

Federated States of Micronesia
European Commission

2007 JOINT ANNUAL REPORT

1.1 EXECUTIVE SUMMARY

The FSM is situated in the western Pacific Ocean and consists of 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. The total land area is about 271 square miles. FSM signed a Compact of Free Association with the United States in November 1986, marking the FSM as an independent nation. The United States retains responsibility for defence and security matters. In 2007, the FSM population was estimated at 108,700 with an annual growth rate of 0.18%. FSM became signatory to the Cotonou Agreement on 23 June 2000. A three-year Fisheries Partnership Agreement between the EU and FSM came into force in February 2007.

The US provided FSM with approximately US\$2 billion in grants and services between 1986-2001 under a Compact Agreement. A renegotiated Compact signed in 2003 provides a further US\$1.8 billion over the next 20 years. The aim of the new Compact assistance is to advance economic self-reliance and complete the transition from U.S. dependence.

Basic social services often fail to reach the poorer strata of society, the outer islands and rural areas. FSM also faces decreasing education enrolment rates, retention rates and access in the outer islands. Although maternal mortality has fallen significantly, it is still relatively high, and the incidence of non-communicable diseases is increasing.

In the general elections in March 2007, Emanuel (Manny) Mori replaced Mr. Urusemal as President. President Mori is from the State of Chuuk. The new Vice President is Alik L. Alik is from the State of Kosrae.

Like other Pacific Islands FSM is vulnerable to natural disasters and its remoteness from major trading markets greatly impedes its ability to economically compete in the global market. Currently the EU provides about 1% of total ODA to FSM. Although small in comparison to that received from the US, the 9th EDF is directed at a single sector – renewable energies – a sector where few other donors are involved. EDF initiatives attempt to redress the imbalance between the urban and rural/outer island and to achieve a more equitable distribution of the nation's resources. Government has again selected the **renewable energy** as the focal sector under the 10th EDF.

1.2 UPDATE ON THE POLITICAL, ECONOMIC, SOCIAL AND ENVIRONMENTAL SITUATION

1.2.1 Political Update FSM is a constitutional confederation in free association with the USA. Each of FSM's four states has its own constitution and its own elected legislature and governor. The state governments maintain considerable power, particularly regarding the implementation of budgetary policies.

The first Compact of Free Association entered into force in 1986 and ended in 2001. A new Compact entered into force on 1 May 2004 for a twenty year period. Under the Compact the United States retains responsibility for defence and security matters.

In the latest general election, in March 2007, Emanuel (Manny) Mori ousted Mr. Urusemal as President. President Mori is from the State of Chuuk. The new Vice President is Alik L. Alik is from the State of Kosrae. Other new appointments include:

Speaker - Isaac V. Figir (Yap)

Vice Speaker - Resio S. Moses (Pohnpei)

Floor Leaders - Joe N. Suka (Chuuk)

Secretary of Foreign Affairs--Lorin Robert

Permanent Representative to the UN--Masao Nakayama

The chairmanship of the Congressional committees are:

Judiciary & Governmental Operations - Senator Peter Sitan

Ways & Means - Senator Dohsis Halbert

External Affairs - Senator Paliknoa K. Welly

Resources & Development - Senator Dion G. Neth

Health, Education and Social Affairs - Senator Joseph J. Urusemal

Transportation, Communications & Infrastructure - Senator Moses A. Nelson.

1.2.2 Economic Update

Under the terms of the Compact of Free Association, the U.S. provided the FSM with about \$2 billion in grants and services between 1986 and 2001. The Compact's financial terms were renegotiated for the 20-year period 2004 through 2023, with the aim of encouraging sustainable development. The U.S. will provide almost \$100 million in direct assistance every year until 2023, which includes the systematic reallocation of a portion of the direct aid to a jointly managed Trust Fund. Additional federal grants to the FSM total approximately \$35 million annually. Assistance under the Amended Compact is distributed by grants in response to a transparent FSM budget process, focusing on the following six sectors: education, health, infrastructure, public sector capacity building, private sector development, and the environment. The U.S. Department of the Interior is responsible for monitoring and implementing the Amended Compact.

The FSM government sector plays a central role in the economy as recipients and domestic administrators of Compact funds. The national and state-level governments employ over half of the country's workers, with government services accounting for more than 40% of GDP. Real wages nationwide have been flat for the past decade, as has the number of jobs in the economy (about 15,500.) Private sector jobs pay about half as much as public sector jobs.

The fishing industry is highly important. Foreign commercial fishing fleets pay over €14 million annually for the right to operate in FSM territorial waters. These licensing fees account for 28% of the national government revenues. Exports of marine products, mainly to Japan, account for nearly 85% of export revenues. A Fisheries Partnership Agreement between the EU and FSM was initialled in 2004. The Agreement has been ratified by both parties and entered into force 26 February 2007. The total financial contribution from the EC amounts to €559,000 p.a. from which at least 18% will finance the definition and implementation of a sectoral fisheries policy aimed at enhancing responsible and sustainable fishing activities in FSM waters. This contribution shall be managed in the light of objectives identified between the EC and FSM.

Some 18,000 tourists visit the islands each year. However, the tourist industry has been hampered by a lack of infrastructure and limited commercial air connections. The Asian Development Bank has identified tourism as one of FSM's potential growth industries.

Agriculture is mainly subsistence farming. The principal crops are breadfruit, coconuts, bananas, betel nuts, cassava, taro, and kava. Less than 10% of the formal labour force and less than 7% of export revenue come from the agricultural sector.

The large inflow of official assistance to FSM allows it to run a substantial trade deficit--imports outstrip exports by a seven-to-one ratio--and to have a much lighter tax burden than other states in the region (11% of GDP in FSM compared to 18%-25% elsewhere). The government borrowed against future Compact disbursements in the early 1990s, yielding a significant external debt, close to \$60 million. In 2005, the FSM Government and Congress took positive steps toward establishing a nationwide tax system to improve collections and more fairly distribute the tax burden.

The economy contracted for a fourth year in a row, with GDP falling by 2.5% in 2007. The decline was most marked in the states of Chuuk and Kosrae, where past financial management deficiencies are now requiring severe fiscal contraction. According to the Asian Development Bank the economic deterioration also reflects the impact on public current expenditures of cuts in US funding under the amended Compact of Free Association, of under spending of grants, and of difficulties on the part of national and state governments in meeting specific requirements to access infrastructure development and capacity building funds provided by the Compact.

Inflation slowed to 2.8% in 2007, after exceeding 4% for 2 years when taxes on alcohol and tobacco had been raised. The use of the US dollar as domestic currency kept domestic interest rate trends aligned with those in that country. The external debt position remained sustainable in FY2007, with gross external debt equivalent to 25.1% of GDP and debt service equivalent to 6.0% of exports of goods and services.

1.2.3 Update on poverty and the social situation

The external support provided to FSM has produced a standard of living in the urban centres that is generally higher than elsewhere in the region. However, the relative position of FSM can be expected to decline as the reduction in external funding and associated budget constraints reduce income levels and the quality of health and education services.

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

The country has seven official languages: English, Ulithian, Woleaian, Yapese, Pohnpeian, Kosraean, and Chuukese.

The other languages spoken in Micronesia are Pingelapese, Ngatikese, Satawalese, Kapingamarangi Language, Nukuoro Language, Puluwatese, and Mokilese.

There has been no recent poverty analysis undertaken in FSM.

1.2.4 Update on the environmental situation

Environmental sustainability is considered as one of the core principles of the FSM National government economic plan and framework for its renegotiation with the United States of America for the renewal of the financial provisions of the nation's Compact of Free Association. The responsibility for environmental issues is shared between the FSM National Government and the individual FSM State governments. This sharing of responsibility has at times resulted in legislation that appears duplicated at the State and National levels. It has also resulted in gaps in legislation and areas in which the location of responsibility between the State and National Governments has been less than clear. The States take the lead role in ensuring that development is avoided in vulnerable areas and ensuring that critical natural systems are protected. Each State has made efforts to control development and manage natural resources through the creation of land use plans, coastal zone plans, legislation and regulations. The National Government provides guidance and technical assistance to the States when needed and requested on matters related to planning, economic development, natural resources, fisheries, and the environment.

The FSM is an active member of several regional and international conventions and is currently reviewing additional conventions. The importance of the nation's biodiversity cannot be understated and is present in every facet of a Micronesian's way of life including the provision of various natural resources for food, shelter, medicinal and traditional purposes. In the past, utilization of these resources was allowed under strict traditional and community management and is believed to have provided a balance with nature that allowed the biodiversity to be utilized in a sustainable manner.

Global environmental crises such as global warming, frequent and severe typhoons, droughts, fires, and sea level rise are major concerns to the nation; the protection and conservation of

island biological resources that can assist the nation to protect itself from these natural forces is extremely important. The development and implementation of suitable traditional and scientific resource management programs that can address these problems for the long term are crucial.

In March 2006 FSM joined Palau, RMI, Guam and NMI in adopting the Micronesian Challenge – a programme which aims to conserve 30 percent of near-shore marine resources and 20 percent of forest resources by 2020.

2.1 Overview of Past and on-going co-operation

Having only joined the ACP group on commencement of the Cotonou Agreement the FSM has no history of EDF funding prior to 2003. Under the 9th EDF FSM was allocated a total of €4.8 million ('A' envelope) and €1.4 million ('B' envelope). The 10th EDF provides FSM with:

A Envelope: €8.3m

B Envelope: €0.7m

9th EDF

Focal sector : 9.ACP.FM.1 Renewable Energy Programme (REP5) Tenders for the supply of solar equipment in three of the four states of FSM were launched in mid-2007. The tender for the fourth state, Kosrae, was launched jointly with that of Palau since grid-connected PV systems were the selected key activity in both cases. The signing of supply contracts is expected in Q1 2008. The first national Programme Estimate (covering i.a. energy efficiency measures and TA) was signed in December 2007.

NSA Programme: 9.ACP.FM.002 Conservation and Environmental Protection Programme. The Micronesia Conservation Trust (MCT), which is tasked with assisting the NAO in managing a Call for Proposals under the Conservation and Environmental Protection Programme (CEPP) is fully operational. The CfP was published on 31 October 2007 in the local press with a submission period of the required 60 days. Grant contracts are expected to be signed in February 2008.

Utilisation of Envelope B

9.ACP.FM.04 Disaster Risk Reduction in 8 Pacific ACP States – A Financing Agreement for the multi-country project which combines the 9th EDF B-envelopes of FSM, RMI, ROP, Nauru, PNG, SI, Tonga and Tuvalu was signed by the RAO at the Forum Leaders Summit on 18 October in Tonga. A Contribution Agreement with SOPAC to manage this EUR 9.26m project will be signed in January 2008. The FSM component amounts to €1.4m and will involve the improvement in emergency communications and operations. It shall be implemented by SOPAC through the Office of Emergency Management OEM which has a staff of eleven.

Other instruments

The 9th EDF Pacific Regional Indicative Programme funded and extended a number of existing projects to the six new Pacific ACP countries, including FSM. These consisted of:

Pacific ACP Regional Economic Integration Programme (PACREIP)
Development of Sustainable Agriculture in the Pacific (DSAP)
Pacific Regional and OCT Fisheries Programme (PROCFISH)
Plant Protection Programme (PPP)
Pacific Regional Initiatives for the Development of (basic) Education (PRIDE)
Reducing Vulnerability in PACP States – SOPAC
Development of Fisheries in the Pacific (DEVFISH)
Pacific Environmental Information Network (PEIN)

Additionally FSM has benefited from training provided through the Technical Support to RAO Project and EPA related technical assistance under a FORSEC implemented intra-ACP funded programme.

10th EDF

Technical Cooperation Facility

The PIF was approved in October 2007. The AAP together with all annexes were forwarded to AIDCO C3 in January 2008. Project commencement is expected to follow quickly after 10th EDF funding becomes available.

Renewable Energy: An MCP project identification mission was launched in October 2007 with the task of identifying actions for continued support to the renewable energy sector. The consultant's report is expected in April 2008.

2.2 Policy Coherence for Development (PCD)

"Climate Change" is an important cross-cutting issue, in particular for the Pacific region and major regional initiatives are being considered in the context of the RIP. Additionally, the Global Climate Change Alliance is likely to bolster FSM's ability to effectively address mitigation and adaptation measures.

Although FSM has not yet demonstrated much enthusiasm regarding EPAs, since the country has little to trade in goods, there are some EPA discussions which could be of interest. These include the discussions on services, regional integration, investment and fisheries, much of which is vital to the sustainable expansion of the tourism industry. FSM can request technical assistance from the Forum Secretariat or under the various EDF ACP facilities. FSM are not members of the WTO, and do not envisage joining.

2.3 EU Strategy for the Pacific

During the discussion in the programming process for the 10th EDF, key strategic directions contained in the EU Pacific Strategy have been taken into account while agreeing on the development response strategy for the European Community support. In this framework, the EU Strategy's focus on the sustainable management of natural resources in the Pacific

provides a clear, result-oriented opportunity for the FSM-EU development cooperation under the 10th EDF renewable energy focal sector.

2.4 Donor coordination and harmonization

No member state has permanent representation or major aid programmes in the FSM. That said, Germany, Greece, France, Spain and the UK all provide small grants from time to time. Currently France is preparing a USD 500,000 renewable energy project for implementation in Chuuk. This project has been designed with assistance from TA provided by the MCP Renewable Energy Programme REP-5. Austria and the Netherlands have also shown some interest in providing small grants assistance to FSM.

3 Dialogue in country with the NAO and NSAs

Dialogue in-country with the Office of the NAO is limited, hampered by the vast distances separating the Delegation and FSM (5000km). There is no EU office or resident adviser in FSM. However, since taking-up office earlier this year the newly elected government has refreshed the institutional framework dealing with economic development. This has involved the creation of a new Department (OSOBC) which combines Statistics, Budget, Overseas Development Assistance (ODA) and Compact II funding. OSBOC is headed by a director, a political appointee and cabinet member who reports directly to the President. ODA's mandate is to coordinate all development aid assistance including EC funding. In December 2007 a change in NAO occurred when the Director OSBOC was appointed the new NAO. This has resulted in a marked improvement in dialogue between the Delegation and FSM.

Good NSA contacts have been established by the Delegation with the FSM Association of NGOs (FANGO) and Micronesian Conservation Trust (MCT), and the Commission's energy programme is well-known to them. NSAs are also represented on the National Authorising Committee – an ad hoc body established to provide the NAO with operational support.

The provision of technical support to the NAO office through the proposed 10th EDF Technical Cooperation Facility will further strengthen FSM-EU cooperation.

4 CONCLUSIONS

The key political development in 2007 was the general elections in March. The new President, Manny Mori, is only the second citizen of Chuuk to serve as president of the FSM, the most populous state in the country.

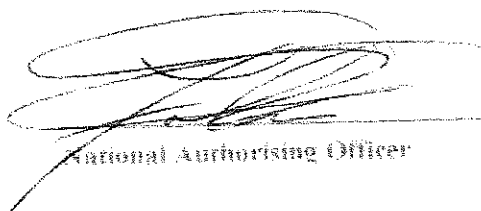
Results in the focal sector have will only be realised when equipment is delivered in 2008.

The signing of the Financing Agreement of the "Disaster Risk Reduction Programme" in 2007 resulted in 100% total commitment of FSM's 9th EDF.

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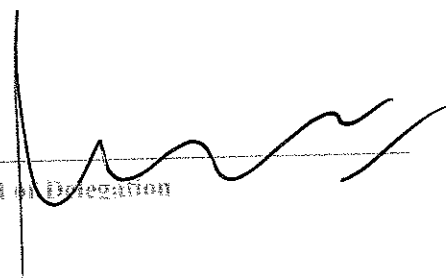
European Commission – Federated States of Micronesia

SIGNED



National Authorising Officer

Date: 12/02/08



Head of Delegation

Date: 4/12/08

ANNEXES

A) General annexes

Annex 1 : Country at a glance : FSM

Annex 1a: KEY SOCIAL DEVELOPMENT INDICATORS

Type	Indicator	2000	2001	2003	2004	2005	2006	2007
Impact	1. Proportion of population below \$1 per day ¹	5.2	n/a	n/a	n/a	n/a	n/a	n/a
	2. Prevalence of underweight children (under-five years of age)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
	3. Under-five mortality rate		47				42	
Outcome	4. Net enrolment ratio in primary education	81.4	n/a	n/a	n/a	n/a	n/a	n/a
	5. Primary Completion Rate	66.9	n/a	n/a	n/a	n/a	n/a	n/a
	6. Ratio of girls to boys in:	95.1	n/a	n/a	n/a	n/a	n/a	n/a
	- primary education	94.2						
	- secondary education							
	- tertiary education							
	7. Proportion of births attended by skilled health personnel	96.0	87.5	n/a	n/a	n/a	n/a	n/a
	8. Proportion of 1 year old children immunised against measles	85	88	91	85	96	n/a	n/a
	9. HIV prevalence among 15-24 year old pregnant women	n/a	n/a	n/a	n/a	n/a	n/a	n/a
	10. Proportion of population with sustainable access to an improved water source	87.8	n/a	n/a	94	n/a	n/a	n/a

Sources: (1) UN Millennium Development Goals Statistical Website/
<http://mdgs.un.org/unsd/mdg/Data.aspx?cr=583> (updated Dec 2007)

Annex 1b: Key Macroeconomic Indicators (ADO)
ADO 2006: Federated States of Micronesia

Indicator	Latest year available
National Accounts	FY06est.
GDP (US\$ millions)	197.91
GDP per capita	\$1,832
International Trade	2005/06
Total imports, value (US\$ 000), CY2006	130,214
Total exports, value (US\$ 000), CY2005	12,984
Consumer Price Index	2006-2007
Jan-Mar 2006	112.3
Apr-Jun 2006	114.1
Jul-Sep 2006	116.1
Oct-Dec 2006	116.4
Jan-Mar 2007	117.0
Apr-Jun 2007	117.6
Government Finance (US millions)	FY06est.
Revenue and grants	140.0
Expenditure	153.0
Overall balance	-13.0
Employment rates	2000(census)
Persons in labor force	37,414

Percent	58.6%
Unemployment rate: male	20.7%
: female	23.8%
Labor Market	FY2006 proj
Persons employed in all industries	16,457
Average annual wage, real	\$5,856
Balance of Payment (US\$ millions)	FY2005est.
Current account balance	(35.5)
Capital & financial account	15.6
Overall balance	(19.9)
Banking	Dec-06
Interest rates: Lending - Consumer loans	13.38
- Commercial loans	8.92
: Deposit - Savings	1.88%
External Debt (US millions)	FY2006
External debt	65.8
Adjusted for offsetting assets	39.2

Source: FSM Statistics Unit

B) Annexes with a retrospective character: financial situation for 9th EDF

Annex 2: Financial situation

		TOTAL ALLOCATION (in Million EURO)	COMMITTED	UNCOMMITTED	RATE OF COMMITMENT %
9th EDF	Envelope 'A'	4.8	4.8	0.0	100
	Envelope 'B'	1.4	1.4	0.0	100
10th EDF	Envelope 'A'	8.3	0	8.3	0
	Envelope 'B'	0.7	0	0.7	0

C) Annexes with a prospective character: 10th EDF

Annex 3a: Indicative timetable of global commitments

	Indicative allocation	2008		2009		2010→	
		1	2	1	2	1	2
1st FOCAL SECTOR – WATER AND ENERGY (RENEWABLE ENERGY)	M €7.47						
- Project 1 : Renewable Energy Programme (MCP)	M €7.47			7.47			
	M €						
2nd FOCAL SECTOR – NONE	M €						
- Project 1	M €						
- Project 2	M €						
NON FOCAL SECTORS	M €						
- Institutional support for non state actors.	M €						
- Technical cooperation facility	M €0.83		0.5				
- Contribution to regional programmes	M €						
-<optional> Support for EPA	M €						
-<optional> Support for Governance	M €						
-Other	M €						
Total Commitments:	M €		0.5	7.47			
Total Cumulative Commitments :	M €		0.5	7.97			

Annex 3 b: Indicative timetable of disbursements

	Indicative allocation	2008		2009		2010→	
		1	2	1	2	1	2
1ST FOCAL SECTOR – WATER AND ENERGY (RENEWABLE ENERGY)	M€7.47						
- Project 1 : Renewable Energy Programme	M€7.47			0.2	0	7.1	0.1
- Project 2 : NONE	M€						
2ND FOCAL SECTOR – <name>	M€						
- Project 1	M€						
- Project 2	M€						
NON FOCAL SECTORS	M€0.83						
- Institutional support for non state actors.	M€						
- Technical cooperation facility	M€0.83		0.15	0.15	0.1	0.1	0.15
- Contribution to regional programmes	M€						
-<optional> Support for EPA	M€						
-<optional> Support for Governance	M€						
-Other	M€						
Total Commitments :	M€		0.15	0.35	0.1	7.2	0.25
Total Cumulative Commitments :	M€		0.15	0.35	0.45	7.65	7.9