Chapter 5. Economic Development, 1987-2003

5.1 Compact I in Historical Perspective

The relationship between the government of the FSM and the US from the end of World War II until 1986 was defined in accordance with the United Nations International Trusteeship System. In the latter years of the transition to independence, the FSM opted to continue its relationship with the US through a treaty of *Free Association*. This relationship was formalized through the Compact of Fee Association (Compact I), which stipulated the respective governments' rights and obligations through a 15-year period term. An important obligation of the US under Compact I was financial aid in terms of general, special, and capital grants that cumulatively amounted to $1.54 billion.

During Compact I, the bulk of financial assistance was provided in the form of budgetary transfers – general and capital grants that were subject only to a few restrictions. Under Compact I, 40% of total grant funding (excluding special grants) was to be allocated to capital investment, as indicated in Table 5, but this was a cumulative requirement and did not have to be met on an annual basis.

Table 5. Compact I Grant Funding by Category and Period: Fiscal 1987 to 2003 (Millions of Current Dollars)

	FY87-91	FY92-96	FY97-01	FY02-03
General Grant	36.00	30.60	24.00	30.198
Capital Grant	24.00	20.40	16.00	20.132
Special Grants	15.27	15.27	15.27	15.27

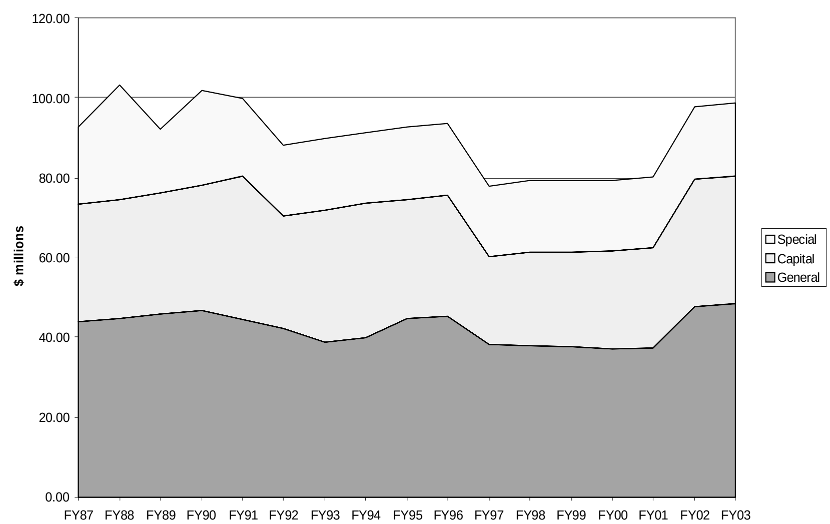
Source: Compact of Free Association, Articles I, II and III. November 1986; and subsidiary agreement specifying allocation of selected Special Grant funding between the FSM and the Republic of the Marshall Islands (Article I, Section 216 and Article II, Section 221).

The smaller special grants were designated for specific purposes, including communications, energy, medical referrals, scholarships, health and education, and support for the activities of the Civic Action Teams provided by the US military. Compact I also provided for continued access to other US domestic programs.

The funding levels under the capital and general grant transfers – and for some of the special grants – were partially adjusted for inflation. They were also subject to substantial step-downs at five-year intervals. In addition, the agreement provided a temporary increase in transfers during a two-year negotiating window following the end of Compact I.

General grant transfers could be combined with funds from other sources and become part of general revenues. Typically, no further accounting to the US was required for the use of these funds. Expenditures to be counted against the required 40% capital investment had to be documented and associated with particular uses, but the list of allowable uses was broad. The level of documentation required by the US was essentially limited to the project description. Of the various special grants, only the grant for health and education required that specific uses be identified.

Figure 1. Compact Transfers by Category



Source: *FSM Department of Economic Affairs, EMPAT.*

The US Department of the Interior (DOI) was the primary agency responsible for Compact management. Other agencies carrying out programs in the FSM were able to obtain reimbursement for their activities through the DOI budget. This eventually created problems for the DOI, as it was unable to effectively manage programs mainly because there appeared to be no ceiling on the value of reimbursement.

Box 6. Federal US Program Assistance

US Federal program assistance was an important part of the overall Compact I aid package, with the health and education sectors being the primary beneficiaries. These programs provided a combination of technical and grant assistance. The FSM was eligible, on a competitive basis with other US states and territories, for a wide range of programs. In addition, several projects included specific provisions for assistance to the FSM and the other Freely Associated States.

Federal Program Assistance in Health and Education: 1996-2000
(in current US $)

	1996	1997	1998	1999	2000
Health	2,123,906	1,854,975	1,976,277	2,168,365	2,120,579
Education	4,471,432	3,246,928	6,803,676	6,814,478	7,180,371

Source: *Deloitte and Touche (1987-2001). Single Audit Report.*

The table above summarizes government current expenditures for health and education, but excludes payments made directly to beneficiaries and programs implemented through non-governmental organizations. Nevertheless, these expenditures accounted for more than 10% of the total value of Compact grant assistance between 1998 and 2000.

5.2 Structure and Performance of Economy

5.2.1 Economic Structure

The FSM economy in the mid-1980s leading into the initial Compact period, was dominated by a large public sector funded by US budgetary transfers. The funds essentially paid for all government functions, including a large public service wage bill and external trade imbalance in favor of merchandise imports. The economic structure of the nation was the product of policies that emphasized the building of institutions and infrastructure patterned after those in the US. Less priority was placed on providing the policy climate, technical assistance, and training and institutional support needed to promote development of a competitive private sector.

National, state and municipal government employment accounted for an average of 58.7% of employment from 1987-1989 (Table 6), compared with a 31.6% employment share for the private sector, 7.9% for the non-profit sector, and 1.9% for public sector enterprises (PSEs). In terms of GDP contribution, the government accounted for 37.5%, compared with a 26.8% share for the private sector. PSEs and non-profit groups each contributed 2.9% of GDP. Other activities, which mainly include the household sector (subsistence agriculture and fisheries), contributed an average of 29.9% of GDP from 1987-1989.

Table 6. FSM Employment and GDP by Institutional Sector: 1987-89 and 2001-03 (figures in %)

Sector	1987-1989 Average		2001-2003 Average	
	Employment	GDP	Employment	GDP
Private	31.6	26.8	42.6	30.8
Government	58.7	37.5	42.9	27.2
Public Sector Enterprises	1.9	2.9	5.6	7.6
Non-Profits	7.9	2.9	8.9	4.8
Other [1/]	–	29.9		29.6
Total	100.1	100.0	100.0	100.0

Source: *Annex A Tables A1 to A10.*
1/ - Other GDP includes subsistence, home ownership, indirect taxes, less bank charges.

Meanwhile, private sector employment averaged 42.6% of total employment in 2001-03 - an 11percentage point gain - almost equal to the government share of 42.9%. The decline in government share by15.8 percentage points was offset by the rise in the PSE share. In terms of GDP contribution, the rise in private sector share was significantly less – only a 4 percentage point gain. On the part of government, its share in the GDP declined by 10.3%. The significantly smaller gain in GDP contribution of the private sector over the 17-year Compact period, compared with employment, is largely explained by the persistently large gap in wage rates between government and private sectors. It also reflects lack of improvement in productivity.

Although employment by itself is a significant structural indicator, the composition of employment within each sector is also important. For example, a large share of private sector jobs in export industries is indicative of a relatively strong economy. Relative wage levels (per employee per period) is also important. More will be said about these dimensions of economic structure in later sections.

5.2.2 Growth of GDP

Income and expenditure accounts in the FSM only present estimates of domestic value added using the income approach. Data on goods and services expenditures (final demand) and capital investment are not available. Gross domestic product estimates for the FSM as a whole and by State are presented in Tables A5 (Appendix A). In the first year under the Compact, nominal GDP was estimated at $113.7 million for the nation, about $1,260 per capita, which placed the FSM among lower middle income developing countries based on World Bank criteria. By the end of the Compact I period in FY2003, nominal GDP doubled to $229.6 million. In real terms (1998 $) GNP grew from $164.3 million (1987) to $218.9 million (2003), representing average annual growth of 1.8% over the entire Compact I period (Table 7).

Table 7. Real GDP and GDP per Capita in the FSM by State: FY1987-FY2003 (GDP in millions US$)

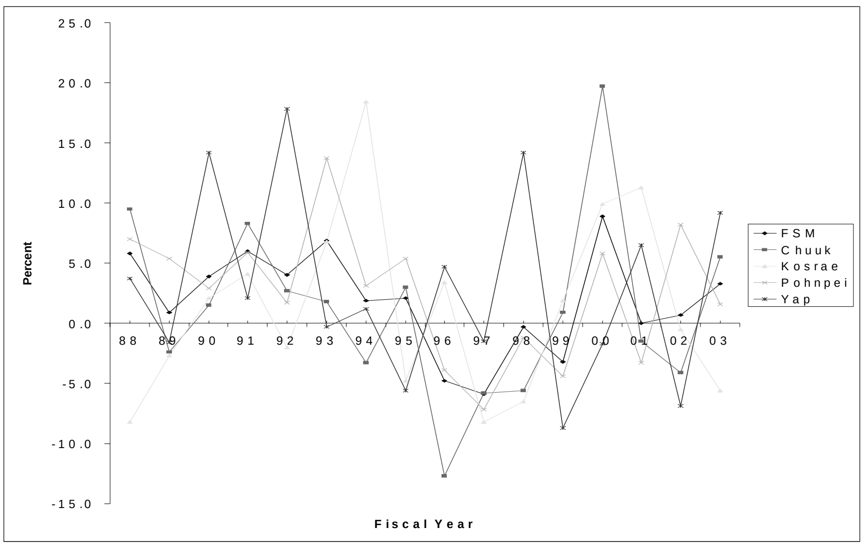
FSM/ State	FY87	FY95	Growth[1/] FY87-95	FY99	Growth FY95-99	FY03	Growth FY99-03	Growth FY87-03
Real GDP:								
FSM	164.3	223.4	3.9	193.2	-3.6	218.9	3.2	1.8
Chuuk	56.6	69.2	2.5	54.2	-5.9	64.7	4.5	0.8
Kosrae	15.9	17.8	1.4	16.1	-2.5	18.5	3.5	1.0
Pohnpei	67.6	104.3	5.6	88.1	-4.1	99.1	3.0	2.4
Yap	24.1	32.2	3.7	34.6	1.8	36.8	1.6	2.7
Real GDPPer capita:								
FSM	1,822	2,112	1.9	1,809	-3.8	2,031	2.9	0.7
Chuuk	1,249	1,296	0.5	1,013	-6.0	1,205	4.4	-0.2
Kosrae	2,446	2,405	-0.2	2,118	-3.1	2,342	2.6	-0.3
Pohnpei	2,372	3,086	3.3	2,561	-4.6	2,840	2.6	1.1
Yap	2,459	2,875	2.0	3,089	1.8	3,257	1.3	1.8

Source: *Table A1, Annex A/ Average annual growth.*

In per capita terms, real growth amounted to 0.7% for the same period. Growth of GDP in the first half of the Compact I period (fiscal 1987-1995) was satisfactory in terms of its rate, particularly in Pohnpei and Yap, but the growth was being generated by large government expenditures and public sector investment. There was no development of competitive, private sector-led activities. The large government and PSE investments, mostly in commercial fisheries, were substantially non-performing, resulting in significant operating losses and need for government subsidies.

The substantial step-downs in US grant assistance in 1992 and 1997, in tandem with the large amount of non-performing government investments, resulted in a significant decline of GDP in the 1995-1999 period. The economic contraction occurred in all states except Yap. Individual states differed significantly (Figure 2). Among the four states, both Chuuk and Kosrae experienced a contraction in real per capita GDP, with only Pohnpei and Yap able to generate a modest positive growth rate for the entire Compact period at 1.1 and 1.8% per annum, respectively.

Figure 2. Growth in FSM and State Real GDP



5.2.3 Balance of Payments

Balance-of-payments current account data are summarized in Table 8. As noted earlier, merchandise imports and official unilateral transfers dominate the nation's external account. In 1994-1996, average merchandise imports amounted to $95.2 million, while merchandise exports averaged $17.9 million, a ratio of 5.3 to 1.0 in favor of imports. This resulted in a large trade deficit averaging $77. million over the three-year period. In the last three years of the Compact, the corresponding deficit in merchandise trade was $88.5 million, with the import to export ratio averaging 3.9 to 1.0.

Table 8. FSM Balance of Payments Current Account: FY1994-FY2003 (in millions US$)

Item	FY94-FY96 Average	FY97-FY00 Average	FY01-FY03 Average
Trade Balance	-77.3	-78.7	-88.5
Exports, fob	17.9	17.1	22.6
Imports, fob	-95.2	-95.8	-111.1
Services	-23.1	-31.6	-29.2
Receipts	17.5	16.5	18.2
Payments	-40.6	-48.1	-47.4
Income	22.5	19.5	10.6
Receipts	34.4	28.7	16.8
Payments	-12.0	-9.2	-6.2
Unrequited Transfers	98.0	89.5	109.8
Private	1.2	2.0	2.3
Official	96.8	87.5	107.5
Current Account Balance	20.1	-1.3	2.7

With implementation of the Public Sector Reform Program (PSRP) in 1996, the level of both imports and exports declined in nominal terms during the period 1997-2000. Exports in 1997-2000 averaged $17.1 million per annum while imports averaged $95.8 million per annum. Details of external trade are covered in Section 5.2.5.

From 1994-2003, there were substantial deficits with respect to services, factor and resource payments, and other current account items. As expected, the deficits were offset by the large official transfers of Compact money. The annual deficit in services, typically in the $20-30 million range (see Table A26), is driven by the large cost of freight, transportation, and insurance of merchandise imports. While the tourism sector does make positive contributions to the national account (an average of $10.6 M from 2001–2003), it is not enough to offset the costs of merchandise imports. Overall, the net income balance has declined from over $20 million in the 1994–1996 period to an average of just over $10 million in 2001–2003. This decline is largely the result of a drop in interest and dividend income in 200–2003.

Between 1994 and 2003, average annual total transfers amounted to $98.2 million. The lowest amount of $80 million came in 1997 and the largest transfer of $122.3 million was made in 2003. Of the official transfers, $37.2 million or 30 per cent came from the donor community. Without these transfers, the current account was in deficit, averaging $81.12 million annually, equivalent to an average of 39% of the GDP from 1994-2004.

5.2.4 External Debt

The external official debt of the FSM is shown in Table A27. The data reported are for the fiscal years 1990 to 2003. The nation had no external debt before 1990. Shortly after the commencement of Compact I, FSM governments began borrowing heavily overseas to fund investments. Much of the early borrowing, through utilization of Medium Term Notes bonds secured by future Compact transfers, was used by Yap for portfolio investment ($71.0 million) and by Chuuk, Kosrae, and Pohnpei to fund fisheries investments ($42.9 million). From nearly $20 million in borrowing in 1990, external debt increased rapidly to a peak of nearly $137 million in 1993. A significant share of this external debt represented financial assets (mainly Yap's portfolio investment) held in overseas investment accounts. Taking into account adjustments made for offsetting externally held financial assets, the external debt balance peaked at $78.3 million in 1993. External debt then declined steadily through 2003, despite the necessity to borrow in 1997-1998, when the country implemented a Public Sector Reform Program.

External debt, with adjustments for overseas financial assets, steadily declined from 41.0% of GDP in fiscal 1993 to 17.0% in 2003. In relation to exports (value of goods and services), debt service declined from 35.0% in 1994 to 7.5% in 2003.

5.2.5 Exports and Imports

Commodity exports and imports for the nation and by state are presented in Tables A40-A41. With respect to total commodity imports (Table A40), the total cif (cost, insurance and freight) value of commodity imports averaged $108.3 million in the three-year period 2000-2002. The largest import category was food and beverages, accounting for 28% ($30.0 million). The next largest category was industrial supplies, which accounted for 18%, followed by fuels and lubricants, with a 15% share. In the food and beverage category, the largest imports were (2000-2002 average): rice ($3.8 million), poultry and meat ($3.1 million), beer

($2.5 million), canned meat ($2.2 million), and canned fish ($1.7 million). Another large item, accounting for $1.6 million, was cigarettes and tobacco.

Table A42 presents figures for total FSM exports for 1992-1994 and 2000-2002. Marine exports represent the single largest category, accounting for over 90% of total exports on average in the 1992-1994 period, and 68 per cent in 2000-2002. It should be noted that the value of marine exports declined sharply from an average value of $43.6 million per annum in 1992-1994 to $16.5 million per annum in 2000-2002 – a 62% drop. The bulk of the decline came in the offshore fish catch. Agricultural commodity exports represented less than 10% of the total in both periods. Chapters 8 and 9 contain a more detailed discussion of agricultural and fisheries exports, respectively.

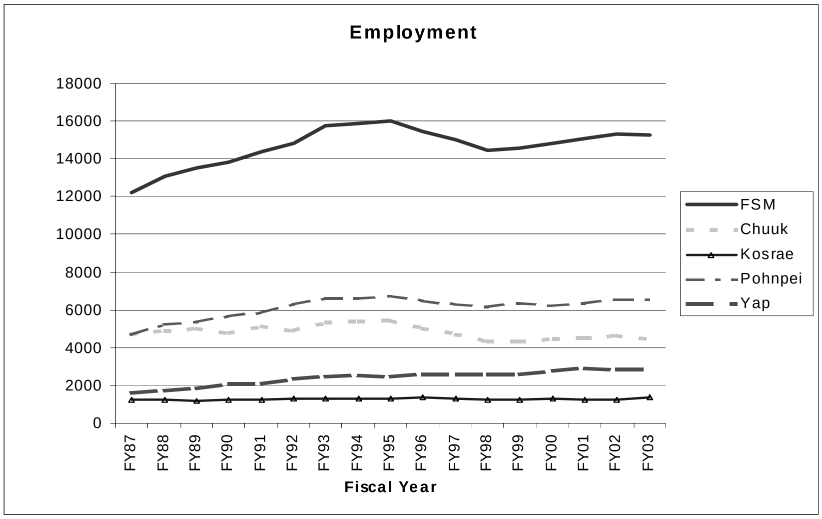
Commodity imports for 2002 by State are shown in Table A41. The pattern of state imports generally follow the order of importance for the nation. Food was the highest import category in all states except Yap which imported more industrial supplies. Chuuk's food imports accounted for 38.3% of its total. This state, with the lowest per capita GDP, was also the leading importer of fuels and lubricants in terms of proportion to total imports (19.4%). Chuuk was also the smallest importer of capital goods (6.2% compared with 11.3% for Kosrae and 12.7% for Pohnpei). Total imports per capita amounted to $550 for Chuuk, $1,279 for Kosrae, $1,255 for Pohnpei, and $1,932 for Yap.

Commodity exports for 1992 and 2002 by state are shown in Table A43. Offshore fish (mainly tuna) was the primary export of the nation accounting for 84% of total exports in 1992 and 61% in 2002. For 1992, nearly all offshore fish exports were produced by Pohnpei and Yap, each with 47% of the total. The second largest commodity export for the FSM is garments, all exported from Yap. In 1992, this commodity comprised about 25% ($3.6 million) of total FSM exports. Given that Compact II removes the import preference granted to FSM imports into the US, the continued viability of this export is in question.

5.2.6 Employment, Wages and Prices

The main data source on formal employment is the FSM Social Security Administration. Their reports contain quarterly and annual data on both private and public sector workers. The data do not include information on those working in the subsistence sector, in family-owned businesses, and the self-employed. In the first years of Compact I, employment growth was strong, averaging 4.0% per annum between 1987 and 1992. Figure 3 depicts employment performance for the FSM and for each of the states. Annual employment and wage figures are detailed in Tables A6-A15, in Appendix A.

Figure 3. FSM and State Total Employment: FY1987-FY2003



Nationwide employment growth remained strong in 1992-1995 averaging 2.6% per annum and reaching a peak of 16,000 in 1995. However, with the severe fiscal shock of the second step-down in Compact funding, overall employment declined in the next three years, before recovering. In the last three years of Compact I (2001-2003), total FSM employment remained level between 15,100 and 15,350.

Private sector employment grew strongly in the first half of Compact I, averaging 7.3% per annum between 1987 and 1995. Most of this growth occurred in non-tradable services industries, including retail and wholesale, construction, and transport. Employment growth in government (including local governments) during the same period averaged 0.6% per annum. In the PSE sector, employment jumped nearly five-fold from about 220 to 949 between FY87 and FY95, a growth average of 21.3% per annum.

Population, labor force, and employment data for the census years 1994 and 2000 are shown in Table 9. There was little population growth between 1994 and 2000, as out-migration to the US and its territories appeared to have accelerated. Out-migration is discussed in Chapter 7.

Table 9. Population and Labor Force by State: 1994 and 2000

	Population	Population	Labor Force	Formal Employment	Subsistence Agriculture/ Fisheries		Unemployed
					Non-Market	Marketed	
1994							
Chuuk	53,319	29,068	11,140	5,373	3,119	430	2,218
Kosrae	7,317	4,251	2,079	1,386	98	282	313
Pohnpei	33,692	19,500	9,020	5,539	1,408	756	1,317
Yap	11,178	6,754	3,733	2,083	1,249	33	368
FSM	105,506	59,573	25,972	14,381	5,874	1,501	4,216
2000							
Chuuk	53,595	31,587	18,192	4,546	5,134	2,299	6,213
Kosrae	7,686	4,628	2,232	1,468	198	198	368
Pohnpei	34,486	20,468	11,816	5,375	3,058	1,935	1,448
Yap	11,241	7,153	5,174	2,570	2,234	160	210
FSM	107,008	63,836	37,414	13,959	10,624	4,592	8,239

Source: *FSM (2002.) National Census Report. Table 9.1*

Despite the lack of growth in overall employment in the last half of Compact I, there was a sizable contingent of foreign workers holding jobs in the FSM – nearly 1,700 at the end of 2003, about 11% of the total workforce (FSM Immigration records).

Government wages have been consistently higher than those in the private sector. There is also a sizable differential in wage rates between national and state governments. Table 10 summarizes wage rates among institutional sectors at beginning and end of Compact I.

In the first three years of the Compact, the average private sector wage rate was around half that of state governments and one-quarter of the national government rate. The municipal government average wage rate was only 40% that of the state. As indicated in Table 10, the differences among levels of government narrowed substantially by the end of Compact I, although average private wage relative to the state government wage remained about the same.

Over the 14-year period between 1989 and 2003, the real wage rate in the private sector declined by 8.0%, while that of both national and state governments also declined, by 29.2% and 5.4%, respectively.

Table 10. FSM Wage Rate Comparisons Among Sectors and Over Time: 1987-2003 (Mean Wage Rates in 1998 US Dollars)

Sector	1987-89 Average	Differential Among Sectors	2001-03 Average	Differential Among Sectors	Wage Rate Increase 1989-2003 (in %)
Private	4,257	0.544	3,915	0.529	-8.0
Non-Profits	4,965	0.635	7,090	0.958	42.8
Public Enterprise	7,699	0.984	9,871	1.334	28.2
National Govt.	15,425	1.972	10,925	1.477	-29.2
State Govt.	7,821	1.000	7,398	1.000	-5.4
Municipal Govt.	3,042	0.389	4,473	0.605	47.0

Source: FSM Department of Economic Affairs

Prior to 1999, the US Consumer Price Index was used as a proxy for movements in price levels in the FSM. In 1999 an FSM CPI was established for the nation and for each state. In the case of Chuuk, however, the CPI was not fully established until the first quarter of 2001, and for the interim period 1999-2000, average prices of index items in the other three states were combined with Chuuk price data (on a subset of items) to estimate the Chuuk CPI series. Annual CPI data are presented in Tables 11 and 12 for the nation and each of the states for the period 2000-2004.

Table 11. Consumer Price Index by State: 2000-2004(All Items 1999=100)

Period	FSM	Chuuk	Kosrae	Pohnpei	Yap
2000 – Q1	100.8	100.4	101.1	101.4	100.1
- Q2	102.0	101.5	101.2	102.8	100.6
- Q3	102.5	101.4	101.4	104.5	101.4
- Q4	103.3	103.1	101.9	104.4	102.1

2001 – Q1	102.8	101.7	101.8	104.4	102.5
- Q2	102.6	100.9	101.3	104.4	103.4
- Q3	102.5	102.3	100.7	102.5	103.6
- Q4	102.7	102.9	100.4	102.8	103.0
2002 – Q1	102.8	102.6	99.1	103.7	102.7
- Q2	102.7	103.4	97.3	102.6	103.4
- Q3	102.4	103.0	96.8	102.6	102.5
- Q4	102.3	103.3	96.6	102.0	102.7
2003 – Q1	102.0	102.7	96.5	102.2	102.1
- Q2	102.6	103.3	96.4	103.4	101.5
- Q3	102.7	103.5	96.7	103.1	102.0
- Q4	103.5	105.6	96.7	102.8	101.9
2004 – Q1	103.9	106.3	97.1	103.2	101.5
- Q2	—	—	—	104.2	—

Table 12. Annual Inflation Rate by State: FY2000-FY2004 (%)

Period	FSM	Chuuk	Kosrae	Pohnpei	Yap
2000	2.0	1.4	1.2	3.6	0.7
2001	1.3	1.0	0.4	1.4	2.4
2002	-0.1	1.0	-3.0	-1.0	0.0
2003	-0.2	.2	-1.8	-0.2	-0.8
2004[1] – Q1	1.9	3.5	0.6	1.0	-0.5

[1] Quarter relative to year earlier quarter

5.2.7 Money and Banking

The unit of currency in the FSM is the US dollar. In the absence of any capacity to control the quantity of money in circulation and exchange rate against other currencies, there is little room for monetary policy as an instrument in overall macroeconomic management. Given the small population and economy of the FSM, together with the long-standing modern era historical trade and political links to the US, the utilization of the US dollar has probably represented stability and efficiency for the financial sector. With little capacity to influence the structure of interest rates, prevailing credit and lending rates have essentially reflected trends in the US economy, with appropriate adjustments for the higher degree of risk in FSM. The risk premium is a consequence of a number of factors including a relative lack of entrepreneurial, technical, and management skills to run businesses profitably, and a high cost of doing business.

The commercial banking sector currently includes only two banks – the Bank of the FSM, which is domestically owned, and Bank of Guam, a branch of the parent corporation that is based in that US Territory. The Bank of Hawaii also operated in the country until December 2002, but closed its FSM operations in line with an overall corporate restructuring. Under the Compact, commercial banks were supervised by the US Federal Deposit Insurance Corporation (FDIC) for greater assurance of a sound banking system. The nation has an FSM Banking Board responsible for the licensing of both domestic and foreign banks. This body takes care of on- and off-site commercial bank supervision, consumer protection, and FDIC coordination.

Commercial bank deposit and loan statistics are compiled by the FSM Banking Board, and are presented in Table A33. Bank assets, and deposit and loan balance sheet data are given for 1993-2003. In this period there was little growth in total assets, essentially reflecting the difficult economic situation coinciding with the large step-down in Compact I funding, implementation of the Public Sector Reform Program, and the period of uncertainty associated with FSM-US negotiations to amend the Compact. While total commercial bank asset growth was marginally positive, total bank loans declined substantially from just over $50 million in the three-year period 1999-2001, to an average of $31.6 million from September 2002 to September 2003, a decline of 39%. Assets not going into loans were essentially invested overseas. The low rate of growth in commercial bank deposits over the 1993-2003 period and decline in loan-to-deposit ratio in 2002 and 2003 may in part reflect the government fiscal crisis that occurred in Chuuk in 2000-2001, when government failed to pay employee allotments – many tied to employee loan payment deductions – and vendors. Given the sharp decline in bank loans in 2002-2003, the banking sector has been criticized as being less competitive since the withdrawal of the Bank of Hawaii.

The FSM development bank (FSMDB) also had to adopt a relatively conservative approach to lending, particularly in recent years, due to concerns about the availability of future capital transfers from the government. Access to loan or grant funds from outside sources is likely to depend largely on the bank's financial performance. The FSMDB is perceived to have increasingly assumed the normal lending functions of a commercial bank, as reflected in the more stringent criteria being applied to prospective borrowers.

negative 6.0% of GDP. Subsequently, the overall balance ranged from negative 1.0% to negative 4.0% from 1991 to 1996. With the larger 22% step-down in Compact basic grant transfers beginning in 1997, compounded by the earlier large external debt financing of non-productive fisheries investments, there was recognition on the part of government and donor community that the magnitude of the required fiscal adjustment would necessitate extraordinary measures. The national government, with ADB support, led the way in implementing a Public Sector Reform Program (PSRP).

To weather the fiscal shock of the large step-down in Compact grants beginning in 1997, the PSRP targeted a 27% reduction in government employment and a 35% reduction in the corresponding wage bill. The PSRP results, while a little short of the targets, did achieve significant reductions by 1999 – 22% and 28%, in employment and wage bill for government respectfully. This coincided with the end of the Early Retirement Program which was funded by an ADB loan. The reductions in spending were achieved as a result of both cuts in the workweek of employees, early retirements, and a freeze on hiring. Unfortunately, by the close of the 15-year Compact I period in 2001, the initial fiscal restraint achieved with the PSRP had been significantly reversed through increases in the wage bill as most governments went back to a full, or nearly full, work week.

5.2.9 State Governments

5.2.9.1 Chuuk

Fiscal performance in the first five years of Compact I was generally satisfactory with respect to maintaining overall and current budgetary balance. However, Chuuk slipped into a small current budget deficit in 1991, the seeds of which had been planted in 1990 when the government wage bill increased 12% over the previous year and continued to rise sharply through 1993.

With respect to the capital budget, Chuuk had a healthy surplus in the early years of the Compact. Chuuk's large capital account balances stemmed mostly from a constitutional provision requiring the state to transfer to the municipalities 40% of all Compact capital grants received. Since the municipalities lacked the capacity to plan and implement capital projects, these funds were spent slowly and large balances accumulated. Interest on the accumulated capital balances accrue to the state, thus contributing to the State's capital account balance, while providing little incentive for the state to assist the municipalities in implementing capital investment projects.

The development bank is able to offer more favorable terms – longer loan terms and lower interest rates – than the commercial banking sector. It allows a loan term of up to 25 years, at a fixed interest rate of 9.0%, while the commercial banks restrict lending to a 5-year term at a variable interest rate. This allows the FSMDB to select the most viable borrowers and projects. Bank management is currently pursuing changes in regulations that would remove the 9.0% cap on interest rates and allow it to charge different rates for different clients and activities.

5.2.8 Fiscal Policy and Macroeconomic Performance

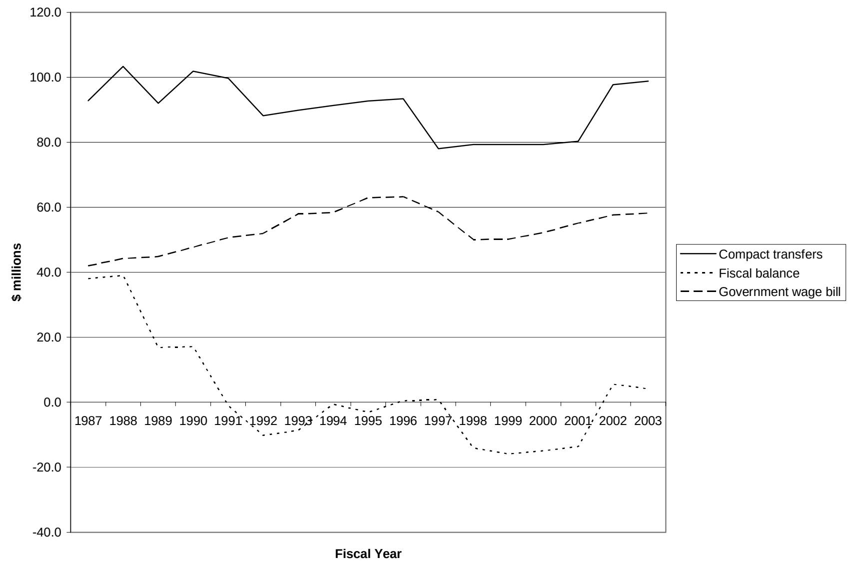
In assessing fiscal and macroeconomic performance in the FSM, it is necessary to examine the position of both national and state governments (see Tables A34-A37). The four states account for a large share (more than two-thirds) of total income and expenditure because they provide most of the essential services including education, health care, and utilities.

5.2.8.1 National and Consolidated Government

With the onset of Compact I in 1986, FSM governments received large US transfers of both current and capital funding. On a consolidated basis, the FSM Government enjoyed a budgetary surplus between 1986 and 1990 (Figure 4). By 1991, government had adjusted to the larger budgetary resources and had begun to make major capital investments, mainly in the fisheries sector. In 1991, the consolidated budget position of government (national and state governments) slipped into a small deficit position as a result of capital expenditures (Figure 5). In the first five years of the Compact, total revenues from grants and all domestic revenue sources amounted to 117% of GDP on average, with grants (mostly through Compact) accounting for 75% of total revenues. The government wage bill in this period amounted to 121% of domestically generated revenues. Tax revenues as a percentage of GDP, the standard measure of tax effort, came to only 9.7% in the initial five years of Compact I. Capital expenditures, which were at modest levels in the first two years, nearly doubled in the next three and averaged $37.5 million during the initial five years of the Compact.

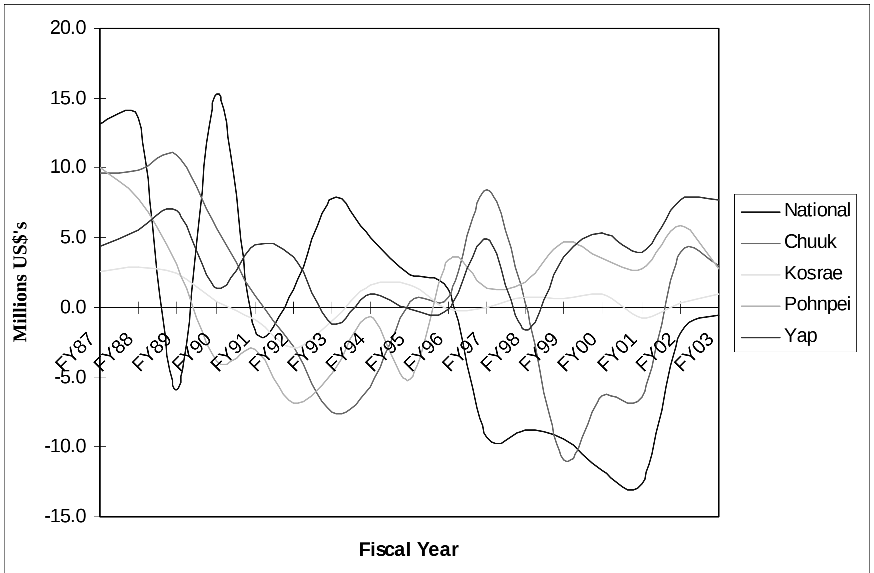
Despite a 15.0% step-down in the basic Compact general and capital grants at the beginning of the sixth year (FY92), governments in general were able to absorb the external shock largely by carrying over unspent revenues, augmented in some States by the issuance of Medium Term Note (MTN) bonds secured by future Compact transfers. From a healthy 12-33% of GDP in 1987 to 1990, overall budgetary balances slipped into deficit, ranging from negative 1.0 to

Figure 4. Compact Transfers in Relation to Government Budgetary Balance and Wage Bill (Consolidated FSM Governments)



Source: *FSM Department of Economic Affair. (2004). EMPAT.*

Figure 5. National and States Budgetary Balance



Lack of fiscal discipline with respect to current expenditures, especially the wage bill, coupled with the step-down in Compact aid funding in 1992, produced a severe financial crisis in the mid-1990s. Reacting to the cash-flow problem, the state ran up large arrears with suppliers and stopped paying allotments on public employee payrolls (money scheduled to be withheld for payment to banks that had made employee loans).

In late 1996, Chuuk began implementing a recovery program with conditional assistance from the national government. Recovery was greatly aided by the FSM-wide PSRP that included the Early Retirement Program, the results of which produced sharp cutbacks in government employment and the wage bill. Total current expenditures were reduced to 20.3% for 1997-1999. Over 90% of this cut in current spending was the result of lowering the state wage bill.

Unfortunately, the fiscal discipline applied by authorities for most of 1997-1999 was not maintained. This lack of restraint was manifest not only with respect to its wage bill, but also because of a jump in capital improvements spending as the state undertook a large airport renovation project and a number of other capital projects that had been put on hold earlier. While the 1999 overall budget deficit was primarily the result of capital spending, current expenditures also began increasing, largely driven by increased wages (and new hiring) and other discretionary spending. The overall budget deficit during the period 1999-2001 totaled $23.6 million.

5.2.9.2 Kosrae

Kosrae, like Chuuk, is heavily dependent on government expenditures to generate overall economic activity, income, and employment. This is a function of a small population with limited markets and little room for economies of scale in competing with outside suppliers to provide goods and services. Although considerable improvement was made over the Compact I period in reducing dependence on government expenditures, the ratio of this spending to GDP still averaged 71% from 1999-2001 (compared to an average of 109% in the first three Compact years, 1987-1989).

During the first three years of the Compact, the state maintained comfortable current and capital budget surpluses. Beginning in 1991, the overall balance fell into deficit mainly as a result of large capital investments. Capital investments, mostly in PSEs, have been large in relation to GDP, particularly in the first half of the Compact period (averaging 43% of GDP in the first seven years of the Compact, 1987-1993; and 23% in the last 8 years, ending in 2001). Given such a high rate of capital investment, the relatively low growth rate of real GDP of an average of 1.5% over the 15-year Compact I period, is a reflection of the poor return on investment in PSEs. The large-scale capital investments made in 1991-1993, partially financed by the sale of MTNs, were mainly responsible for the State's overall budget deficits in the same period.

Kosrae's fiscal performance with respect to the current budget was commendable, even after the first step-down in Compact grant aid. Limiting growth in the wage bill was an important contributory factor. Even with the substantially larger second Compact step-down in fiscal 1997, Kosrae was able to maintain fiscal balance in the current budget, except for the initial step-down year, when it failed to act quickly enough in implementing the PSRP to further reduce payroll costs.

5.2.9.3 Pohnpei

Pohnpei is least dependent on grants to fund operations and capital investment. In the first seven years of the Compact, total grants averaged only 42% of state GDP, and 26% in the last eight years. Despite having the least dependence on external aid, Pohnpei failed to restrain growth in the wage bill, which increased 49% between 1989 and 1997. Lack of discipline on the wage bill, in conjunction with the first step-down in Compact aid, resulted in a current budget deficit equivalent to 2% of GDP in 1992. This deficit persisted through 1996, peaking at 9% of GDP in 1995. The situation was worsened by the onset of interest payments on MTNs issued earlier to fund large capital investments.

Pohnpei, like Chuuk and Yap, made large-scale investments in the fisheries sector early in the Compact period. The state resorted to the sale of $23.9 million in MTN bonds between 1990 and 1993 to invest in a fish processing plant and the Caroline Fisheries Corporation. Beginning early in the Compact period, Pohnpei invested aggressively, not only in state-owned fisheries operations but in other PSEs as well. In general, these investments were not productive and subsequently drained the current budget in terms of interest and principal payments against borrowing. The investments ended up requiring subsidies to maintain operations. Between 1989 and 1993, capital budget deficits ranged from 3.1% to 8.5% of GDP.

By implementing the PSRP in coordination with national government, the state substantially reduced its wage bill, achieving an estimated $4.0 million in payroll savings as of September 2002 (IMF Staff Report, 2003:7). Fiscal performance in terms of the current budget was strong between 1997 and 2001.

5.2.9.4 Yap

During Compact I, Yap's overall fiscal performance was strong. With respect to the current budget, in only one year (1993) did the state run a deficit. Early on, Yap opted to pursue a monetization scheme whereby MTNs were issued to borrow externally, with the state using the proceeds to make overseas portfolio investments. The success of the scheme depended on the borrowing cost being lower than the return on portfolio investment. Since the MTN bonds were secured with future Compact grant receipts, Yap could expect to obtain a favorably low borrowing rate. Thus, instead of investing heavily in PSEs that proved unproductive, Yap was able to profit from the monetization scheme by obtaining a positive return on the portfolio investment.

Even with the sharper second step-down in Compact aid in 1997, Yap was able to avoid a current budget deficit. Much of its strong fiscal performance was due to restraint in the wage bill. Unique among the states, Yap exceeded its workforce reduction and wage bill reduction targets, maintaining a 33% cut in workforce and 34% cut in wage bill as of September 2002 (FSM Department of Economic Affairs, EMPAT). Perhaps the only area in which performance lagged was state tax revenue which declined from $1.8 million in 1996 to $0.9 million in 2001.

5.3 Economic Adjustment and Public Sector Reform

Following the initial step-down in Compact assistance in 1992, the FSM continued to enjoy real growth through 1995. Faced however with the much sharper second step-down in fiscal 1997, it was apparent that FSM would have to implement extraordinary fiscal measures to avoid a major economic crisis.

In anticipation of the second step-down, the FSM requested assistance from the ADB to prepare for reduced funding. The resulting study showed that there should be a substantial structural change centered on the public sector.

An FSM Economic Summit was held in November 1995. This summit became one of three convened between November 1995 and April 2004. The initial 1995 summit (subsequently referred to as First Summit) brought together a wide range of stakeholders to discuss sector development strategies and overall national development goals and strategies. The First Summit endorsed a set of economic reforms that were then presented to a Consultative Group (i.e., donor community) and discussed in a series of state-level summits during 1996.

In 1996, each of the five FSM governments created a task force charged with reviewing current public sector organizational structures, and developing the elements to be included in a set of policy matrices that would constitute the core elements of a Public Sector Reform Program (PSRP) loan proposal to be submitted to the ADB. The main objectives of the PSRP were to: (a) restructure government operations, thereby reducing the size and cost of the civil service; (b) transform or restructure public enterprises to eliminate subsidies and increase operating efficiencies); and, (c) promote private sector development.

The PSRP loan, which entailed two payment installments totaling $18 million, was approved by the ADB in April 1997. The centerpiece of the PSRP initiative was an Early Retirement Program (ERP). In advance of the PSRP, about 500 positions were eliminated throughout the five governments through a combination of attrition, hiring freezes, termination of temporary and contractual personnel, and the relocation of some employees to public enterprises (primarily to the public utilities).

As part of the PSRP program, there was a streamlining of government operations at the national level whereby several departments, divisions, or offices were merged. The Office of Planning and Statistics became part of the Department of Economic Affairs. The Office of Administrative Services and the Budget Office were incorporated in a newly organized Department of Finance and Administration. The Departments of Health and Education were combined in a new Department of Health, Education, and Social Affairs. This organizational restructuring resulted in the elimination of about 50 positions at the national level.

A number of additional positions were removed through a bargaining process between the different departments. Employees in positions identified as being non-essential were encouraged to leave the public service through departure bonuses. Finally, the individual governments also resorted to reductions in the length of the workweek as a means of reducing wage bills.

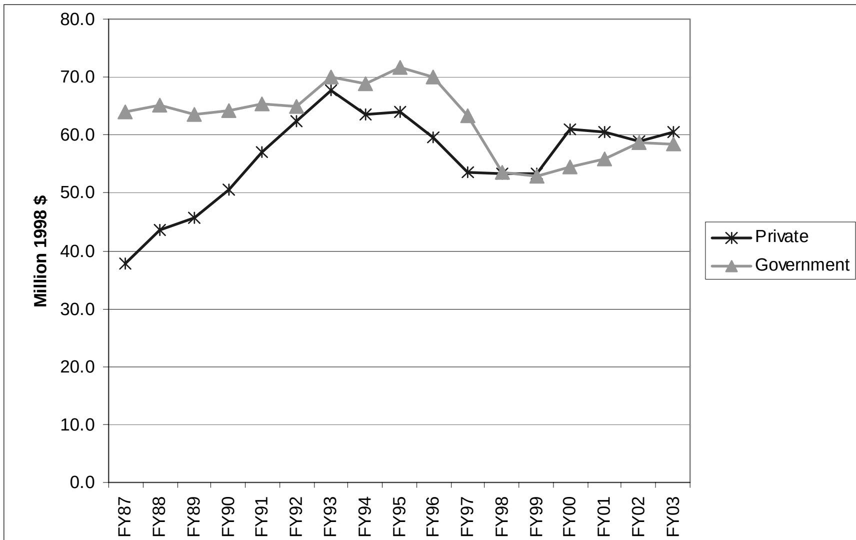
While a significant reduction in the overall public sector wage bill was achieved, this was not matched by unit labor costs, mainly because the wage bill reductions came through shortening the workweek. Also, the ability of some government offices to effectively carry out their functions was compromised. The targets for reductions were not closely tied to the personnel needs of the different offices and agencies, while rules for eligibility for the ERP inadvertently encouraged the departure of some of the more highly skilled employees. The hope had been that reductions in the wage bill would be implemented in a way that would lead to a reduction in public sector unit labor costs thereby enabling the private sector to attract skilled workers, which in turn could be expected to make FSM exports more competitive in regional markets.

The reduction in the public sector wage bill had a significant impact on overall economic growth. At the national level, real GDP growth was negative for three consecutive years, from 1996 through 1999. Performance at the state level varied, with only Yap showing positive growth during this interval. Growth resumed towards the end of the 1990s, led by the private sector.

The slowing of growth in the public sector following the initial step-down led to an actual contraction in the private sector, despite the fact that the government wage bill continued to increase. This probably reflects the impact of delayed payments from government to private sector vendors, which was one of the means by which Chuuk funded its fiscal deficit. The private sector experienced negative growth in 1994, 1996 and 1997, and grew relatively slowly in 1998 and 1999, before rebounding strongly in 2000.

By 2000, it was clear that the US intended to provide continued grant assistance, although the level of future assistance was not yet known. The increase in funding during the two-year negotiating period added to the eventual adjustment burden as some of the FSM governments used much of the step-up funding to support increased current expenditure. Efforts to persuade the states to save the additional funds were only partially successful. Some of the funds were retained to help meet the required FSM contribution to the new Compact (Compact II) trust fund, but a substantial portion went to increased government spending.

Figure 6. Relative Growth in Real GDP Contribution of Government and Private Sectors



Source: *FSM Department of Economic Affairs.*

Box 7. Economic Summits and the Economic Policy Interpretation Council

The Economic Summits and the Economic Policy Implementation Council (EPIC) were used to respond to the macroeconomic implications of the unsustainable public sector fiscal structure. The two institutional initiatives have been used to bring representatives from the different governments together to discuss issues that affect the FSM as a whole. They are essentially advisory bodies, whose work is reflected in the form of resolutions aimed at the executive and legislative bodies of the five governments. Without the endorsement of these bodies, either in accepting or modifying the content of the Summit or EPIC resolutions, there can be no action or implementation of the resolutions. While the advisory bodies have no legally defined role in policy setting, they have served as useful forums for discussing policy issues and proposed actions.

The three economic summits brought together a broad range of stakeholders, including government officials, and private sector for-profits and non-profits comprising the non-governmental sector. These advisory bodies provide a framework for consultation, particularly in conjunction with critical emerging issues such as the PSRP. Beginning with the Second Economic Summit, they became the vehicle for identifying sector-level development goals and objectives. The results of each of the Summits were endorsed by the participating leaders of the five governments, through the issuance of a Joint Communiqué. However, given the advisory role of the Summits, this did not constitute approval and adoption. Approval and adoption of Summit development goals and policies still must be accomplished through individual National and State Government action.

With the implementation of performance-based budgeting in all governments in the FSM, the role of the Summits took on even greater significance. With the terms of Compact II having been largely agreed, the Third Economic Summit was designed to cast its policy and planning results in the form of sector specific Strategic Planning Matrices. These were seen to be critically important for meeting the requirements for receiving the sector grants provided for in Compact II. Much of the work in developing sector specific objectives and performance measures took place in advance of the summit. Both health and education sectors organized workshops, bringing together personnel from the State and National offices.

The EPIC originally was intended to bring the leadership of the different governments together to address policy issues related to the reform program. Members of EPIC include the FSM President, governors of the states, and the presiding officers of the state and national legislatures. In addition, the state and national delegations include a number of other officials. It has essentially taken over the role of the previously held state and national leadership conferences.