FSM governments is the outcome of re-negotiations of the US Compact. If successful from a FSM perspective, there will be a long-term source of financial support but probably lower than in the past. The pressure for significant economic restructuring in the short-term will be eased and Micronesians may experience less compulsion to emigrate to Guam, Hawaii, and the US mainland in search of employment. If the re-

¹ Loan No. 1520 approved on 29 April 1997.

negotiations are unsuccessful, there is still provision for grant transfers in 2002 and 2003 at the average level of the 15-year period 1986-2000, but then the economic situation will dramatically worsen. It is important for the Government to vigorously pursue policy actions for private sector-led development.

B. Poverty Assessment

8. The assertion that the Pacific is a region free of absolute or significant poverty where people live in subsistence affluence is being challenged despite very limited data. In FSM, of serious future concerns are the implications of population growth exceeding economic growth, and inequality of standard of living increasing between the population of the outer islands¹ and migrants to Pohnpei and Chuuk.² Recent successive economic contractions suggests that there will be a decline in the already low standards of education, health and law and order enforcement which will have a negative impact particularly on the outer-islanders and migrants in the main islands who are virtually landless. Lack of land affects well over half the population of the FSM. Poverty assessment is further complicated by limited data on poverty as well as lack of consensus that significant poverty exists in the country. The Human Poverty Index of 26.7 indicates the fourth highest extent of poverty amongst PDMCs.

C. Assessment of Socio-Environmental Performance

1. Gender Issues

9. In FSM, women lag significantly behind males in almost every respect: proportionately fewer attend secondary school and college, they have a smaller share of the job market and are mainly employed in subordinate and lowly paid jobs,³ and, if reproductive health is counted, they have more health problems than men. Furthermore, they are weakly organized and underrepresented in terms of a voice for women in policy-making at state and national levels.

10. The FSM Government recognizes the need to improve the status of women and to include women in the development policy-making process. This is reflected by the FSM main gender policy objectives: (i) strengthening women's participation in economic and social development, (ii) research and data collection on the status of women⁴, (iii) improving maternal and child health and community services, (iv) improving rural and outer island water and sanitation, and (v) household food security. The Government will address gender issues in preparing its Strategic Policy Framework, new development strategy for FSM, at national and state levels.

2. Human Development

¹ The population of the outer islands living on remote atolls far from the main islands, capitals, and urban centers of the four main islands comprise about 18,000 people, 17 per cent of FSM's total population.

² In Pohnpei State over 2,000 outer islanders have settled on the main island of Pohnpei, while 5,000 outer islanders have settled on the small island of Weno, the State capital of Chuuk.

³ Women spend roughly 53 per cent of their time in unpaid labor or subsistence work. In FSM unpaid work refers to child care, housekeeping, food preparation and production, farming and fishing, and assisting with the management and operation of family owned enterprises. The 47 percent wage earners are employed by state and national governments and private companies. Of all the women who work, three quarters are in service delivery or support services, and less than 10 percent are in administration.

⁴ The newly established National Statistics Office needs further institutional strengthening to update gender-related statistics on a sustainable basis.

11. A decline in the fertility rate, though still relatively high, and the suppressed rate of infant mortality may indicate some future containment of the rate of population growth. However, while annual population growth rates are eased by emigration to Guam, Northern Marianas and the US, the natural rate of population increase averages between 2.3 and 2.5 percent, which is high. FSM also has one of the youngest populations in the Pacific with some 50 percent under 18 years' of age. This is a result of the high fertility rate on the one hand and the migration of adults on the other. Therefore, the age-dependency ratio is very high, placing a large burden on the working-age population for funding of government services. In the medium term, the working-age (15-64 years) population is expected to increase considerably, both in proportion and in absolute numbers. Given a low economic growth perspective, providing adequate education and training, as well as employment for the existing and growing labor force is a major concern.

12. Health expenditure as a proportion of GDP is low by regional standards. The FSM allocates less than 8 percent of GDP for health compared to 16 percent of GDP for education.¹ The incidence of some diseases has increased partly as a result of improper nutrition and there is also concern over the distribution of health services between both income groups and between islands. As with other Pacific developing member countries (PDMCs), a much larger proportion of government health expenditures support curative rather than preventive health care which is not considered to be sustainable. Inadequate management of the hospitals and dispensaries is a major impediment to improving the health care system.

13. Levels of adult literacy and primary and secondary school enrolments are high by regional standards, but there are concerns over the declining standards and quality of education. FSM is not producing the range of skills required by a modernizing economy. The country is also failing to produce the levels of school graduates that were achieved in previous generations. The 1995 human resource development study notes that the poor performance of the education system results from a lack of proper facilities, well trained teachers, planning, monitoring and, most importantly, management. Access to quality health and education services will need to be addressed as part of poverty alleviation strategy.

3. Environment

14. There are no reliable environmental indicators for FSM. However, major environmental issues assessed by the South Pacific Regional Environment Programme (SPREP) in 1993 identify environmental problems to include climate change and sea level rise, increasing urban population concentrations, and poor solid waste management - including toxic and hazardous waste, overcultivation of sloping lands and soil erosion in the State of Pohnpei, destruction of reefs by dynamite fishing and cyanide poisoning in the case of Chuuk State, coastal pollution as a result of land reclamation, dredging and construction in all States, the poorly controlled entry of non-indigenous flora and fauna, and a lack of protection of the existing bio-diversity. It sets out four broad environmental objectives including (i) integrate environmental considerations in economic development; (ii) improve environmental awareness and education; (iii) manage and protect natural resources; and (iv) improve waste management and pollution control.

D. Governance: Sound Development Management

¹ Asian Development Bank (1995) *Human Resource Development: Small Pacific Island Countries*. Pacific Studies Series.

15. The system of government is modelled on that of the United States. Each of the four States has a high degree of autonomy with its own constitution, limiting collective development objectives and consistent fiscal management. 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. The current system of government may be considered to be excessive for a population of just over 100,000. The decision in January 1998 to reduce the National Government from 11 departments and offices to six is noteworthy and will hopefully lead to greater focus and prioritization of Government at the State level but this will need further encouragement. The Government has shown a notably increased awareness and commitment towards better governance. The task is complex, involving four states and one central government.

16. The major governance issues continue to be: (i) the large machinery of government; (ii) the legal and regulatory framework which tends to stifle private sector development; (iii) inadequate managerial and technical capacities affecting reform implementation and delivery of services; and (iv) continuing dependence on transfers from the US Compact agreement to finance a large government wage bill. The earlier reform actions (retrenchments and wage cuts) have reduced government expenditure, but still the public sector continues to account for 70 per cent of GDP. There is scope for improving efficiency and delivery of services. Also, public sector wages are almost double that of the private sector on average. Public enterprises, many of which suffer considerable losses and crowd out the private sector, account for approximately 14 per cent of GDP and employ about 1,400 persons (about 10 per cent of formal sector employment). Legal and regulatory frameworks, including those governing access to land, have also proven to be impediments to attracting and realizing new investment, and, in some cases, have driven away potential investors. Capacity building is a continuing challenge, given the inadequacy of skilled administrators and technical staff at national and local levels, and in part the open U.S. immigration window for FSM nationals. The uncertainty regarding future Compact payments has in some quarters dampened the will to push forward along the reform track. There remains hope that a "successful" Compact renegotiation will ease the economic and fiscal difficulties facing the Government and enable it to pursue a reform agenda.

E. Implementation Assessment

1. The Portfolio

17. As of 31 December 1999, cumulative ADB lending to FSM consisted of three loan projects for a total of \$35.1 million. In addition, ADB has provided thirty-one TAs totalling \$17.55 million (see Appendix 2, pages 1 and 2 for implementation, disbursement performance, post-evaluation results, and status of implementation). Loans have been approved for a public sector reform program (PSRP), water supply and sanitation, and fisheries development.¹

18. The PSRP loan resulting in successful fiscal adjustments of the national and state governments was closed in December 1999.² ADB's other two ongoing loan projects have

¹ Loan No. 1520-FSM: Public Sector Reform Program for \$17.9 million was approved in June 1997, Loan No. 1459-FSM: Water Supply and Sanitation Project for \$10.2 million in September 1996, and Loan No. 1257-FSM: Fishery Development Project for \$ 6.4million approved in October 1993.

² The initial loan closing date was extended by one year to allow the Borrower to have sufficient time to accomplish the remaining reform targets.

experienced delays in implementation and a mixed performance to date. Restructuring of the problematic Micronesian Longlining Fishing Company (MLFC), which is a private venture established under Loan No. 1257-FSM: Fishery Development Project, is a key issue. The Kosrae state component under Loan No. 1459-FSM: Water Supply and Sanitation Project is to be cancelled with funds reallocated to components of other states.

19. TA grants have included six project preparatory TAs of which only 2 have so far led to the approval of a loan. TAs to date have covered economic policy and planning, natural resource development, and support to the finance and industry sectors. As of 31 December 2000, there are a total of four ongoing TA projects covering economic policy advice, privatization and corporate governance, and strengthening the statistical system.

2. Issues in Project Implementation

20. In June 1999, the final second tranche drawdown for the PSRP¹ was disbursed as Chuuk and Pohnpei state governments have met the required conditions by passing the foreign investment law and other legislation. ADB's other two ongoing loan projects² have had a mixed performance. The lessons learned are: (i) ADB's project needs to be based on the individual state needs and (ii) ongoing economic reforms to create a more private sector-friendly environment should precede or at least coincide with, ADB's investment in revenue generating sectors.

21. The political system, which allows each of the states a high degree of autonomy with each having its own Constitution, poses a task for project and program design. The separations of legislature and executive at national and state levels make consensus building more challenging. It is, therefore, imperative that attention be given to the political realities in the entry stage of project/program design to avoid delays and difficulties during implementation. Conditionalities in project design should be realistic and acceptable within the broad framework of the Constitution of each state and allow for adequate flexibility for implementation to proceed even if all states are not in compliance.

¹ Loan No. 1520-FSM: *Public Sector Reform Program* for \$17.9 million was approved in June 1997.

² Loan No. 1459-FSM: *Water Supply and Sanitation Project* for \$10.2 million in September 1996 and Loan No.1257-FSM: *Fishery Development Project* for \$ 6.4million approved in October 1993.

II. Country Operational Strategy

A. The COS

22. ADB's strategy in FSM reflects the government's development strategy aimed at implementing the economic reforms which was presented to the Fourth Consultative Group (CG) Meeting in Manila in February 2000. It is consistent with ADB's Poverty Reduction Strategy. To effectively implement the ADB's strategy in FSM, emphasis will be put on the needs of individual states, and stronger linkages will be established with the states' performance, commitment to reform and related policy dialogue. The priorities for FSM include the following:

- consolidate progress of public sector reforms;
- increased targeted attention to fostering the growth of the private sector;
- provide direct assistance to the social sectors; and
- due attention to developing the overall economic and policy management capacity of both the national and state governments.

B. Progress in Implementation

23. ADB financed PSRP has succeeded in bringing about required fiscal adjustments in all five governments.¹ FSM is continuing to downsize government, restructure the economy, and pursue public sector and economic reforms. However, as observed at the national economic summit in September 1999, more policy formulation remains to be done, and implementation will have to be effective. Particularly in regard to attracting foreign investment, there is a need to make the application of regulations non-discriminatory, transparent, and faster. Other loans are progressing satisfactorily. However, the Fisheries Development Project has experienced delays and implementation problems due to external factors and dependence on various government agencies for operational requirements.

24. The renegotiations of the current Compact agreement with the US may lead to further decline in government revenues. Whatever the result the Compact renegotiations, FSM will have to stay the course of the reforms aimed at improving the performance of the public sector and, equally important, developing the private sector. The national and state governments are working on a comprehensive development strategy which will enable the FSM economy to develop in a more sustainable way with less reliance on external assistance. This needs to be based on a broad consensus of the population and should start its implementation before the end of the current Compact.

25. ADB's strategy and program continues to focus on policy and institutional reform, sound macroeconomic policies, and improved performance of both national and state governments. To more effectively implement ADB's strategy, more emphasis will be put on individual states' needs, and stronger linkages will be established with the states' performance, including their commitment to reform and related policy dialogue under proposed ADB interventions. This approach will be applied to future country programming as well as to future individual project designs. The need to maintain equity between the four states in terms of ADB assistance will,

¹ An Interdepartmental Task Group reviewed the Public Sector Reform Program (PSRP) in early 1999 and confirmed successful fiscal adjustments achieved under PSRP in FSM.

however, also be kept in mind. Both the national and state governments have fully supported increased focus on specific state operations and requirements.

C. Poverty Partnership Agreement

26. The preparatory work for developing a country specific Poverty Alleviation Strategy for FSM leading to a partnership agreement has been initiated under TA 3258¹. Household income and other relevant data required for poverty assessment is currently being compiled. The objective is to undertake a preliminary analysis of poverty and inequality and to further examine and define the particular nature and extent of poverty and inequality in FSM. The concepts of economic and social opportunity as it may apply to FSM will be examined with also the importance of vulnerability as a factor impacting the economy and society of FSM. This would lead to a Poverty Partnership Agreement between FSM and ADB.

III. Sector Strategies

A. Infrastructure

27. The FSM country assistance program has developed from one that previously emphasized sector specific lending, to a program that is focused on the policies and institutions required for further economic restructuring and the liberalization of factor markets in support of investment and growth. Direct assistance to physical infrastructure does, therefore, not feature prominently in the FSM country assistance plan. Current priorities acknowledge the extent of existing infrastructure and the lack of adequate public asset management and maintenance as requiring attention.

28. ADB will continue to monitor the progress of reforms in the public sector and factor market liberalization which will improve governance and institutional capacity, including management of public assets and the promotion of a business friendly environment. Subject to further implementation of reforms, ADB would consider assistance for physical infrastructure development.

B. Social Infrastructure

29. A general decline of human development status is a concern in FSM. The state and national governments are preparing their social sector policies under ADB's ongoing EMPAT II TA². These new social sector policies will be further discussed at the state and national economic summits with a wide participation of beneficiary groups and stakeholders. These initiatives are also welcomed as the FSM government is entering into the re-negotiations of US Compact Agreement, on which most health and education expenditures are reliant. To support the introduction of these new policies, a loan for *Basic Social Services*, was approved in December 2000. The Project will underpin essential, social sector government finances. It will be particularly relevant to the proposed state focused approach because the FSM constitution gives responsibility for the provision of education and health service delivery to the state governments.

30. Restoring the quality of education, health and other social services will be addressed through the prioritization of government activities under the proposed Basic Social Services

¹ TA 3258-FSM: *Strengthening the National Statistical System*, for \$400,000, approved on 21 September 1999.

² TA No.3024: *Economic Policy Reform and Management (EMPAT II)*.

project. Successful implementation of community-based elementary schools in Yap and further communities' participation in dispensary management in Yap and Pohnpei would be a useful model to enhance the management of basic social services.

C. Environment

31. An ongoing regional TA for the development of an international fishing agreement will help in the conservation and management of the fishery resources. An ongoing loan for better water supply and sanitation will help improve environmental conditions. Finally, more secure title and economic use of land under the proposed private sector development project planned for 2001 should also support improved preservation and management of the environment.

D. Governance Dimensions of ADB Operations

32. The Government has shown a notably increased awareness and commitment towards better governance. This has been supported by ADB-funded PSRP and complementary technical assistance. FSM's extensive and complex system of government can be further rationalized and prioritized through the strategic application of performance budgeting. The ADB program in FSM places emphasis on governance issues as they relate to the application of the law, the pursuit of a balanced regulatory environment, ensuring improved basic social services, corporate governance, and the rights and responsibilities of civil society. Formal public and private systems of accountability still require strengthening.

33. Under country operational strategy, most TAs for the period of 2001~2003 are concentrated on capacity building encompassing economic policy management, budget management, privatization and legal staff training. Particularly, a TA for strengthening state governments is programmed in 2001. A law and governance TA program phased over three years, will commence in 2000 to improve the legal capacity of the states and national government and legislatures, and ameliorate the regulatory environment for private sector development. Another TA program for privatization and corporate governance will contribute to more efficient public services and the withdrawal of government from commercial activities. ADB will also support the strengthening of the capacity of national audit and judiciary staff through its regional technical assistance (RETA).

E. Gender Dimensions of ADB Operations

34. Under the Basic Social Services Project loan, a built-in performance monitoring mechanism on social services will ensure due attention to the needs of women and the poor. Improved governance underpinned by ADB's TA program particularly in the area of economic policy and financial management and basic health and education services will ensure equal opportunity of gender to public services and private sector activities.

F. Private Sector Development

35. In FSM, pressures to create more jobs and business opportunities in the private sector stem from: (i) the decline of the public sector leaving many retiring employees searching for jobs in the private sector, (ii) the decline in household income mainly due to the decreasing external assistance resulting in more demand for formal and informal employment, and (iii) continuing population growth and youthful demographic pattern resulting in a continuously high demand for job opportunities. Private sector-led economic development is a major strategic objective of the country assistance plan. Key policy issues in support of the strategy are the liberalization of factor markets including the removal of restrictive trade and investment practices.

36. A three year-phased Public Enterprise Privatization and Corporate Governance TA coupled with a proposed Private Sector Development Project in 2001 in support of establishing a non-governmental land intermediary agency and improved regulatory environment will assist the Government in achieving this objective. FSM is also planning a Private Investment Symposium in 2000. The symposium aims at brokering specific domestic and foreign ventures based on the recommendations of ADB sponsored second Banking and Private Sector Development Symposium (October 1998). ADB will support the Symposium through the ongoing EMPAT II TA and the proposed privatization TA with possible inputs from a proposed RETA for Financial Sector Study in Selected PDMCs. ADB funded regional agencies including Kula Fund, South Pacific Project Facility (SPPF), and Foreign Investment Advisory Service (FIAS) will also participate in the symposium. Finally, the TA program for law and development and basic skills development (2001) will also contribute to creating a conducive environment of private sector development.

IV. Regional Economic Cooperation

37. The Forum Secretariat indicated its willingness to cooperate with ADB in social sector policy development in health, education and the social impacts of economic reform. A close interaction with the Forum in the sector would also facilitate the proposed Basic Social Services program. Kula Fund, SPPF and FIAS will contribute to the Government's private sector development initiative. Pacific Financial Technical Assistance Centre (PFTAC) will continue to provide short-term advisory and training inputs for strengthening the government capacities in the areas of statistics, tax, banking, and public expenditures management. This will complement the ongoing EMPAT II TA and the proposed statistics TA.

38. An ongoing RETA (RETA No. 5830) for long-term regional training program for members of the South Pacific Association of Supreme Audit Institutions will contribute to strengthening FSM's audit capacity. Another proposed regional TA will conduct the review of the financial sector in FSM, with focus on government-owned development financial institutions and commercial banks. The RETA for Judicial Training cofinanced with UNDP is also expected to contribute to enhancing FSM's capacity in the sector. Finally, the ongoing RETA for the Development of an International Fisheries Agreement in the Conservation and Management of Tuna (RETA No. 5813) is particularly relevant to FSM which possesses major offshore, deep sea marine resources (a major source of foreign exchange), as well as near shore fisheries which are probably the most important natural resource to local communities.

V. Donor Activities and Aid Coordination

39. The major program of external assistance to FSM remains the Compact of Free Association with the Government of the USA. Annual grants of \$60 million for the first five years (1986/87 to 1990/1991) were reduced to \$51 million for the next five years and to \$40 million for the final five years. A wide range of Federal and non-Federal US services and programs of assistance are also available to the governments and to other organizations in the FSM. The US Pacific Islands Training Institute (PITI) also finances the training of accountants and auditors, which will also complement ADB-funded activities. The overall external assistance to FSM is shown in Appendix 3.

40. Japan is the second largest bilateral donor to FSM supplying annual grants of some \$10 million, mainly linked to fisheries agreements. These grants are provided to the four States basically on an annual rotation and have commonly financed the construction of government-owned wharves, port and fisheries infrastructure, and small solar power projects in the outer islands. Japan also provides an annual sum of up to \$1 million for small-scale fisheries projects, and it funds a regional program to repair earlier Japan-funded equipment.

41. Australia provided approximately \$1.3 million equivalent in aid to FSM per year mainly for education and training, and health. Technical advisors to strengthen fisheries monitoring and surveillance in support of the FSM sea patrol program are also funded under Australia's Defense Cooperation Program. Australia's regional Policy and Management Reform Fund also supplies advisory technical assistance complementary to ADB's program. Particularly, assistance for health care policy design and health care financing will contribute to the formulation of state and national health strategy plans to be included in the new Government's Strategic Policy Framework.

42. In addition to its annual Article IV consultations, the International Monetary Fund has given technical assistance in support of ADB-sponsored reforms, mostly in the fiscal area. The World Bank has mounted only a very limited program of assistance in recent years with its bi-annual preparation of a regional report and occasional TA, including advice on fisheries privatization.

43. The United Nations Development Programme (UNDP) previously financed UN volunteer economists and associate experts in economic planning, and two new UNDP funded economists are to be recruited to assist the governments of the two most populous states of Chuuk and Pohnpei. This complements the work of TA No. 3024 (EMPAT II). The UNDP also finances the Micronesian Entrepreneur Development Center project which has successfully helped mitigate the impact of the early retirement schemes under the PSRP. Regional UNDP public sector reform and governance programs also include FSM.

44. The People's Republic of China (PRC) provides small grants, concentrated in the fisheries, health, and education sectors. PRC offers two scholarships each year to FSM for higher education or technical training in the PRC and soft loans for construction projects.

45. Main aid coordination area over the next few years include the health and education sectors under the *Basic Social Services Project* in 2000. Capacity building in core areas of tax, audit, legal sector, and statistics will need continued efforts for aid coordination.

VI. Cofinancing and Catalyzing External Resources

46. Main opportunity for loan cofinancing over the current operational cycle will be explored for the proposed Basic Social Services and the private sector development projects. The enhanced sector policies to be developed under the projects should provide sound and sustainable framework for contributions by other donors primarily to the social sectors. Initial indications are that the new Compact will provide specific funding for health and education based on the progress of the proposed ADB projects.

VII. ADB's Operational Program

47. Over the 2001-2003 period, proposed ADB lending to FSM amounts to about \$12 million for one loan on ADF terms. Such lending level is considered appropriate as FSM's economic reform performance deserves continued ADB lending assistance, and the proposed lending intervention is not expected to unduly strain the country's absorptive capacity. Use of ADF resources for this loan is considered fully appropriate given FSM current severe economic difficulties brought about by a massive public sector restructuring program and significant reductions in Compact funding.

48. The TA program will underpin the three main thrusts of the country program, namely continue to enhance public sector performance, create a more conducive environment for private sector development, and improve basic health and education service in a sustainable manner. Public sector performance improvements will be supported by TAs which will emphasize areas of state governments capacity building, budget management, and fishery resources management. TAs for private sector development will stress areas of land management, law and development, and privatization. The social sector will be assisted through economic sector work, capacity building for statistics compilation and skills development.

49. The proposed loan and TA program over the 2001 – 2003 period is presented in Table 1 and is listed in Appendix 4. Appendix 5 shows proposed lending by poverty classification, crosscutting operational priority, and sector. A project profile for the 2001 loan is in Appendix 6.

Table 1: Lending and Technical Assistance Program, 2000-2003

A. Public Sector Lending Program

	1999 Actual		2000		2001		2002		2003	
	(No.)	(\$ million)	(No.)	(\$ million)	(No.)	(\$ million)	(No.)	(\$ million)	(No.)	(\$ million)
Lending Program	-	-	1	8.0	1	12.0	-	-	-	-
ADF	-	-	1	8.0	1	12.0	-	-	-	-
OCR	-	-	-	-	-	-	-	-	-	-
Lending Pipeline	-	-	-	-	-	-	-	-	-	-
ADF	-	-	-	-	-	-	-	-	-	-
OCR	-	-	-	-	-	-	-	-	-	-

B. Technical Assistance Program

	1999 Actual		2000		2001		2002		2003	
	(No.)	(\$'000)	(No.)	(\$'000)	(No.)	(\$'000)	(No.)	(\$'000)	(No.)	(\$'000)
TA Program	4	1,400.0	3	1,200.0	-	-	-	-	-	-
TA Pipeline	-	-	-	-	3	1,100.0	2	900.0	-	-

VIII. Economic and Sector Work Program

50. ADB has produced a Human Resource Development (HRD) Study for PDMCs in 1995. An HRD study for FSM was also conducted under the Study. Through the 1996 PIER for FSM, a complementary study on the education sector was also carried out. Despite the fact that a general decline of human development status has been observed in FSM, there is however no updated and reliable sector analyses in health and education sector since ADB financed studies. To update and broaden the picture, ADB provided in 1999 a SSTA¹ to assist the preparation of a comprehensive sector study on human resource development.

51. The newly established National Statistics Office (NSO) is not yet in a position to establish a basic compilation system for social indicators.² The need to enhance the institutional capacity of maintaining up-to-date social statistics should be addressed as the FSM government is entering into the re-negotiations of the US Compact Agreement, on which most health and education expenditures are reliant. Accordingly a TA for strengthening the national statistical system was approved in 1999 and will be implemented over the current operational cycle. Finally, preparation of a new PIER for FSM will be carried out during the program period.

IX. Local Cost Financing

52. FSM's ability to finance local cost of ADB projects remains limited due to financial constraints arising from decline in Compact funding. The constraints are more significant at the individual state level than at the overall national aggregate as a result of budgetary allocation between the state and national government and the priorities set by each state. The FSM and states governments, nevertheless, continue to finance portions of local costs for advisors and other externally funded priority programs. The Government is considering ceiling for external debts based on its ability to meet the debt service and corresponding counterpart funding requirements. Over the medium to long term domestic resource mobilization measures, improved public expenditure management, and other fiscal reforms being introduced should improve the tight budgetary situation and allow for a gradual increase in local cost financing by the Government.

¹ TA No 3195 approved on 14 May 1999.

² A TA for strengthening the National Statistics Office was approved in 1999, which will focus on the real sector related statistics. Possible IMF's assistance to complement the TA project will cover government finance and banking sector.

**FEDERATED STATES OF MICRONESIA
COUNTRY PERFORMANCE INDICATORS**

Item	1995	1996	1997	1998	1999	2000 ^a
ECONOMIC INDICATORS						
A. Income and Growth						
1. GDP per Capita (dollars, current)	1,925	1,913	1,813	1,734	...	...
2. GDP Growth (% in constant prices)	1.6	0.7	-4.2	-0.8	0.3	...
Agriculture	...	...	...	...	...	...
Industry	...	...	...	...	...	...
Services	...	...	...	...	...	...
B. Saving and Investment (current market prices) (percent of GDP)						
1. Gross Domestic Investment	...	...	...	...	...	...
2. Gross Domestic Saving	...	...	...	...	...	...
C. Money and Inflation (annual percent change)						
1. Consumer Prices (annual average)	4.0	4.0	3.0	3.0	2.6	...
2. Broad Money (M2)	...	...	...	...	...	...
D. Government Finance (US\$ million)						
1. Total Revenue	172.5	80.5	64.8	161.0	...	...
(Less Grants)	-60.2	-68.4	-65.8	-68.8	...	...
2. Total Expenditure and Net Lending	169.1	163.5	154.2	160.3	...	...
3. Overall Surplus/Deficit (-)	3.4	14.8	3.1	0.7	...	...
(Less Grants)	-52.9	-44.2	-41.5	-43.0	...	...
E. Balance of Payments						
1. Merchandise Trade Balance (% of GDP)	-36.7	-27.4	-24.2	-24.0	...	...
2. Current Account Balance (% of GDP)	22.3	28.6	30.0	31.4	...	...
3. Export (\$) growth (annual percent change)	-26.1	-34.7	3.1	-3.0	...	...
4. Import (\$) growth (annual percent change)	-22.2	-26.8	-6.7	-2.4	...	...
F. External Payments Indicators						
1. International Reserves (billion dollars, end of period)	...	...	...	61.7	...	...
- months of imports	...	...	...	9.0	...	...
2. External Debt Service (% of exports of goods & services)	21.4	25.3	25.8	26.8	25.0	...
3. External Debt (% of GDP)	54.0	44.0	52.3	43.0	38.0	...
Memorandum Items:						
GDP (US\$ million)	205.8	215.5	213.0	212.7	...	...
GNP (US\$ million)	...	...	...	...	...	...
Exchange Rate	1.0	1.0	1.0	1.0	1.0	...
Population (million)	...	...	...	...	...	...

^a Estimate

¹ Fiscal year ends on 30 September.

Source: IMF, International Financial Statistics and Government Estimates

**FEDERATED STATES OF MICRONESIA
COUNTRY PERFORMANCE INDICATORS**

	1985	1990	1998
POPULATION INDICATORS			
Total Population (thousands)	73.2	95.7	114.1
Annual Population Growth Rate (% change)	2.3	0.1	2.1 (1990-98)
SOCIAL INDICATORS			
Total Fertility Rate (births per woman)	7.4	...	5.0
Maternal Mortality Rate (per hundred thousand live births)	...	...	...
Infant Mortality Rate (below 1 year; per '000 live births)	48.0	46.0	46.0
Life Expectancy at Birth (years)	65	65.0	66.0
Female	...	...	67.0
Male	...	...	63.0
Adult Literacy (%)	89.0	...	71.0
Primary School Enrollment (% of school age population)	...	...	83.0
Female	...	...	83.0
Secondary School Enrollment (% of school age population)	...	...	44.0
Female	...	...	43.0
Child Malnutrition (% of under age 5)	...	...	15.0
Population Below Poverty Line (%)	...	...	...
Income Ratio of Highest 20% to Lowest 20%	...	...	...
Population with Access to Safe Water (%)	90.0	...	44.0
Population with Access to Sanitation (%)	8.0	...	51.0
Public Education Expenditure as % of GNP	...	6.9	0.4
Public Health Expenditure as % of GDP	...	8.3	...
Human Development Index	...	...	0.569
Human Development Ranking	...	...	120.0
Human Poverty Index	...	...	26.7
ENVIRONMENTAL INDICATORS			
Forestry			
Deforestation			
Total Area	...	...	...
Annual deforestation	...	...	...
Biodiversity			
Nationally protected area			
Area	...	...	...
Number	...	...	...
As % of land area	...	...	...
Biosphere reserves			
Area	...	...	...
Number	...	...	...
World Heritage sites (number)	...	...	...
Wetlands of international importance			
Area	...	...	...
Number	...	...	...
Land Use			
Cropland; permanent pasture	...	...	...
Air Pollution (Ambient concentrations)			
Particulates	...	...	...
SO ₂	...	...	...
Water Pollution (concentration of pollutants in water bodies)			
Biochemical Oxygen Demand (BOD)	...	...	...
Chemical Oxygen Demand (COD)	...	...	...
Global Environmental Problems			
CO ₂ emissions (total and per capita)	...	...	...

FEDERATED STATES OF MICRONESIA

PORTFOLIO PERFORMANCE

**Table 1 : Implementation, Disbursement Performance and Postevaluation Results
Public Sector Projects only
(as of 31 December 1999)**

A. Project Portfolio	Net Loan Amount \$ million %		Rating (No.) ^a									
			Total		Implementation Progress				Development Objectives			
			No.	%	HS	S	PS	U	HS	S	PS	U
Agriculture and Natural Resources	6.36	18.7	1	50.0	0	0	0	1	0	1	0	0
Energy	0.00	0.0	0	0.0	0	0	0	0	0	0	0	0
Finance and Industry	17.68	52.1	0	0.0	0	0	0	0	0	0	0	0
Social Infrastructure	9.92	29.2	1	50.0	0	1	0	0	0	1	0	0
Transport and Communications	0.00	0.0	0	0.0	0	0	0	0	0	0	0	0
Others/Multisector	0.00	0.0	0	0.0	0	0	0	0	0	0	0	0
Total	33.96	100.0	2	100.0	0	1	0	1	0	2	0	0

B. Disbursements	OCR	ADF	Total
(1) Total funds available for withdrawal (\$ mn, active loans only)	0.0	34.5	34.5
(2) Disbursed amount (\$ mn, cumulative, active loans only)	0.0	18.0	18.0
(3) Percentage disbursed [(2)/(1)] (%)	0.0	52.00	52.0
(4) Disbursements (\$mn, active loans only, latest year)	0.0	6.3	6.3
(5) Disbursement ratio (%) ^b	0.0	29.00	29.0

C. Net Transfer of Resources ^c (\$ million)	OCR	ADF	Total
Net transfer in 1995	0.0	0.3	0.3
Net transfer in 1996	0.0	0.1	0.1
Net transfer in 1997	0.0	11.3	11.3
Net transfer in 1998	0.0	6.2	6.2
Net transfer in 1999	0.0	0.0	0.0

D. Post-Evaluated Projects (By Year of Approval)	1968 - 1977		1978 - 1987		1988 - 1999		1968 - 1999			
	No.	%	No.	%	No.	%	No.	%		
1. Postevaluation Rating (as of 31 December 1999)										
Rated Generally Successful (GS)	0	-	0	-	0	-	0	-		
Rated Partly Successful (PS)	0	-	0	-	0	-	0	-		
Rated Unsuccessful (US)	0	-	0	-	0	-	0	-		
No Rating	0	-	0	-	0	-	0	-		
Total	0	0.0	0	0.0	0	0.0	0	0.0		
2. Postevaluation Rating by Sector 1968-99 (as of 31 December 1999)										
	GS		PS		US		NR		Total	
	No.	%	No.	%	No.	%	No.	%	No.	%
Agriculture and Natural Resources	0	-	0	-	0	-	0	-	0	-
Energy	0	-	0	-	0	-	0	-	0	-
Finance and Industry	0	-	0	-	0	-	0	-	0	-
Social Infrastructure	0	-	0	-	0	-	0	-	0	-
Transport and Communications	0	-	0	-	0	-	0	-	0	-
Others/Multisector	0	-	0	-	0	-	0	-	0	-
Total	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0

^a HS: Highly satisfactory; S: Satisfactory; PS: Partially satisfactory; U: Unsatisfactory

^b Ratio of disbursement during the year over the undisbursed net loan balance less cancellations at the beginning of the year. Effective loans during the year have also been added to the beginning balance of undisbursed loans.

^c Includes private sector projects for countries with private sector operations.

**FEDERATED STATES OF MICRONESIA
PORTFOLIO PERFORMANCE
Table 2: Status of Project Implementation
Public Sector Projects Only
(As of 31 December 1999)**

Sector ^a	Project Title	Net Loan Amount		Approval Date (mm/yy)	Effectivity Date (mm/yy)	Closing Date		Project Progress (% complete)	Cum Contract Awards (\$ million)	Cummulative Disbursement (\$ million)	Project Performance Rating ^b	
		OCR (\$ million)	ADF			Original (mm/yy)	Revised (mm/yy)				Implementation Progress	Development Objective
AGR	Fisheries Development Loan 1257-FSM(SF)		6.4	Oct-93	Sep-94	Dec-98	Dec-99	20	3.687	3.687	U	S
SOC	Water Supply and Sanitation Loan No. 1459-FSM(SF)		10.2	Sep-96	Oct-97	Oct-00	-	5	1.103	0.614	U	S
OTH	Public Sector Reform Loan No. 1520-FSM(SF)		17.9	Apr-97	Jun-97	May-99	-		14.000	14.000	S	S
Total		0.0	34.5						18.8	18.3		

^a Sector:

AGR: Agriculture & Natural Resources

ENE: Energy

F&I: Finance and Industry

SOC: Social Infrastructure

T&C: Transport and Communications

OTH: Others/Multisector

^b HS: Highly satisfactory; S: Satisfactory; PS: Partially satisfactory; U: Unsatisfactory

FEDERATED STATES OF MICRONESIA
OVERALL EXTERNAL ASSISTANCE
(in \$ million)

External Source	Past 3-5 Years (annual average)		1999 Approvals	
	Loan/Credit	TA	Loan/Credit	TA
A. Multilateral Assistance				
ADB	9.8	2.8	...	1.3
UNDP	...	0.8	...	...
World Bank	...	1.4	...	0.5
Subtotal	9.8	5.0	0.0	1.8
B. Bilateral Assistance				
Australia	...	1.3	...	1.3
Canada	...	...	...	...
France	...	...	...	...
Germany	...	...	...	...
Italy	...	...	...	...
Japan	...	10.0	...	10.0
United Kingdom	...	...	...	...
United States	...	40.0	...	70.0
Subtotal	0.0	51.3	0.0	81.3
Total	9.8	56.3	0.0	83.1
Memo Items:				
External Assistance as % of Current Expenditures				
External Assistance as % of Capital Expenditures				

Sources: POHQ estimates.

FEDERATED STATES OF MICRONESIA
LENDING PIPELINE AND TECHNICAL ASSISTANCE PROGRAM, 2001-2003

Sector/Project Name	Poverty Classification ^a *	Crosscutting Operational Priority ^b *	Responsible Division	Year of PPTA	PROJECT COST (in \$ million)					
					TOTAL	Bank			Gov't	Cofinancing (Others)
						OCR	ADF	Total		
2001 FIRM LOANS										
Finance and Industry										
1 Private Sector Development	ODI	PSD	POHQ		12.0	0.0	12.0	12.0		
<i>Subtotal</i>					12.0	0.0	12.0	12.0	0.0	0.0
Total					12.0	0.0	12.0	12.0	0.0	0.0
2002 LOAN PIPELINE										
NONE IDENTIFIED										
2003 LOAN PIPELINE										
NONE IDENTIFIED										

^a CPI = Core Poverty Intervention; PI = Poverty Intervention; ODI = Other Development Interventions

^b ENV = Environmental Protection; GAD = Gender and Development; GG = Good Governance; HD = Human Development; PSD = Private Sector Development and RC = Regional Cooperation

* This classification was completed prior to the finalization of the improved and redesigned classification system in December 2000, which will be applied from January 2001.

**FEDERATED STATES OF MICRONESIA
LENDING PIPELINE AND TECHNICAL ASSISTANCE PROGRAM, 2001-2003**

Sector/Project Name	Responsible Division	Type of TA	Amount (\$ '000)		
			ADB	Others	Total
2001 TECHNICAL ASSISTANCE PROGRAM					
Social Infrastructure					
1 Basic Skills Development	POHQ	AD	400.0		400.0
	Subtotal		<u>400.0</u>	<u>0.0</u>	<u>400.0</u>
Others/Multisector					
2 State Government Capacity Building I	POHQ	AD	500.0		500.0
3 Private Sector Development	POHQ	AD	200.0		200.0
	Subtotal		<u>700.0</u>	<u>0.0</u>	<u>700.0</u>
Total			1,100.0	0.0	1,100.0
2002 TECHNICAL ASSISTANCE PROGRAM					
Others/Multisector					
1 Public Enterprises Privatization and Corporate Governance III	POHQ	AD	400.0		
2 State Government Capacity Building II	POHQ	AD	500.0		500.0
	Subtotal		<u>900.0</u>	<u>0.0</u>	<u>500.0</u>
Total			900.0	0.0	500.0
2003 TECHNICAL ASSISTANCE PROGRAM					
NONE IDENTIFIED					

FEDERATED STATES OF MICRONESIA
LENDING PROGRAM, 2001-2003
BY POVERTY CLASSIFICATION, CROSSCUTTING OPERATIONAL PRIORITY AND SECTOR

Classification	2001 (Firm)		2002-2003	
	No.	%	No.	%
I. By Poverty Classification*				
A. Core Poverty Intervention	0	0.0	0	0.0
B. Poverty Intervention (Non-core)	0	0.0	0	0.0
C. Other Development Interventions	1	100.0	0	0.0
Total		100.0	0	0.0
II. By Crosscutting Operational Priority				
A. Environment	0	0.0	0	0.0
B. Gender and Development	0	0.0	0	0.0
C. Good Governance	0	0.0	0	0.0
D. Human Development	0	0.0	0	0.0
E. Private Sector Development	1	100.0	0	0.0
F. Regional Cooperation	0	0.0	0	0.0
Total	1	100.0	0	0.0
III. By Sector				
A. Agriculture and Natural Resources	0	0.0	0	0.0
B. Energy	0	0.0	0	0.0
C. Finance and Industry	1	100.0	0	0.0
D. Social Infrastructure	0	0.0	0	0.0
E. Transport and Communications	0	0.0	0	0.0
F. Others/Multisector	0	0.0	0	0.0
Total	1	100.0	0	0.0

* This classification was completed prior to the finalization of the improved and redesigned classification system in December 2000, which will be applied from January 2001.

FEDERATED STATES OF MICRONESIA

PROJECT PROFILE				
1. Project Name: Private Sector Development		2. Sector/Subsector: Others		
3. Poverty Classification: ^a ODI		4. Crosscutting Operational Priority: ^b PSD		
5. Rationale & Objectives: FSM urgently needs to transform the aid dependent and public sector dominant economy into a more self-reliant and sustainable economy led by the private sector.		6. Beneficiary Participation/Consultation Needs: Most beneficiary groups will be represented at the proposed private sector development council that will overview the progress of the program.		
7. Scope: The Project will: (i) enhance the institutional capacity of the national and state governments in land administration and management, (ii) improve the vocational training schemes, (iii) improve financial support to small and medium enterprises, (iv) strengthen business and entrepreneurial development support, and (v) improve the policy and regulatory environment for private sector development.				
8. Estimated Cost & Financing Plan:			Remarks:	
Loan Project Cost (\$m)				
Financing (Source)	FC	LC		Total
ADB				12.0
Co-financing				
Borrower				
Sub-borrowers				-
Total				12.0
9. Estimated Benefits and Beneficiary Groups: Private sector and eventually all population of FSM.				
10. Executing Agency: Department of Economic Affairs		11. Project Implementation Period: Start: TBD End: TBD		
12. Environment Category: B		13. Processing Year: 2001		

^a CPI = Core Poverty Intervention; PI = Poverty Intervention; ODI = Other Development Interventions.

^b ENV = Environmental Protection; GAD = Gender and Development; GG = Good Governance; HD = Human Development; PSD=Private Sector Development and RC = Regional Cooperation

* This classification was completed prior to the finalization of the improved and redesigned classification system in December 2000, which will be applied from January 2001.