

Chapter 1. Introduction

The Federated States of Micronesia (FSM) attained self-government in 1979 when four of the seven districts comprising the Trust Territory of the Pacific Islands ratified the Constitution of the Federated States of Micronesia. Under the newly-formed federation, the former Trust Territory districts became the States of Chuuk, Kosrae, Pohnpei, and Yap. Negotiations on the terms of a Compact of Free Association between the US and the Congress of Micronesia (then representing all seven districts of the Trust Territory) began in 1967. In 1986, the Compact was finally implemented and the United Nations Trusteeship of the Pacific Islands administered by the US was formally ended. United Nations' acknowledgment of the Compact of Free Association signaled formal international recognition of the FSM as a sovereign nation.

The FSM is situated in the western Pacific Ocean, extending from 135° to 165° east longitude and 1° south to 14° north latitude. The FSM includes more than 600 small islands historically known as the Caroline Islands. The geographic dispersion of the islands has resulted in an Exclusive Economic Zone (EEZ) of approximately 1.0 million square miles, giving the FSM one of the largest tuna fisheries in the Pacific. While the FSM is comprised of numerous islands, the total land area is only about 271 square miles.

The FSM population is small and dispersed. Only the state capital islands include urban areas. Statistics on population, population density, and economically active population by State in 2000 are given in Table 1.

Table 1. Population, Population Density and Economically Active in FSM: 2000

Area	Population	Population Density	Employed
Chuuk State	53,595	1,094	11,979
Kosrae State	7,686	179	1,864
Pohnpei State	34,486	261	10,368
Yap State	11,241	244	4,964
FSM Total	107,008	395	29,175

Source : FSM (2000) Census of Population and Housing.

Notes : (1) Population density is number of residents per square mile.

(2) Employed in formal employment, self-employment and economically active in subsistence production.

The discovery of the Caroline Islands by the West occurred in the early 1500s with first contact made by Spanish and Portuguese explorers. However, it was not until the early 1800s that the many island groups and distinct cultures of the Caroline Islands were in frequent contact with foreigners. These contacts were mainly with European traders interested in goods destined for the Asian markets. German traders established the copra trade in the mid-1850s and came to dominate commerce through their control of this industry despite Spain's established colonial control over the Caroline Islands. Spanish colonial rule from 1885 to 1898 ended when they sold the Caroline Islands to Germany after their defeat in the hands of the Americans and the subsequent relinquishing of the Philippines and Guam.

German colonial rule of the Caroline Islands lasted until World War I. With the tacit agreement of Great Britain, Japanese naval forces quickly captured the Northern Marianas, Marshall, and Caroline Islands in 1914. At the end of WWI, the League of Nations mandated the Pacific Islands of Micronesia, including the Caroline Islands to Japan which remained as an occupying power until the end of World War II.

Fisheries and agricultural production, including the cultivation of rice, was substantial and contributed to the Japanese empire and war effort in WWII. At the end of the war, American military forces took control of Micronesia and in 1947 the United Nations established the Trust Territory of the Pacific Islands, which was placed under American administration.

The long colonial period that lasted a century under four different foreign powers provided little opportunity for Micronesians to develop the administrative, technical, and commercial skills needed to govern a nation in the twentieth century. Despite American efforts in the 60s and 70s to institute education, healthcare and infrastructure systems, much remained to be done in terms of building an economy that could stand on its own. With this recognition on the part of both Micronesian and US negotiators, economic assistance was inevitably one of the key elements of the negotiations on the political relationship to be established upon termination of the Trusteeship.

The Congress of Micronesia was established in 1965 to represent the different island groups comprising the Trust Territory in negotiating with the US on the future political relationship that was to be formed. Early on, most of the Trust Territory Districts decided on a "freely associated" relationship with the US. However, it took nearly 20 years for the districts comprising the FSM to negotiate the Compact of Free Association. The Compact accomplished several important objectives including: (a) defining the freely associated political relationship that recognized the FSM as an independent sovereign

nation, with national security being guaranteed by the US; (b) enabling FSM citizens the right to reside and work in the US and its territories without any restrictions; and, (c) providing an economic aid package of annual grant assistance and access to a range of stipulated US Government services (e.g., US Postal Service, weather service, Federal Deposit Insurance Corporation program), and federal grant programs.

The Compact economic assistance package was committed by the US for a period of 15 years, from 1987 to 2001. An additional two years economic assistance was stipulated, provided negotiations towards a new compact agreement were in progress. The overall economic assistance actually received by the FSM in the period 1987-2003 was about \$2.1 billion in 2003 dollar terms, including grant aid from non-US multi- and bilateral donors.

As provided in the Compact, negotiations towards an amended or second Compact agreement began in 1999. The negotiations for Compact II (as the Amended Compact will be referred to hereinafter) were focused mainly on the economic benefits package. The lengthy negotiations produced an agreement on Compact II in 2003. The main economic and related provisions of Compact II are summarized in Box 1.

With Compact II, the FSM, the US, and the wider donor community anticipate progress in building the nation and reaching economic self-sufficiency through the adoption of more effective development policies.

The FSM has just begun the transition to the new US aid package under Compact II, and difficult medium term economic adjustments must be made. The significant decline in grant aid under Compact II, following difficult economic conditions in 1997-2000, requires a major policy shift on the part of all FSM governments. This shift will require steadfast commitment to policies and objectives that have been proposed in the past, but which have never been fully supported.

The present economic report reviews the past performance of the economy under Compact I, and closely examines the institutional setting and societal responses to development driven by large-scale US grant funding. The institutional environment, distinctly shaped by the different cultures coming together to form a federation, has in turn profoundly affected intergovernmental relations. All of this has an impact on efficiently and effectively managing the economic development of the nation.

Chapters 2-4 cover the historical experience of the FSM and the influence of this on contemporary society and institutional structure. These chapters also discuss how this experience has impacted economic decision making on the part of government and private sector institutions. Chapters 5-7 discuss the economic

Box 1. Economic Benefits of Compact II

- Annual grant assistance starting at \$76.0 million in the initial 3-year period from 2004-2006, then steadily declining from 2007 to 2023 as an additional \$0.8 million each year is taken from grant and deposited in Trust Fund along with an annual deposit of \$16.0 million by the US.
- The Trust Fund is intended to replace annual US grant assistance beginning in 2024 following the end of Compact II.
- The annual grant is to be allocated to six sectors: (1) education, (2) health, (3) private sector development, (4) capacity building in the public sector, (5) environment, and (6) public infrastructure. Allocations are to be determined in accordance with sector development plans prepared by the FSM, consistent with annual sector grant proposals made by FSM, subject to policy review and discussions annually by the Joint Economic Management Committee (JEMCO). Voting membership of JEMCO includes three members from US and two members from FSM. Policy decisions are in accordance with majority vote.
- Additional grant and program assistance is made available under Section 221 (of Title Two – Economic Relations). Stipulated programs include US Weather Service and Postal Service, and grant assistance to education and health sectors under the Supplemental Education Grant (SEG). In fiscal year 2005, the amount of the SEG grant was \$12.2 million. The SEG amount is not set and will vary from year to year. Additional US federal grant assistance is available on a competitive basis with other US states and territories. Available funding is ultimately dependent on US Congressional appropriations.

performance of the FSM during the Compact I period, from 1986-2003, and address the substantially altered US economic aid package negotiated for the Compact II period to run from 2004 to 2023. These chapters also tackle the need for renewed commitment to development goals and policies that have been widely discussed and supported by stakeholders representing all segments of FSM society.

In Chapters 8-11, the nation's three most important productive sectors – agriculture, fisheries, and tourism – will be discussed in more detail as these must play a significant role in enabling the transition to sustainable long-term growth and development. Also covered in these chapters section are other significant emerging economic issues that will need further analysis and debate to be appropriately addressed by development policies and strategies. In the report's final chapter, findings and conclusions will be summarized along with policy recommendations.