

THE 5TH CONSULTATIVE GROUP MEETING (CGM) FOR THE FEDERATED STATES OF MICRONESIA (FSM)

I. Introduction

1. The 5th CGM was held after a gap of over six years, following the 4th CGM in Manila in February 2000. FSM had initially requested ADB assistance in preparing for a CGM in 2005, however funding and scheduling issues delayed the holding of the CGM until 8 November 2006.
2. ADB supported FSM in its preparations for the CGM by providing a macroeconomist to assist in preparation of background documents and statements. This assistance acted to ensure the national and four state governments all had the opportunity to contribute to FSM's preparation for the CGM. This whole-of-government interest in the CGM was also reflected in the representation of all states, three at the Lieutenant Governor level, in the FSM's delegation.
3. Representatives of participating countries and development partners¹ attended the CGM sessions. They shared their views on development progress to date, macroeconomic management, and challenges to future growth. The CGM ended with a session to finalize the joint Communiqué, which was released after the CGM.
4. The Meeting consisted of four sessions: FSM's Strategic Development Plan 2004-2023; The Economic Outlook for FSM; Donor Statements of Strategy; and Thematic Discussions. There was no pledging session, although a number of development partners confirmed their priority areas for assistance in FSM. For the first time thematic sessions were added to the CGM, with the intent of deepening participant discussion on key development issues. This occurred, but the extent to which these issues were linked to a clear and coordinated donor plan to redress the identified development challenges was limited by the inability of some key donors to attend.
5. This Board Information Paper is a report on the proceedings of the CGM. The press release issued by ADB is in Attachment 1, while the Communiqué issued at the conclusion of the CGM is in Attachment 2.

II. Development Progress

A. Strategic Development Plan

6. FSM's Strategic Development Plan (SDP) was envisaged to lead to sustained growth over the period 2004 to 2023 and its development involved comprehensive consultation. The core components of the SDP included macroeconomic stability, good governance, development of an outward oriented, private sector led economy, investment in human resource development; investment in infrastructure, and ensuring long term sustainability by addressing environmental, social and intergenerational equity

¹ Representatives of the Governments of France and the United States of America attended the Meeting. The International Finance Corporation (IFC), International Monetary Fund (IMF), Pacific Islands Forum Secretariat (PIFS), United Nations Economic, Social and Cultural Organization (UNESCO), and World Health Organization (WHO) were also represented, in addition to ADB.

issues. Agriculture, fisheries and tourism were identified as priority sectors for development.

7. Overall progress in implementing the SDP has been very slow. A large part of the problem relates to weaknesses in coordination, capacity and communication with respect to key government departments. There is generally very limited capacity across most sectors and governments to formulate policies and plans, establish priorities, consult effectively, monitor and document progress in implementation and to resolve problems. Further, many government agencies have struggled to understand the financing and reporting requirements of the amended Compact arrangements and this has delayed the financing of SDP implementation.

8. There had been some positive developments in SDP implementation, such as initial progress on tax reform and financial administration, secured transactions legislation, curriculum development, and meeting textbooks standards.

9. The Government did not foresee effective progress in SDP implementation without both a commitment by all governments in the FSM to implement the SDP and a comprehensive and well-coordinated package of external assistance. The Government noted the level of TA required far exceeded available Compact resources and highlighted the following broad areas for assistance:

- (i) Private sector, specifically assistance in land registration and markets, public enterprise reforms, and for ADB to examine outcomes from the private sector development loans and build on these.
- (ii) Public sector, specifically a review of the structure, functions and cost of government with a detailed roadmap on how to restructure these, an institutional capacity building roadmap, and other related capacity building.
- (iii) Sector specific needs in agriculture, fisheries, tourism, environment, health, education, gender and social development, infrastructure, and trust funds.

10. To enhance the impact of additional assistance, the Government intends to strengthen efforts to monitor progress in SDP implementation; and strengthen donor coordination and oversight of external assistance.

B. Economic Outlook

11. Long term economic performance in FSM has been poor. There has been a decline in real GDP per capita since 1995 in all States, except Yap. This decline has become more significant since 2003 in Chuuk and Kosrae. FSM has experienced a decline in overall employment since 1995, while there has been poor growth in employment since 2003 in all sectors except wholesale and retail trade and government.

12. Some pressure has been eased by a slowing in the growth of the population reflecting increasing emigration to neighboring US territories and the US mainland. Nonetheless, FSM achieved only modest growth in 2005 and the economy had since contracted. The Government considers the current weakness in the economy reflects the reduction in Compact funding, the failure to utilize infrastructure funding, inadequate budgeting and planning, and the impact of higher energy prices.

13. Inflationary pressures have also been building, although the overall inflation rate for FSM was still below 5 per cent in early 2006. Overall economic weakness is

expected in the period 2006 to 2008, reflecting pressures related to reduced government expenditure.

14. FSM receives significant levels of development assistance (over 60% of government revenue comes in the form of grants). Unfortunately, utilization of this assistance has been characterized, in part, by limited financial responsibility, limited monitoring of performance, distortion of decision making, reliance on the public sector, reduced pressure for raising domestic revenue, and no strong pressure for policy change.

15. Efforts have been made to redress some of these problems. Elements introduced in Compact II, such as the shift to a trust fund and the requirement for a government contribution to the infrastructure maintenance fund, are designed to promote self-sufficiency and government ownership. Compact II also promotes a greater focus on financial and performance monitoring to strengthen development outcomes.

16. In terms of immediate challenges, the Government emphasized the uneven fiscal discipline across States. Recent fiscal deficits have led to a substantial draw down in reserves, so that only Yap now has a reasonable level of unrestricted financial reserves. In Chuuk, there are no reserves and government arrears have climbed to over 40 per cent of GDP. There are also no reserves in Kosrae and Pohnpei and the National Government's reserves are less than 2 per cent of GDP.

17. A comprehensive set of reform measures are needed to avoid the dire financial situation that some of the states are facing and that others could potentially face in the medium-term. While a fiscal adjustment and transition plan has been developed, the central feature of this is tax reform, which will take some time to effect. Measures are needed in the short term to manage the potential financial crisis.

18. The adjustments that lie ahead suggest that the FSM economy as a whole will continue to face important budgetary and economic development constraints over the medium and longer term. It is also unlikely to be the case that the economy can be self reliant on future trust fund income given the planned contributions.

C. Discussion

19. The meeting noted that, despite large per capita assistance, economic and social development had not been as hoped. Many issues discussed in the 2000 CGM remained current - the need to consolidate public sector reforms, to move forward on tax reforms, to improve public services (health and education), strengthen accountability and transparency, strengthen capacity, and to create a supportive environment for private sector development. The Delegates stressed the ongoing importance of addressing these core issues.

20. While the Meeting recognized the Government's request for additional donor assistance, it was considered that further prioritization by the Government was necessary to allow for effective sequencing and targeting of assistance. The meeting noted the contradiction between the clear lack of people with the capacity to undertake priority tasks and the fiscal pressures to downsize the public sector. The areas where trained people need to be added or cut to balance the budget needed to be carefully prioritized.

21. The Meeting urged that aid effectiveness be improved. FSM's smaller donors recognized they could add value by acting as catalysts in areas in which they had a comparative advantage, thereby increasing the effectiveness of use of Compact funds. Assistance was offered to FSM to improve its aid coordination mechanisms.

22. More than additional financial and technical assistance are needed to respond to FSM's pending fiscal crisis. The appetite for reform needs to be developed, so that the painful decisions government has to take are widely understood and supported. Consultative and participatory processes need to be utilized to support social change and adaptation.

II. Development Partner Statements

23. Several partners noted their intent to strengthen involvement in their areas of expertise in the northern Pacific, which gave potential for additional assistance to FSM. Much of this would be in the form of technical assistance.

24. The Government noted the importance of the support of all of FSM's development partners, in order to achieve the sustained growth espoused in the SDP. The Government also noted that the regionally-developed objectives and program of actions in the Pacific Plan, endorsed by the leaders of the sixteen Forum island countries in October 2005, were seen as a supplement to the SDP.

III. Thematic Discussions

A. Governance

25. Issues discussed included the governance difficulties arising from the federal nature of FSM and the relationship this created between the national and state governments. The added layer of coordination with municipal government was also noted. Clear communication between levels of government was considered important to good governance.

26. There was a recognition of the need to improve national/state coordination and cooperation. Development partners noted the importance of involving states at the early stages of discussing assistance in sectors where state governments are responsible for implementation (such as education and health). Such consultation needed to occur in a coordinated manner and involve national government.

27. The Meeting considered the population had a good understanding of local governance but this was weaker regarding national issues. Improved communication and greater consultation and participation were seen as central to improved governance. There is a need for a concerted effort to raise public awareness and understanding of reform priorities and development objectives.

28. Strengthening performance-based budgeting and results monitoring was seen as a key element of improved governance. It was noted that performance indicators needs to be widely used, for example legislators need to be kept aware of developments.

B. Private Sector Development

29. Delegates noted there had been some difficulties in implementation of private sector development activities, due to the unwillingness and inability of some states to take practical action in terms of policy and legislative change. Some considered there had been a backtracking in government commitment to reform which was enabled by a lack of domestically generated pressure for change, the protectionist attitude of some existing businesses, and the seemingly entrenched public view that the role of government was to create jobs rather than to foster investment.

30. The Government expressed its resolve to improve the business climate in support of private sector development and highlighted tax reform as a serious undertaking in this area. It noted that the foreign investment regime had improved over the past decade, although progress varied across states.

31. The Government considered that there may be a misconception among the existing private sector, which appeared to fear direct competition with foreign investors. Direct foreign investment should be targeted towards export-oriented productive sectors and as such would not compete with the existing private sector. Some delegates raised concerns about the potential for inefficiencies to be introduced into the economy through use of industrial targeting.

32. The importance of donor assistance in supporting private sector development was recognized by Government with further assistance being particularly required in the areas of tax reform, public enterprise reform, and some areas of land registration.

Attachments:

1. ADB Press Release
2. CGM Communiqué
3. ADB Donor Statement

ADB PRESS RELEASE 9 November 2006**Donors Stress Reforms Needed to Boost Results in Micronesia**

MANILA, PHILIPPINES – Donors this week called for reforms to be stepped up in the Federated States of Micronesia (FSM) to assure greater progress in future assistance programs.

Development partners and officials from FSM met at ADB Headquarters in Manila to discuss ways to overcome constraints to achieving better results from development assistance.

Talks at the fifth Consultative Group meeting for FSM focused on advancing good governance, increasing aid effectiveness, promoting macroeconomic stability and ensuring long-term sustainability, creating the environment for private sector led growth, and providing basic social services.

FSM continues to rely heavily on foreign aid, particularly from grants provided by the United States government under the Compact of Free Association approved in 1986.

The FSM delegation, led by Vice-President Redley Killion, highlighted its efforts to plan and carry out policies and programs in the light of reducing funds from the Compact. The delegates recognized that there were weaknesses in external and internal coordination, capacity and communication, and slow implementation of infrastructure development projects.

They stressed that a comprehensive and well-coordinated package of assistance was essential, and should comprise a combination of financial and technical assistance.

Development partners noted that significant levels of assistance are received by FSM, but previous programs have not always achieved their objectives.

They urged the Government to demonstrate its commitment to achieving improved results through speedier reforms to:

- Promote more effective donor coordination
- Improve national/state coordination and cooperation
- Strengthen the focus on performance-based budgeting and results monitoring
- Provide appropriate counterparts and financial contributions to development partner supported activities
- Improve the climate for business, including foreign investment
- Raise public awareness and understanding of reform priorities and development objectives.

In considering FSM's development priorities, development partners committed to improved coordination, with a particular focus on supporting the use of Compact funds and US grant assistance, to push faster progress in the country's Strategic Development Plan.

Consultative Group meetings are held to enable the international donor community to coordinate assistance to a developing country in line with the country's own national development priorities.

Participating development partners this week included ADB, France, United States, International Finance Corporation, International Monetary Fund, Pacific Islands Forum Secretariat, United Nations Educational, Scientific and Cultural Organization, and the World Health Organization.

ADB's strategy in the FSM focuses on three broad objectives: good governance, social service development, and pro-poor economic growth. Since joining ADB in 1990, FSM has received more than \$97 million in assistance, comprised of eight loans, worth more than \$75 million, and 40 technical assistance programs worth \$23.28 million.

FEDERATED STATES OF MICRONESIA CONSULTATIVE GROUP COMMUNIQUÉ

DEVELOPMENT PARTNERS CRITICALLY REVIEW FEDERATED STATES OF MICRONESIA'S DEVELOPMENT PLAN

The progress and problems encountered in implementing the Strategic Development Plan 2004-2023 were presented by the Federated States of Micronesia (FSM) at the fifth Consultative Group meeting with development partners at the Asian Development Bank in Manila, on 8 November 2006. The FSM delegation was led by His Excellency Vice President Redley Killion.

FSM highlighted efforts through the Strategic Development Plan to plan and implement policies and programs to enhance their development and to adjust to a situation of reducing Compact funds. FSM recognized weaknesses in external and internal coordination, capacity and communication and slow implementation of Infrastructure Development Projects has constrained progress in implementation of the Strategic Development Plan. FSM urged that a comprehensive and well-coordinated package of assistance was essential, and should comprise a combination of financial and technical assistance. The development partners were presented with a list of sector-specific requests for technical assistance that the FSM considered necessary for more effective implementation of SDP.

Development partners noted the significant levels of development assistance which are received annually by FSM. Together, with FSM, they sought to identify binding constraints which need to be overcome to translate this financial assistance into sustained development outcomes. It was suggested, given the long list of assistance requests, that prioritization of needs would be important.

Key constraints to development were considered to be lack of capacity within the national and state governments, weaknesses in national/state government and donor coordination and cooperation, and limited domestic revenue generation. These factors hampered essential public sector reforms and the creation of an environment conducive to private sector growth.

Development partners noted that past assistance programs have not always achieved their objectives, and emphasized that reforms are needed to assure progress in any future assistance programs. Specifically, development partners urged the government to demonstrate its commitment to achieving improved development outcomes through taking steps to: promote more effective donor coordination; improve national/state coordination and cooperation; strengthen the focus on performance-based budgeting and results monitoring; provide appropriate counterparts and financial contributions to development partner supported activities; improve the climate for business, including foreign investment; and raise public awareness and understanding of reform priorities and development objectives. FSM recognized that an improvement in the implementation of existing projects would facilitate additional financial support from development partners.

Development partners welcomed the statements of commitment from FSM to implement the Strategic Development Plan and noted the specific requests for

assistance. FSM noted an immediate priority for capacity support was in the area of financial management, economic policy and planning. In considering FSM's development priorities, development partners committed to improved coordination, with a particular focus on facilitating and supporting the use of Compact funds and US grant assistance, so as to progress implementation of the Strategic Development Plan. Furthermore, development partners committed to working towards supporting FSM to consolidate economic reforms for effective implementation of the SDP through a comprehensive and well-coordinated package of assistance.

The development partners at the meeting comprised Asian Development Bank; France; the International Finance Corporation; the International Monetary Fund; Pacific Islands Forum Secretariat; the United Nations Educational, Scientific and Cultural Organization; the United States; and the World Health Organization.

ASIAN DEVELOPMENT BANK**DONOR STATEMENT****FEDERATED STATES OF MICRONESIA CONSULTATIVE GROUP MEETING
8 November 2006**

ADB has been involved in supporting FSM for more than two decades, and our strategy is summarized in *Country Strategy and Program Update: Federated States of Micronesia 2006-2007*. This strategy is consistent with our *Pacific Strategy for the Asian Development Bank 2005-2009* and supports the areas of good governance, inclusive social development, and pro-poor economic growth.

In the Federated States of Micronesia, we have two-pronged strategy.

Firstly, to improve the performance of ADB's ongoing portfolio. This portfolio consists of four ongoing projects and one major technical assistance. These projects which are not doing well, are at risk or on the verge of being at risk, relate to basic social services, private sector development, and infrastructure. The technical assistance being provided is on the implementation of the public sector capacity building road map. Our approach moving forward is to improve the performance of the portfolio and align these projects better with assistance provided to the country through Compact.

Secondly, to look to support activities which show immediate results. For our future program, we have decided to pull back our assistance in FSM due to poor portfolio performance during the last several years. In doing so, we have chosen to be slightly conservative in our program, as a result, we are expecting to approve only one TA for 2007. This can change, subject to portfolio performance, greater demonstration of commitment to reform and improvement to coordination between national and state governments (a major obstacle to major portfolio performance).

With this, we look forward to greater effective involvement in supporting the country.