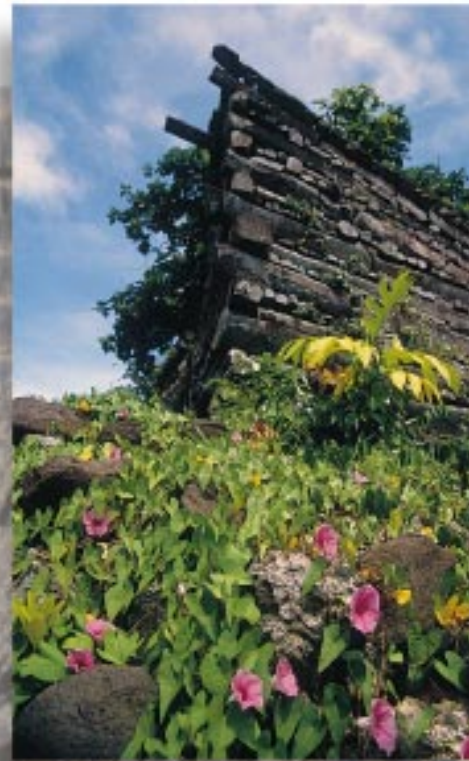


FEDERATED STATES OF MICRONESIA

ECONOMIC REPORT

JULY 2000





Hawaii

- Bank of Hawaii (76 branches)

Arizona

- Pacific Century Bank, N.A. (9 branches)

California

- Pacific Century Bank, N.A. (19 branches)

West Pacific

Commonwealth of the Northern Mariana Islands (CNMI)

- Bank of Hawaii (2 branches)

Federated States of Micronesia (FSM)

- Bank of Hawaii (3 branches)

Guam

- Bank of Hawaii (3 branches)
- First Savings and Loan Association of America (3 offices, 4 in-store branches)

Republic of the Marshall Islands (RMI)

- Bank of Hawaii (1 branch)

Republic of Palau

- Bank of Hawaii (1 branch)

South Pacific

American Samoa

- Bank of Hawaii (2 branches)

Fiji

- Bank of Hawaii (3 branches)

Subsidiary Banks

French Polynesia

- Banque de Tahiti (17 branches)

New Caledonia

- Bank of Hawaii - Nouvelle Calédonie (8 branches)

Vanuatu

- Banque d'Hawaii (Vanuatu), Ltd. (2 branches)

Papua New Guinea

- Bank of Hawaii (PNG), Ltd. (2 branches)

Affiliate Banks

Samoa

- Pacific Commercial Bank, Ltd. (4 branches)

Tonga

- Bank of Tonga (5 branches)

Solomon Islands

- National Bank of Solomon Islands (11 branches)

Alliance

Australia

- Bank of Queensland Limited (95 branches)

International Offices/Branches

Hong Kong

- Bank of Hawaii (1 branch)

The Philippines

- Bank of Hawaii (1 representative office, 2 extension offices)

Nassau

- Bank of Hawaii (1 branch)

New York

- Bank of Hawaii International Corporation, New York

Seoul

- Bank of Hawaii (1 branch)

Singapore

- Bank of Hawaii (1 branch)

Taipei

- Bank of Hawaii (1 branch)

Tokyo

- Bank of Hawaii (1 branch)

About Bank of Hawaii

Bank of Hawaii is the principal subsidiary of Pacific Century Financial Corporation, a regional financial services holding company with \$14.5 billion in assets and more than 180 business locations. Through our trans-Pacific network of offices, subsidiaries and correspondents, Bank of Hawaii provides a full range of financial services to businesses, governments and consumers in four principal markets: Hawaii, the West and South Pacific, Asia and selected markets on the US Mainland.

Whether you are interested in trade finance, working capital loans, correspondent banking, foreign exchange, real estate investment or establishing operations in another country, Bank of Hawaii can open up a world of new business opportunities for you. Please visit our Internet website at www.boh.com for more information.

TO OUR CLIENTS AND FRIENDS:

We are pleased to present our fourth economic report on the Federated States of Micronesia (FSM). It contains a review of business and economic conditions of the last decade and offers a perspective on the FSM economy's future prospects.

The FSM economy is at a critical stage of economic and financial development, especially in relation to the United States. Currently, FSM negotiates the next financial package of the Compact of Free Association with the United States. The present financial package expires in 2001. The FSM and US governments will conclude their talks before the current package expires. We are optimistic the two sides will produce an outcome of mutually agreeable elements. With a new financial package in place, the FSM economy will be in a better position to take advantage of opportunities in the dynamic Asia-Pacific region.

Bank of Hawaii's presence in FSM dates back to 1963. Over the years, we have contributed to economic development and change and look forward to continuing our active participation in FSM.

This report on the FSM economy is a part of our continuing commitment to the Pacific markets we serve. We invite you to visit the Economics Section of Bank of Hawaii's Internet web site www.boh.com for other reports on the Pacific markets as well as information on the broad range of financial products and services we offer.

Aloha,



Lawrence M. Johnson
Chairman of the Board &
Chief Executive Officer



Richard J. Dahl
President and
Chief Operating Officer



Lawrence M. Johnson



Richard J. Dahl

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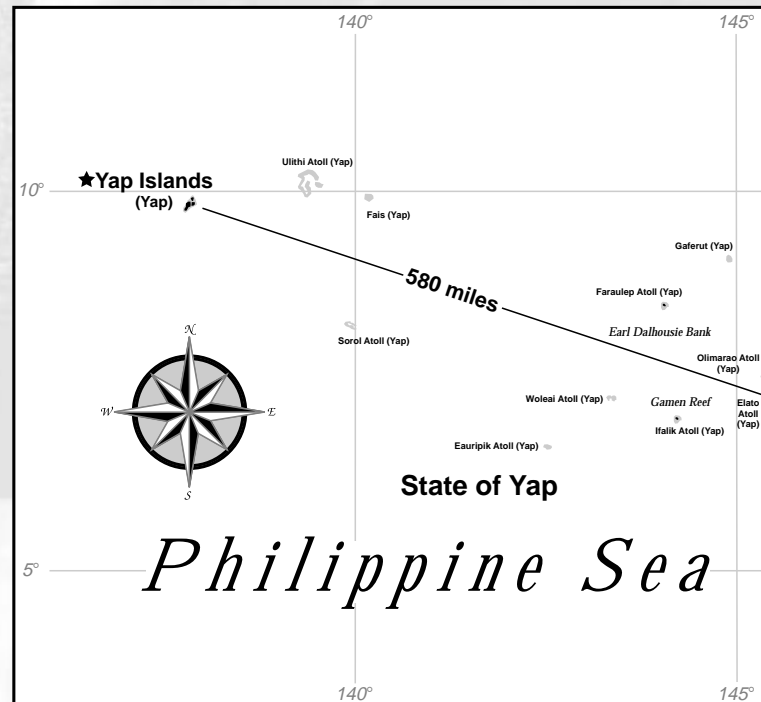
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Acknowledgments

This report was written by Wali M. Osman, Ph.D., Vice President and Bank of Hawaii Regional Economist, with grateful acknowledgment to the Offices of the President and the Vice President of the Federated States of Micronesia (FSM), Office of the Vice Speaker of the FSM National Congress, the Secretary of Finance, the FSM Department of Economic Affairs, especially the Economic Management and Policy Advisory Team (EMPAT), the Chief Negotiator and the Executive Director of the Joint Committee on Compact Negotiations, FSM Social Security Administration, FSM Banking Board, the Pohnpei Chamber of Commerce, a number of other business and public leaders for their assistance and insight, and especially Bank of Hawaii, FSM.

Cover photos: Clockwise from top left: Chuuk Lagoon; Nan Madol, Pohnpei; cultural dance, Yap; mangrove forest, Kosrae; all cover and in-text photos courtesy of FSM Visitors Board.



Source: US Geological Survey, 1985

FEDERATED STATES OF MICRONESIA

Land Area

Total: 270.8 square miles for 607 islands
 Largest Island: Pohnpei (130 square miles)
 Inhabited Islands: 65

Political Status

Independent nation in free association with the United States; US-style democracy with a national and four state governments; Renegotiating Compact's financial package with the United States; Negotiations to conclude in 2001.

Population

1980: 73,159
 1990: 97,617
 1999: 116,268
 1980-90 growth rate: 3.0 percent
 1990-99 growth rate: 2.0 percent

Economy

Currency: US dollar
 Income sources: US Compact payments, public sector, fishing & fisheries, services, tourism and subsistence agriculture and fishing
 Gross Domestic Product (GDP) in 1999: \$230.0 million
 Per capita GDP in 1999: \$1,977

GDP distribution by sectors in 1999

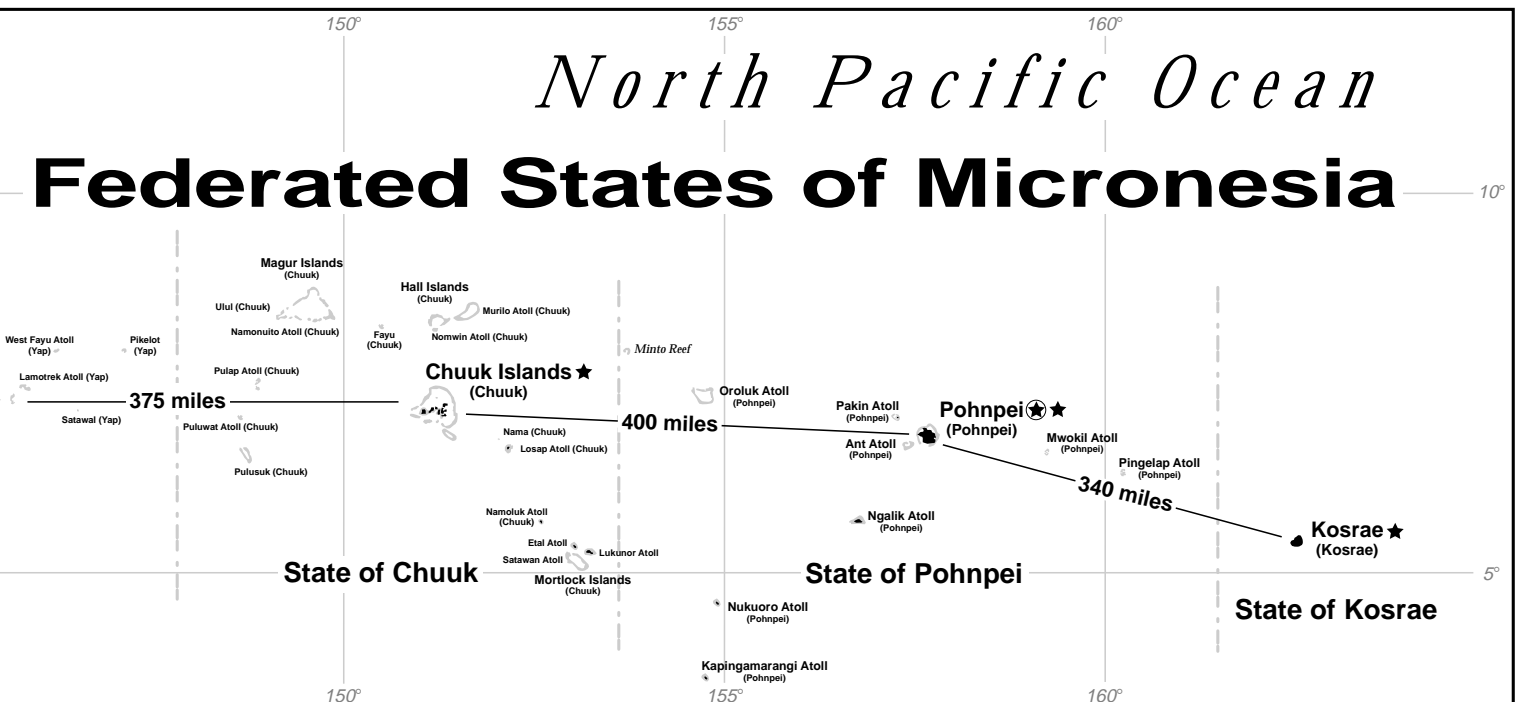
Public sector: 34.4 percent
 Private sector: 35.9 percent
 Subsistence production: 14.3 percent
 Homeownership: 8.4 percent
 Indirect taxes: 7.0 percent

Payroll employment in 1999

Total: 18,669
 Public sector: 9,917
 Private sector: 8,752

Distance From

Honolulu: 2,500 miles
 Sydney: 1,580 miles
 Tokyo: 2,220 miles
 Regular commercial flights to and from Honolulu and Guam



I. GENERAL CHARACTERISTICS

I.1 Introduction

The 607 islands and islets that make up the Federated States of Micronesia (FSM) are the eastern and central parts of the Caroline Island chain located in the Western Pacific about 2,500 miles west of Hawaii. The Republic of Palau, to the west of Yap, FSM's westernmost state, completes the Caroline archipelago.

FSM has a tropical climate with relatively uniform temperature throughout the year, averaging 81 degrees Fahrenheit (27 degrees Centigrade). Annual rainfall ranges from 110 inches in Yap to a formidable 180-330 inches on Pohnpei. Droughts also occur in the 65 inhabited islands. The availability of ground water reserves in Chuuk and Yap has frequently been mentioned as concerns in the long run. FSM's natural resources are its landmass, however small, and the Pacific Ocean.

FSM emerged from the union of four districts of the former United Nations Trust Territory of the Pacific Islands (TTPI), administered by the United States from the end of World War II until its dissolution in 1994. TTPI's remaining district, Palau, became independent in October 1994.

FSM became a sovereign nation in May 1979 when the four districts of TTPI, Ponape (now Pohnpei), Truk (now Chuuk), Yap and Kosrae formed a political union, ratified a new constitution and declared themselves as the Federated States of Micronesia. FSM joined the United Nations in 1991, and has since become a member of the International Monetary Fund (IMF) and Asian Development Bank (ADB). FSM is also a member of several other regional political and economic organizations.

FSM has a total land area of only 270.8 square miles, scattered over more than one million square miles of the Pacific Ocean which extends 1,700 miles east to west from Kosrae to Yap. The 130-square-mile Island of Pohnpei is the largest in FSM and home to the nation's capital as well as its trade, commerce and civic centers.

The national capital and the states are linked by air service which Continental Micronesia, a unit of Continental Air Lines, has provided since the early 1960s. There is no commuter or local air service at this point. The well-known "island-hopper" flight that originates in Honolulu and ends in Guam connects the four states of FSM to each other and to the outside world. Honolulu-based Aloha Air Lines has commenced flights to Majuro, the capital of the Republic of the Marshall Islands (RMI), but it is unclear whether the carrier will expand service to FSM and beyond.

FSM is among the Pacific's more heterogeneous mixtures of peoples, cultures and languages with different customs, traditions and institutions spread over a relatively small landmass. These island groups were united, sometimes without their consent, by certain common political, economic, historical and strategic forces through most of the 19th and 20th centuries. The ties leading to a unified political and economic body, still contentious at times, were cemented in the 1970s and 1980s by the islands' necessity to form a unified political body (nation-state) and enter into the Compact of Free Association with the United States in 1986.

There are at least eight major indigenous languages in FSM, but none is spoken throughout the island group. While English is the common language of commerce and government, every state has a language of its own. Many people, however, are familiar with Japanese because FSM was once ruled by Japan prior to World War II.

I.2 A Brief History

The Caroline Islands are believed to have been first settled by Micronesians some 4000 years ago. The islands that make up today's FSM were typically ruled by tribal chiefs and a form of a tributary empire emerged at some point, initially based in Kosrae but later taken over by a stronger one based in Yap.

In their search for the fabled Spice Islands (Indonesia), Portuguese navigators first sighted the Islands of Yap and Ulithi in 1525 and Spanish expeditions subsequently reached these and other Caroline Islands. Spain formally claimed the islands in 1886, only to relinquish them in 1899 when Spain sold its Micronesian possessions in the Caroline Islands, including Palau, and the Mariana Islands (except the southernmost island of Guam) to Germany which had already secured the Marshall Islands. Not much happened in Micronesia during the brief period of Spanish rule. With the Spanish empire in decline, especially in Latin America, Spain invested little in Micronesia.

Germany played a more active role by encouraging trade and copra production. Germany's rule in Micronesia, however, was also brief. With the breakout of World War I in 1914, Japan captured the Western Pacific from Germany and assumed formal control of "German Micronesia" through a League of Nations mandate in 1920. The Caroline archipelago became a part of the Japanese empire from 1922 to the end of World War II when the United States liberated the Western Pacific.

Early in the Japanese administration, a large number of Japanese immigrants to Micronesia helped the total population reach 100,000, two and a half times the indigenous population at the time.¹ Japan also helped Micronesia build a basic infrastructure including electricity, roads, harbors and education. Through the introduction of technology, agricultural production was increased for export back to Japan.

On withdrawing from the League of Nations in 1935, Japan used military force to keep control of the islands. To maintain a long-term military presence in the area and to project its power in the region, Japan built military bases in Chuuk and Palau. More than half a century later, a sunken Japanese fleet in the Chuuk Lagoon is now a tourist attraction.

¹Development Associates, Inc., *A Report on the Progress of the Federated States of Micronesia Under the Compact of Free Association with the United States, 1986-96* (Revised and Updated, 1999), October 1999, p. 3.

FSM POPULATION BY STATES

	1980		1990		1999		1980-90	1990-99	1980-99
	Number	% Share of Total	Number	% Share of Total	Number	% Share of Total	Annual Growth (%)	Annual Growth (%)	Annual Growth (%)
Chuuk	37,488	51.2	48,914	50.1	59,367	51.1	2.7	2.2	2.4
Pohnpei	22,080	30.2	31,251	32.0	37,013	31.8	3.5	1.9	2.8
Yap	8,100	11.1	10,523	10.8	12,055	10.4	2.7	1.5	2.1
Kosrae	5,491	7.5	6,929	7.1	7,833	6.7	2.4	1.4	1.9
Total	73,159	100.0	97,617	100.0	116,268	100.0	2.9	2.0	2.5

Source: FSM Department of Economic Affairs (Economic Management & Policy Advisory Team—EMPAT) and Bank of Hawaii.

At the end of World War II, the United States turned the islands into a UN trust territory and assumed its administration on behalf of the United Nations. Under US administration, TTPI was placed with the Department of the Interior in 1951, following a brief period of control by the US Navy. With the exception of the Marianas, which remained under US naval command until 1962, TTPI was under civilian rule through most of its existence.

Demands for self-rule and sovereignty could be heard in various parts of TTPI as early as the 1960s. Yielding to these political aspirations, the United States helped Micronesia form the Congress of Micronesia in 1967 which declared the area sovereign in 1970. Following a decade of talks, the United States agreed in 1977 to terminate the UN trusteeship.

In 1978, the Mariana District of TTPI declared itself as the Commonwealth of the Northern Mariana Islands (CNMI) and entered into a political union with the United States. Under the Commonwealth Covenant, CNMI became a US territory with powers typical of a US state as well as those for self-rule which include making its own labor, immigration and tax laws. CNMI is permanently affiliated with the United States and its residents are US citizens.

TTPI's District of the Marshall Islands adopted its own constitution in 1979, creating RMI. RMI also entered into a 15-year compact of free association with the United States a short time later. TTPI's District of Palau became the Republic of Palau in 1981 and a sovereign nation in 1994 in a 50-year compact of free association with the United States. In return for exclusive access to Palau's water, especially for military purposes, the United States will make total payments in rent and aid of about \$630 million in the 15 years starting in October 1994.

FSM entered into a 15-year pact with the United States in 1986. By the end of 2001, total rent and aid payments to FSM under the Compact will have amounted to roughly \$1.4 billion. These payments are intended to help FSM move from a consumption to a production economy.

The continuation of the unique link between the United States and the small countries in the region such as FSM is critical to US strategic, political and economic interests in the Pacific. This link in turn has important implications for the region's economic and social well-being.

I.3 Population and Migration Dynamics

FSM's population was an estimated 116,268 in 1999, up 19.1 percent from 1990. The annual growth rate of 2.0 percent in 1990-99 was lower than in the previous decades, but still considered rapid. From the 1950s to the 1980s, FSM's population growth rate averaged 3.0 percent a year.

There is now clear evidence showing that emigration played a key role in reducing the population growth rate in FSM in the 1990s. The Compacts between the United States and FSM, RMI and Palau allow free movement of the citizens of these freely-associated countries to the United States and its territories. Migration from these countries to Guam, Hawaii and CNMI has increased so notably in the last decade that the additional financial burden these migrants create for their host markets has caused some tension.

Guam and CNMI have asked the federal government for repayment of expenses linked to Micronesian migrants. By order of the Congress, the Department of the Interior (DOI) keeps track of the migration patterns, as the federal government determines the proper reimbursement amount to the US territories and Hawaii.

The total financial burden these emigrants creates for host markets is unknown. Also unknown is their positive contributions to these markets in terms of labor supplied, wages earned and taxes paid. The estimated cost of providing public education to these migrants alone ranged from \$2.4 million in CNMI to \$7.2 million in Hawaii and \$10.8 million on Guam. Health and welfare cost estimates ranged from \$1.5 million in CNMI to \$6.7 million on Guam. The total of these costs ranged from \$3.9 million in CNMI to \$17.5 million on Guam.

Accurate figures are unavailable. However, the total estimates of Micronesian migrants to not only Guam, CNMI, and Hawaii but also to the contiguous 48 states range from 20,000 to 30,000. These may not appear to be large numbers, especially in relation to the population of the United States which is approaching 270-275 million. However, these numbers represent a significant proportion of Micronesia's population. FSM, RMI and Palau together have a population of roughly 187,000, thus 30,000 migrants represent 16 percent.

**MICRONESIAN MIGRANTS TO GUAM,
HAWAII AND CNMI: 1997-98**

	Compact Migrants to:			Total	Percent of Total
	Guam 1997	Hawaii 1997	CNMI 1998		
Pre-Compact					
FSM	270	232	289	791	31.2
RMI	2	185	18	205	8.1
Palau	458	193	885	1,536	60.7
Total	730	610	1,192	2,532	100.0
Post-Compact					
FSM	6,325	3,312	1,503	11,140	80.6
RMI	123	2,070	74	2,267	16.4
Palau	102	127	178	407	2.9
Total	6,550	5,509	1,755	13,814	100.0
Total					
FSM	6,595	3,544	1,792	11,931	73.0
RMI	125	2,255	92	2,472	15.1
Palau	560	320	1,063	1,943	11.9
Total	7,280	6,119	2,947	16,346	100.0

Source: Office of Insular Affairs (DOI), *The Impact of the Compacts of Free Association on the United States Territories and Commonwealths and on the State of Hawaii*, March 1999, p. 3.

Migration from the freely-associated states will continue, especially if economic and financial opportunities do not improve in the home markets. According to the DOI's Office of Insular Affairs (OIA), 7,280 migrants from Micronesia (FSM, RMI and Palau) resided on Guam, 6,119 in Hawaii, and 2,947 in CNMI, for a total of 16,346 in 1997-98.²

FSM migrants made up 73.0 percent of the total, 93.4 percent of whom migrated after the Compact took effect. Of all "post-Compact" migrants, 80.6 percent were from FSM, 16.4 percent from RMI and 2.9 percent from Palau. The majority of FSM migrants were from the State of Chuuk which has the lowest standard of living of FSM's four states and offers fewer economic and financial opportunities to its residents.

The most likely explanation for this exodus is the lack of economic and financial opportunity in FSM itself. While there is no detailed information on the background of FSM migrants, those emigrating to the United States and its territories are very likely skilled and more proficient in the English language. This loss of skilled labor force in the proverbial "brain drain" pattern puts FSM at a disadvantage for future economic growth as it represents losses in future tax revenues and, more important, people who are to contribute to economic development of the local market.

²Office of Insular Affairs (US Department of the Interior), *The Impact of the Compacts of Free Association on the United States Territories and Commonwealths and on the State of the Hawaii*, March 1999, p. 3.

Economic contraction caused by the step-downs in Compact funds and a reform package administered by ADB became so severe later in the decade that mass migration resulted. While that phase of the economic and financial adjustment process has ended, returning to economic stability and a more stable population growth in FSM is doubtful without US commitment to continued funding.

I.4 Government and Modern Democratic Institutions

FSM's linguistic, cultural and historical differences at the state and national levels have often made national consensus difficult. Yet the US-style democratic government has been blended smoothly with FSM's traditional system. The result has been slow steps toward change.

Government organization follows that of the United States. There are three levels of government: national, headed by a president, state, headed by a governor, and municipal, headed by village elders. Both the national and state governments have judiciaries that follow the US legal system and procedures.

Evolution of modern democratic institutions and the political process in FSM has largely followed the American example. While tradition plays an important role in all political and economic matters, especially reaching consensus on critical issues, the national and state governments work in ways remarkably similar to those in the United States.

Administratively, FSM is divided into four states: Pohnpei, Chuuk, Yap and Kosrae. Pohnpei includes the Island of Pohnpei, 25 smaller islands and another 137 coral reefs. The state's total land area is 133.4 square miles of which the Island of Pohnpei alone is 130 square miles.

The State of Chuuk consists of seven major island groups with its capital located on Moen, the state's largest island. Moen and the state's other 98 islands are surrounded by a coral reef ring that forms the Chuuk Lagoon, the site of some of the fiercest battles of World War II. The lagoon, known for its diving, covers more than 800 square miles of the Pacific Ocean. Chuuk's total land area is 49.2 square miles.

The westernmost state of Yap is only a 45-minute flight from Palau, and is made up of four large and seven small islands plus another 134 islets. Yap has a total land area of approximately 45.6 square miles. Kosrae, FSM's easternmost state, consists of five closely situated islands with a total land area of 42.3 square miles.

Municipal government, in some ways the most important level of government, exists at the village level, and its main purpose is to keep the traditional culture current and in control. Heads of local government are mostly traditional chiefs or other prominent community figures, mostly native persons. Centuries-old local custom plays an important role in the economic, social and governmental structures.

Tradition sometimes recognizes the local chiefs as more important than elected leaders. The chiefs reflect the

opinion of the people and very little can happen without their consent. The Council of Chiefs, for instance, has veto power over legislation affecting traditional ways, and any shift perceived to change the culture can be challenged. A complex and highly hierarchical system has been established over the centuries which serves to curb rapid change and maintain social and political stability.

The social welfare system arising from the traditional system is among the most critical factors behind village and community cohesion, especially in times of economic and financial crises when income losses create tensions. The traditional system of discouraging accumulation of individual wealth and promoting sharing of wealth among the extended family is most effective in diffusing crises. Such a collective incentive structure does not allow a person to gain because that gain is by necessity the gain of the whole community. However, social scientists who have studied communal structures over the years have often come to the conclusion that the extended family concept of collective gain is the root cause of the lack of entrepreneurial drive in communal cultures.

Given the unique mix of social and economic factors at work, the role of government is much greater than is typical of market economies. American individualism and FSM communalism are at opposite ends of the spectrum. That difference has been among the main causes of frustration for those who have sought a greater degree of Americanization of FSM. Understanding these differences is essential to achieving a higher living standard through a productive market economy.

Defenders of the status quo argue that 15 years is too short a period for the market system to be widely held. However, the longer the transition from traditional to modern ways takes, the more difficult and costly it will be. There is no indication that this change in FSM will occur more rapidly in the future as major changes in its institutions, infrastructure and reward system are still necessary.

1.5 Economic Base and the Compact of Free Association

For over five decades now, the United States has sustained FSM's mainly consumption economy. A small, widely scattered tourist plant that is not very competitive regionally has been built in FSM in the last 20 years. FSM is off the main air and sea transport lanes that connect other markets such as Guam, CNMI and Palau to East Asia, which supplies the majority of tourists to the region. As a result of these and other conditions such as high transport costs, FSM is unlikely to benefit as much as some of its neighbors from the economic rebound currently underway in Asia.

Of the two million tourists who visit Guam and CNMI, for instance, 80 percent of those to Guam and 70 percent to CNMI are from Japan. As the Japanese economy recovers, tourist traffic from Japan is expected to rise. Tourists from East Asia as a whole are also expected to

increase in the future, giving Guam and CNMI with proximity, tourist infrastructure and attractively-priced tour packages an advantage.

In contrast, visitor traffic to FSM reached 30,000 in 1993, of which only about a quarter were from Japan and 60 percent from the United States. Those who visit FSM consist of professional divers seeking the most notable diving spots in the Pacific, regardless of the class and quality of facilities, limited scientific and cultural expeditions, business and government visitors and returning residents.

Other barriers to developing tourism have been the distances among the islands themselves which are scattered in the ocean with scant means of transport and communication, and the continuing lack of desire among some islanders to develop tourism as a business. There appear to be no incentives to create and expand income-generating assets such as tourist services which should be among the pillars of the economy.

A money economy with modern communications, transport and utilities has developed over the last five decades, but is limited to the population centers of the main islands. Since its days as part of the Trust Territory followed by the Compact of Free Association in 1986, FSM's main economic engine has been fueled by payments from the US Congress.

US payments to FSM and other members of the former TTPI in compacts of free association with the United States are not merely economic aid without quid pro quo, but are for the strategic purpose of maintaining exclusive access to the area's waterways. The current link between the United States and FSM is first and foremost a strategic and political alliance, and only secondarily an economic partnership. This is not a typical donor-client relationship.

The United States will have invested about \$3 billion in FSM by 2001 when the first financial package of the Compact expires. Slightly more than half of that money was spent in the 30 years beginning in 1955, with the balance in 1986-2001. US dollars have sustained what can reasonably be considered an adequate standard of living for FSM's population which grew from roughly 40,000 in 1958 to 116,268 in 1999. However, the national economy has created few income-generating assets using US funds, and the small subsistence sector has declined over the last three decades as more people have switched to the money economy.

FSM and the United States are currently negotiating the second financial package of the Compact. They are to conclude these talks some time next year with an agreement on two principal issues: (1) a fixed rent amount over a given period for which the United States will retain exclusive access to FSM waters, and (2) economic and financial aid that would help FSM move toward increased self-sufficiency through expansion of the private sector so it becomes the economy's main engine. To increase the scope of the private sector and raise the level of self-sufficiency, a concrete agenda with specific private sector growth targets

and some enforcement mechanism must be established.

What the United States will ultimately pay for exclusive access to the FSM waters is an issue that preoccupies all those affected by the Compact. While there is room for speculation, it appears that the immediate strategic value of the FSM waters has dropped since the last financial package of the Compact was negotiated at the peak of the Cold War. Still, it is highly unlikely that the United States would allow any potential for a power vacuum or instability in the region. That Hawaii is the headquarters for the nation's largest combined military command outside the contiguous 48 states reflects the importance of the Pacific to the national interest.

Meanwhile, the relationships that have developed politically and between the peoples of the United States and FSM are also extremely valuable to both sides. The United States has not only invested in FSM's physical infrastructure since the end of World War II, but has also helped FSM become a democracy. This is not a small feat, given the political atmosphere in the Pacific's developing economies where traditional political structures are still in place and economic opportunities are severely limited by both natural and market constraints.

The United States has also helped cultivate constitutional liberalism (the rule of law) in Micronesia, which is a major achievement, regardless of other economic and financial considerations.

The next Compact phase is expected to help FSM turn its democracy into an open and efficient market system, but this transformation will require time and financial commitment. Washington's incredible turnaround of its large fiscal deficits of 30 years into possible surpluses in coming years has not only restored financial credibility to the nation's capital, it has substantially improved the federal government's financial flexibility. Aware that only the United States has the resources and the capacity to aid the transformation, the FSM government must make a strong case for that in the context of the Compact negotiations.

In coming to terms, a much greater emphasis on economic growth and development throughout FSM will be necessary. It is in the long-term interest of both sides to create more income-generating assets in FSM's private sector in the next phase of the Compact's financial package and move the economy, even if slowly, toward increased production in creating value and wealth.

II. MACROECONOMIC REVIEW AND FORECAST

II.1 Macroeconomic Review

Despite a well-developed money economy and a relatively high per capita income, FSM is a developing economy. Its per capita gross domestic product (GDP) was an estimated \$1,977 in 1999, which places FSM among economies the World Bank classifies as middle-income.

Structurally, the FSM economy is somewhat unique. Under the Compact, the FSM will have received annual payments of roughly \$89 million a year in 1986-2001. FSM has also received other grants from the US government. In total, FSM has received about \$100 million a year since 1986. These US payments amount to roughly \$1,000 per person per year. In addition, the national and state governments have borrowed against future US payments. Some of these obligations are to be paid in 2001.

In macroeconomic terms, the FSM economy is relatively simple. US funds are the only primary income source. These funds are used mainly to pay government wages, salaries and benefits, and a portion goes towards adding to public infrastructure (public capital formation). Thus, the economy's engine is the public sector which, in turn, supports a private sector that is made up largely of services and distribution activities. There is very little indigenous commercial production economy other than subsistence production which has stagnated in the last 10 years.

Except for a garment factory in Yap which employed 383 in 2000 (the same as a decade ago when it first opened) and another small factory on Pohnpei, employing only 170 in early 2000, traditional manufacturing is a very small part of the economy. Handicrafts and other small concerns have certainly added to manufacturing, but it is far from becoming a large income source. Tourist traffic has risen and fallen in the last decade, with more ups and downs to come.

Up until 4-5 years ago when ADB's financial and technical aid made it possible to generate consistent macroeconomic data, there was a serious shortage of accurate and timely information on the economy's makeup and performance. The data ADB has helped to generate, along with the wage and employment data from the FSM Social Security Administration, have enabled an informed quantitative assessment of economic performance over the last decade. As most FSM observers have suspected, these figures verify that there has been very little change in FSM's basic economic structure since the Compact took effect.

The FSM economy began to grow, although erratically and unevenly, when the Compact took effect in 1986. In 1987, real (adjusted for inflation) GDP grew 2.5 percent, according to the FSM Department of Economic Affairs, followed by a robust 6.8 percent gain in 1988 then a miniscule 0.9 percent rise in 1989. Since the first three years of the Compact (1986-88) are regarded as an adjustment period under the new economic regime, they should be excluded from any long-term trend analyses.

The 1989-99 period for which detailed macroeconomic data for both FSM and the four states are now available offers a realistic assessment of the economy's adjustment to the Compact, the changes in its makeup and performance in the post-Compact period. It is also an adequate representation of the long term. In real GDP growth alone, the 1989-99 period can be divided into two distinct sub-periods: 1989-93, the growth and prosperity years, and 1994-99, the years of

**FSM GROSS DOMESTIC PRODUCT (GDP) BY EXPENDITURES TYPE
(\$MILLIONS, FISCAL YEARS) AND POPULATION**

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Public Sector	50.20	53.87	58.19	60.39	69.41	72.75	81.12	82.87	82.83	77.94	79.18
Government	45.95	48.88	52.18	53.33	59.25	59.62	64.28	63.93	59.28	53.67	53.37
Public Enterprises	4.25	4.99	6.01	7.06	10.16	13.13	16.84	18.94	23.55	24.27	25.81
Private Sector	48.31	54.96	65.69	75.12	82.75	80.87	84.21	82.06	76.31	79.51	82.52
Wages	21.21	24.21	27.30	33.35	36.37	37.34	37.17	37.49	36.50	37.96	39.35
Profits	27.10	30.75	38.39	41.77	46.38	43.53	47.04	44.56	39.81	41.55	43.16
Subsistence	20.16	21.82	23.00	24.14	25.27	26.53	27.73	29.12	30.32	31.37	32.82
Homeownership	11.92	12.89	13.58	14.25	14.90	15.63	16.33	17.14	17.83	18.44	19.28
Indirect Taxes	9.03	9.66	12.13	13.01	15.21	15.43	14.91	14.59	14.28	16.34	16.08
Nominal GDP	139.62	153.20	172.59	186.91	207.54	211.21	224.30	225.78	221.57	223.60	229.88
Public Sector as % of GDP	36.0	35.2	33.7	32.3	33.4	34.4	36.2	36.7	37.4	34.9	34.4
Private Sector as % of GDP	34.6	35.9	38.1	40.2	39.9	38.3	37.5	36.3	34.4	35.6	35.9
Subsistence as % of GDP	14.4	14.2	13.3	12.9	12.2	12.6	12.4	12.9	13.7	14.0	14.3
Homeownership as % of GDP	8.5	8.4	7.9	7.6	7.2	7.4	7.3	7.6	8.0	8.2	8.4
Indirect Taxes as % of GDP	6.5	6.3	7.0	7.0	7.3	7.3	6.6	6.5	6.4	7.3	7.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Real GDP (In Fiscal 98\$)	182.7	188.9	205.8	216.4	234.0	231.3	239.5	234.1	224.9	223.6	224.0
Real GDP Growth Rate (%)	0.9	3.4	8.9	5.2	8.1	(1.2)	3.5	(2.3)	(3.9)	(0.6)	0.2
Population	95,740	97,618	99,533	101,485	103,476	105,506	107,576	109,686	111,837	114,031	116,268
Nominal GDP Per Capita (\$)	1,458.3	1,569.4	1,734.0	1,841.8	2,005.7	2,001.9	2,085.0	2,058.4	1,981.2	1,960.9	1,977.2
Real GDP Per Capita (\$)	1,908.3	1,935.1	2,067.7	2,132.3	2,261.4	2,192.3	2,226.3	2,134.3	2,011.0	1,960.9	1,926.6
Inflation Index (US CPI 98=100)	76.4	81.1	83.9	86.4	88.7	91.3	93.6	96.5	98.5	100.0	102.6
Inflation Rate (%)	4.3	6.2	3.4	3.0	2.7	3.0	2.5	3.0	2.2	1.5	2.6

Source: FSM Department of Economic Affairs (Economic Management & Policy Advisory Team—EMPAT)

stagnation and contraction.

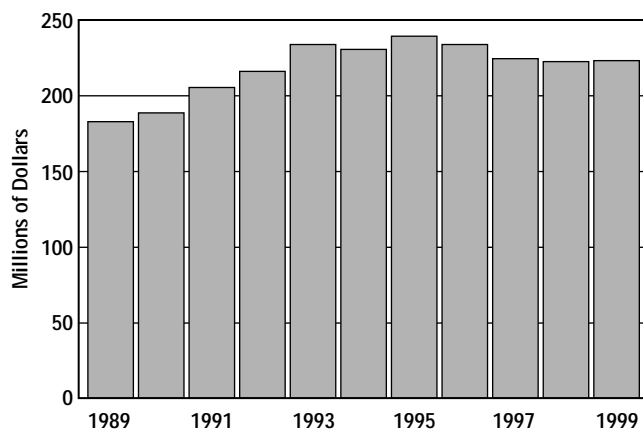
In 1989, FSM generated a total real GDP of \$182.7 million (in 1998 dollars) and a per capita GDP of \$1,908. By 1993, total real GDP had grown to \$234.0 million and per capita real GDP to \$2,261. In 1989-93, real GDP gained a robust 5.1 percent annually while per capita real GDP increased a healthy 3.5 percent a year.

A recession in 1994 followed this 7-year real GDP growth period and real GDP dropped 1.2 percent. Although

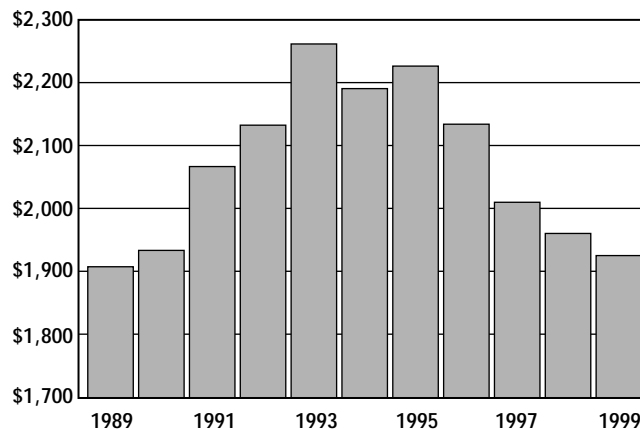
real GDP grew a relatively strong 3.6 percent in 1995, which marked the highest level for real GDP in FSM, the gain was short-lived. Total real GDP peaked at \$239.5 million in 1995 and then dropped for three consecutive years (1996-98) until it rose a scant 0.2 percent in 1999.

In 1994-99, real GDP growth rate averaged 0.9 percent a year. Per capita real GDP peaked in 1993 at \$2,261 but fell during the recession of 1994. It picked up slightly in 1995 when the economy grew again, but dropped

FSM'S REAL GDP (IN 1998 DOLLARS)



FSM'S REAL PER CAPITA GDP (IN 1998 DOLLARS)



**YAP GROSS DOMESTIC PRODUCT (GDP) BY EXPENDITURES TYPE
(\$MILLIONS, FISCAL YEARS) AND POPULATION**

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Public Sector	6.6	6.9	7.3	7.6	8.4	9.0	9.9	10.5	11.5	9.9	9.9
Government	5.9	6.1	6.2	6.2	6.5	7.0	7.3	7.2	6.8	5.7	5.5
Public Enterprises	0.7	0.9	1.1	1.5	1.9	2.0	2.7	3.3	4.7	4.2	4.4
Private Sector	5.9	9.0	10.7	14.7	14.3	14.1	13.0	14.3	14.6	15.5	15.9
Wages	2.7	3.8	4.0	5.5	5.0	5.9	5.6	6.1	6.5	7.1	7.2
Profits	3.1	5.2	6.7	9.2	9.2	8.3	7.4	8.2	8.1	8.4	8.7
Subsistence	3.5	3.8	3.9	4.1	4.3	4.5	4.7	4.9	5.1	5.2	5.4
Homeownership	2.5	2.7	2.8	3.0	3.1	3.2	3.4	3.5	3.6	3.8	3.9
Indirect Taxes	1.4	2.1	2.3	3.0	3.5	3.6	2.8	3.4	3.2	3.7	3.1
Nominal GDP	19.8	24.4	27.0	32.3	33.5	34.4	33.8	36.6	38.0	38.1	38.2
Public Sector as % of GDP	33.1	28.4	26.9	23.6	25.0	26.1	29.4	28.6	30.3	26.0	25.9
Private Sector as % of GDP	29.6	36.8	39.5	45.4	42.6	41.0	38.4	39.2	38.5	40.7	41.5
Subsistence as % of GDP	17.6	15.4	14.6	12.7	12.8	13.0	13.9	13.4	13.4	13.7	14.2
Homeownership as % of GDP	12.6	11.0	10.5	9.1	9.2	9.4	9.9	9.6	9.6	9.9	10.2
Indirect Taxes as % of GDP	7.1	8.4	8.5	9.1	10.4	10.5	8.4	9.3	8.3	9.8	8.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Real GDP (In Fiscal 98\$)	25.9	30.1	32.2	37.5	37.8	37.7	36.1	37.9	38.5	38.1	37.3
Real GDP Growth Rate (%)	(2.6)	16.2	7.0	16.5	0.8	(0.3)	(4.2)	5.0	1.6	(1.0)	(2.1)
Population	10,366	10,523	10,683	10,845	11,010	11,178	11,348	11,521	11,696	11,874	12,055
Nominal GDP Per Capita (\$)	1,910.1	2,318.7	2,526.4	2,982.0	3,043.6	3,080.2	2,976.7	3,173.3	3,245.6	3,206.2	3,171.3
Real GDP Per Capita (\$)	2,498.6	2,860.4	3,014.1	3,457.8	3,433.2	3,372.7	3,181.2	3,289.6	3,291.7	3,208.7	3,094.2
Inflation Index (US CPI 98=100)	76.4	81.1	83.9	86.4	88.7	91.3	93.6	96.5	98.5	100.0	102.6
Inflation Rate (%)	4.3	6.2	3.4	3.0	2.7	3.0	2.5	3.0	2.2	1.5	2.6

Source: FSM Department of Economic Affairs (Economic Management & Policy Advisory Team—EMPAT)

**POHNPEI GROSS DOMESTIC PRODUCT (GDP) BY EXPENDITURES TYPE
(\$MILLIONS, FISCAL YEARS) AND POPULATION**

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Public Sector	23.13	24.47	26.86	27.66	33.79	37.10	41.07	41.49	42.27	41.42	42.21
Government	19.78	20.65	22.24	22.51	25.93	26.85	29.11	29.51	29.31	27.86	28.30
Public Enterprises	3.35	3.82	4.62	5.15	7.86	10.25	11.96	11.98	12.96	13.56	13.91
Private Sector	24.02	27.06	31.46	36.13	43.15	41.06	45.19	43.80	40.21	40.89	42.32
Wages	11.67	13.38	15.21	18.75	21.62	21.54	21.50	21.88	21.04	21.56	22.23
Profits	12.35	13.68	16.24	17.38	21.53	19.53	23.69	21.92	19.17	19.33	20.09
Subsistence	5.92	6.41	6.75	7.08	7.41	7.78	8.13	8.53	8.88	9.18	9.60
Homeownership	6.53	7.06	7.44	7.81	8.17	8.56	8.95	9.40	9.78	10.12	10.58
Indirect Taxes	3.47	3.52	4.23	4.83	5.92	5.94	6.32	6.33	6.14	6.70	6.79
Nominal GDP	63.07	68.52	76.74	83.51	98.44	100.44	109.66	109.55	107.28	108.31	111.50
Public Sector as % of GDP	36.7	35.7	35.0	33.1	34.3	36.9	37.5	37.9	39.4	38.2	37.9
Private Sector as % of GDP	38.1	39.5	41.0	43.3	43.8	40.9	41.2	40.0	37.5	37.8	38.0
Subsistence as % of GDP	9.4	9.4	8.8	8.5	7.5	7.7	7.4	7.8	8.3	8.5	8.6
Homeownership as % of GDP	10.4	10.3	9.7	9.4	8.3	8.5	8.2	8.6	9.1	9.3	9.5
Indirect Taxes as % of GDP	5.5	5.1	5.5	5.8	6.0	5.9	5.8	5.8	5.7	6.2	6.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Real GDP (In Fiscal 98\$)	82.6	84.5	91.5	96.7	111.0	110.0	117.1	113.6	108.9	108.3	108.7
Real GDP Growth Rate (%)	4.6	2.3	8.3	5.7	14.8	(0.9)	6.5	(3.0)	(4.1)	(0.6)	0.4
Population	30,669	31,251	31,844	32,449	33,064	33,692	34,331	34,983	35,647	36,324	37,013
Nominal GDP Per Capita (\$)	2,056.5	2,192.6	2,409.9	2,573.6	2,977.3	2,981.1	3,194.2	3,131.5	3,009.5	2,981.8	3,012.5
Real GDP Per Capita (\$)	2,693.3	2,703.9	2,873.4	2,980.1	3,357.1	3,264.9	3,410.9	3,247.3	3,055.0	2,981.5	2,936.8
Inflation Index (US CPI 98=100)	76.4	81.1	83.9	86.4	88.7	91.3	93.6	96.5	98.5	100.0	102.6
Inflation Rate (%)	4.3	6.2	3.4	3.0	2.7	3.0	2.5	3.0	2.2	1.5	2.6

Source: FSM Department of Economic Affairs (Economic Management & Policy Advisory Team—EMPAT)

**KOSRAE GROSS DOMESTIC PRODUCT (GDP) BY EXPENDITURES TYPE
(\$MILLIONS, FISCAL YEARS) AND POPULATION**

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Public Sector	4.74	4.89	5.09	5.32	5.55	5.95	7.68	8.08	8.35	7.57	7.81
Government	4.74	4.89	5.09	5.32	5.55	5.49	5.87	6.28	6.20	4.99	5.09
Public Enterprises	—	—	—	—	—	0.46	1.81	1.80	2.15	2.58	2.72
Private Sector	3.24	3.65	4.45	4.02	4.60	5.61	5.20	6.10	4.97	5.56	5.77
Wages	0.98	1.19	1.34	1.60	1.65	1.75	1.78	1.88	1.80	1.96	2.06
Profits	2.26	2.45	3.11	2.42	2.95	3.86	3.42	4.22	3.17	3.60	3.71
Subsistence	1.14	1.22	1.28	1.34	1.39	1.45	1.51	1.58	1.63	1.68	1.75
Homeownership	0.27	0.29	0.30	0.32	0.33	0.34	0.36	0.37	0.39	0.40	0.41
Indirect Taxes	0.63	0.72	0.87	0.83	0.92	1.12	1.15	1.24	1.15	1.30	1.44
Nominal GDP	10.02	10.77	11.99	11.83	12.79	14.47	15.90	17.37	16.49	16.51	17.18
Public Sector as % of GDP	47.3	45.4	42.5	45.0	43.4	41.1	48.3	46.5	50.6	45.9	45.5
Private Sector as % of GDP	32.3	33.9	37.1	34.0	36.0	38.8	32.7	35.1	30.1	33.7	33.6
Subsistence as % of GDP	11.4	11.3	10.7	11.3	10.9	10.0	9.5	9.1	9.9	10.2	10.2
Homeownership as % of GDP	2.7	2.7	2.5	2.7	2.6	2.3	2.3	2.1	2.4	2.4	2.4
Indirect Taxes as % of GDP	6.3	6.7	7.3	7.0	7.2	7.7	7.2	7.1	7.0	7.9	8.4
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Real GDP (In Fiscal 98\$)	13.1	13.3	14.3	13.7	14.4	15.8	17.0	18.0	16.7	16.5	16.7
Real GDP Growth Rate (%)	(2.7)	1.5	7.5	(4.2)	5.1	9.7	7.6	5.9	(7.2)	(1.2)	1.2
Population	6,835	6,929	7,024	7,120	7,218	7,317	7,417	7,519	7,622	7,727	7,833
Nominal GDP Per Capita (\$)	1,466.0	1,554.3	1,707.0	1,661.5	1,772.0	1,977.6	2,143.7	2,310.1	2,163.5	2,136.7	2,193.3
Real GDP Per Capita (\$)	1,916.6	1,919.5	2,035.9	1,924.2	1,995.0	2,159.4	2,292.0	2,393.9	2,191.0	2,135.4	2,132.0
Inflation Index (US CPI 98=100)	76.4	81.1	83.9	86.4	88.7	91.3	93.6	96.5	98.5	100.0	102.6
Inflation Rate (%)	4.3	6.2	3.4	3.0	2.7	3.0	2.5	3.0	2.2	1.5	2.6

Source: FSM Department of Economic Affairs (Economic Management & Policy Advisory Team—EMPAT)

**CHUUK GROSS DOMESTIC PRODUCT (GDP) BY EXPENDITURES TYPE
(\$MILLIONS, FISCAL YEARS) AND POPULATION**

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Public Sector	15.76	17.58	18.98	19.76	21.70	20.72	22.44	22.86	20.71	19.05	19.26
Government	15.54	17.29	18.66	19.31	21.30	20.31	22.05	20.96	16.99	15.11	14.51
Public Enterprises	0.22	0.29	0.32	0.45	0.40	0.41	0.39	1.90	3.72	3.94	4.75
Private Sector	15.19	15.28	19.13	20.29	20.75	20.06	20.84	17.84	16.52	17.57	18.55
Wages	5.84	5.86	6.81	7.54	8.07	8.18	8.28	7.63	7.15	7.36	7.89
Profits	9.35	9.43	12.32	12.75	12.68	11.88	12.56	10.21	9.38	10.21	10.66
Subsistence	9.62	10.44	11.02	11.60	12.17	12.81	13.42	14.12	14.74	15.29	16.03
Homeownership	2.63	2.85	3.01	3.17	3.33	3.50	3.67	3.86	4.03	4.18	4.38
Indirect Taxes	3.53	3.37	4.73	4.39	4.88	4.76	4.61	3.62	3.84	4.63	4.72
Nominal GDP	46.73	49.52	56.87	59.21	62.83	61.85	64.98	62.30	59.84	60.72	62.94
Public Sector as % of GDP	33.7	35.5	33.4	33.4	34.5	33.5	34.5	36.7	34.6	31.4	30.6
Private Sector as % of GDP	32.5	30.9	33.6	34.3	33.0	32.4	32.1	28.6	27.6	28.9	29.5
Subsistence as % of GDP	20.6	21.1	19.4	19.6	19.4	20.7	20.7	22.7	24.6	25.2	25.5
Homeownership as % of GDP	5.6	5.8	5.3	5.4	5.3	5.7	5.6	6.2	6.7	6.9	7.0
Indirect Taxes as % of GDP	7.6	6.8	8.3	7.4	7.8	7.7	7.1	5.8	6.4	7.6	7.5
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Real GDP (In Fiscal 98\$)	61.2	61.0	67.8	68.6	70.8	67.7	69.4	64.6	60.7	60.7	61.3
Real GDP Growth Rate (%)	(1.7)	(0.3)	11.1	1.2	3.2	(4.4)	2.5	(6.9)	(6.0)	—	1.0
Population	47,871	48,914	49,980	51,069	52,182	53,319	54,481	55,668	56,881	58,121	59,367
Nominal GDP Per Capita (\$)	976.2	1,012.4	1,137.9	1,159.4	1,204.1	1,160.0	1,192.7	1,119.1	1,052.0	1,044.7	1,060.2
Real GDP Per Capita (\$)	1,278.4	1,247.1	1,356.5	1,343.3	1,356.8	1,269.7	1,273.8	1,160.5	1,067.1	1,044.4	1,032.6
Inflation Index (US CPI 98=100)	76.4	81.1	83.9	86.4	88.7	91.3	93.6	96.5	98.5	100.0	102.6
Inflation Rate (%)	4.3	6.2	3.4	3.0	2.7	3.0	2.5	3.0	2.2	1.5	2.6

Source: FSM Department of Economic Affairs (Economic Management & Policy Advisory Team—EMPAT)

every year in 1996-99 until it settled at \$1,927, only slightly higher than 1989's level of \$1,908.

In 1989-99, FSM's total real GDP grew 22.6 percent (2.1 percent a year) and population grew 21.4 percent (2.0 percent annually), while per capita real GDP increased only 1.0 percent during the whole decade. As a general rule in measuring standard of living, if real GDP grows at a rate close to that of the population (when the labor market barely absorbs new entrants to the labor force), a certain living standard can be maintained, but as in the case of FSM, the average standard of living does not improve. Improvement in the average standard of living requires more rapid growth in both real GDP and per capita real GDP than in population.

FSM macroeconomic and population figures show that the average living standard did not improve in 1989-99, mainly because economic growth remained highly erratic and uneven while population continued to grow. Had it not been for migration to the United States and its territories, both total and per capita GDP would have shown even less spectacular results. At the same time, few new income-generating assets were created to add momentum to the economy's vitality and productivity. FSM's economic growth in 1989-99 was primarily fueled by keeping the consumption level steady. Any drop in that level showed up immediately in the aggregate economic accounts.

In addition to the uninspired macroeconomic performance over the entire 1989-99 period, the composition of the economy remained practically unchanged. In 1989, the public sector (the government and other public enterprises) was 36.0 percent of GDP. In 1999, it was 34.4 percent of GDP, despite reductions in the public sector's share as a result of lesser Compact funds in the last five years and a forced reduction in government payroll. In 1989-99, the public sector averaged 35.0 percent of GDP.

As a share of total national income, the private sector was 34.6 percent in 1989 and 35.9 percent a decade later. It averaged 37.0 percent for the entire 1989-99 period. The private sector peaked at 40.2 percent of GDP in 1992 but dropped steadily until it was back down to 34.4 percent in 1997, the lowest share of GDP during the decade. In 1998-99, it went back up slightly to 35.6 and 35.9 percent, close to where it was in 1989.

Subsistence production, which some government reports claim to be as much as a quarter of the economy, was 14.4 percent in 1989 and 14.3 percent in 1999, and averaged 13.4 percent during the entire period. Homeownership (mainly investment in a principal residence) was 8.5 percent of GDP in 1989 and 8.4 percent in 1999, averaging 7.9 percent during the decade. With indirect taxes changing little (from 6.5 percent in 1989 to 7.0 percent in 1999), the essential makeup of the economy in 1999 was practically the same as it was a decade earlier.

It is possible that macroeconomic data may obscure certain realities because numbers often do not capture every

action or change. However, statistical irregularities and errors resulting from omission tend to be small and are subject to revision with better data.

II.2 Economic Growth & Living Standards Among the States

Economic vitality and living standards vary among the states of FSM as they do in large economies. Yap outranked the other states in economic vitality (real GDP growth rate) in the 1990s. At \$3,094, Yap's real per capita GDP in 1999 was the highest of all states and 60 percent higher than that of FSM as a whole. In 1989-99, Yap's population grew 16.3 percent while FSM's rose 21.4 percent. During the same period, Yap's real GDP increased 44.0 percent, rising 3.3 percent per annum as compared to FSM's growth of 2.1 percent per year.

The economic decline of the late 1990s affected Yap just as much as any other state and the nation as a whole. Yap's real per capita GDP in 1999 was down 3.6 percent from the year before and 10.5 percent from its 1992 peak of \$3,458. However, more rapid real income growth throughout the 1989-99 period left the state's living standard (real per capita GDP) in 1999 23.8 percent higher than in 1989.

It was not always this way. In 1989, Yap's real per capita GDP of \$2,499 was below Pohnpei's \$2,693, then the highest in FSM. In 1990, Yap overtook Pohnpei in per capita income and remained in the top spot until 1995 when it lost that position to Pohnpei for one year. In each of the subsequent four years, Yap's per capita income remained above Pohnpei's and much higher than FSM's average.

What is Yap's secret? Apart from the differences in language and culture which undoubtedly explain some of the economic and financial differences among the states, Yap's advantages include a small population, a vigorous system of collective controls over resources, and a stronger sense of modern economic and financial management, including economic diversification. Yap's small garment factory was the first such facility in FSM. While it is not clear exactly how much it has contributed to Yap's economic and financial vitality, its production has stayed pretty much at the same level for a decade.

As favorable as Yap's economic and financial management record has been in the last decade, the state was as ill-prepared as any for the Compact fund step-downs in 1991-92 and 1996-97. Although these reductions were anticipated, public spending on personnel, goods and services rose as a share of total public spending through 1994-95 and continued in 1998-99.

Once the step-downs occurred and the state's financial situation deteriorated, Yap took steps to reduce the emerging fiscal gap. Thus, it emerged with relatively minor fiscal deficits. Having gotten past the step-downs and the public sector adjustment process, Yap has positioned itself to regain momentum when the economy begins to grow by mid-decade.

Pohnpei followed Yap in per capita GDP in 1999. Its \$2,937 real per capita GDP was 52.4 percent higher than FSM's and only slightly lower than in the year before. In 1989-99, Pohnpei's real GDP increased 31.6 percent (2.8 percent annually) while its population increased 20.7 percent (1.9 percent annually). A real GDP growth rate greater than that of its population made it possible for Pohnpei to realize a modest (9.0 percent) gain in real per capita GDP (living standard) over the decade.

Pohnpei's per capita GDP peaked at \$3,411 in 1995 when the national real GDP also peaked. In 1999, Pohnpei was home to 31.8 percent of FSM's total population as well as the national capital, and is the nation's civic and commercial center. The presence of the national capital, according to the Department of Economic Affairs, adds about \$400 per person per year to the state's nominal per capita GDP. The Compact step-downs and the public sector reduction program in the late 1990s affected Pohnpei in similar fashion as other states. Pohnpei, too, will benefit when the economy picks up steam by mid-decade.

Pohnpei's advantages are that it contains FSM's largest landmass, the nation's capital, and a more refined infrastructure than in other states. Given these attributes are permanent, Pohnpei has greater potential than any other state to develop a production economy. As past experience has shown, the island's landmass makes it possible to produce both farm and manufactured goods commercially. Pohnpei can show by example that its main advantages can be the foundation of a much broader economic base and a more vigorous pursuit of a production economy which will benefit not only the state but the whole nation.

The State of Kosrae came in third based on per capita GDP in 1999, which was closest to FSM's average. In terms of population, it is the smallest of the four states, accounting for only 6.7 percent of FSM's total population. The state's total real GDP increased 27.5 percent in 1989-99 (growing 2.5 percent annually). Its population increased 14.6 percent in 1989-99 (1.4 percent annually). It had the smallest population gain of any state, which accounted for the 11.2 percent improvement in the standard of living over the decade.

Because of the Compact step-downs and the public sector reduction, Kosrae's real per capita GDP of \$2,132 in 1999 was 10.9 percent below its 1996 peak. Its smallness gives Kosrae both advantages and disadvantages. However, the state has effectively managed the financial difficulties of the last decade by diversifying its economy. Farming, citrus fruits and bananas hold potential for the state.

Fourth among the states in real per capita GDP in 1999 was Chuuk, FSM's most populous state. Its real per capita GDP in 1999 was \$1,033, 53.6 percent of FSM's and one-third of Yap's. Chuuk's real GDP in 1999 was only 0.2 percent higher than in 1989, but its population increased 24.0 percent during the decade. In 1999, its real per capita GDP was 19.2 percent below 1989's level.

Chuuk has apparently put all of its financial problems of the past decade behind it. Its new administration has

publicly committed itself to more sound financial management, and Chuuk can now seek opportunities for creating increased production and distribution activities in the state.

The sale of the former Intercontinental Hotel to a Hawaii-based firm will help refurbish the hotel, which will be a first step to reviving Chuuk's stagnant tourist services industry. It may take much more to stem the flow of emigration which is only a short-term solution to the economic difficulties of Chuuk. A better solution in the long run is to expand the state's productive capacity within its resources.

II.3 Employment & Wages

Critics of US policy in Micronesia have often charged that the United States has helped create a culture of dependency by providing fixed funds without stringent rules for creating more income-generating assets. Since FSM is a sovereign nation, albeit in free association with the United States, this assertion is unfounded. However, the criticism is somewhat justified as there has been little progress in building and expanding a productive private sector in FSM. Nothing shows this situation better than FSM's wage and employment data from the Social Security Administration.

Total payroll employment in FSM increased only 4.9 percent from 17,791 in 1988 to 18,669 in 1997 (having peaked at 21,641 in 1993). During roughly the same time (1990-99), FSM's population increased 58.9 percent, nearly 12 times the rate of employment growth. In 1988-97, total public sector employment dropped 4.7 percent while private sector employment gained 18.5 percent. Although this increase in private sector employment may appear large, it would have been even greater had private sector employment not dropped from its peak of 10,518 in 1994 when it practically equaled public sector employment.

In 1988, the public sector employed 10,405 persons in FSM while the private sector employed 7,386. Nearly a decade later, public sector and private sector employment levels showed relatively little changes. In 1997, the latest year for which these data are available, the public sector employed 9,917 and the private sector employed 8,752. Meanwhile, both experienced declines from their respective peaks in 1993-95.

Apart from a stagnant, even declining, private sector which relies on the public sector for survival, government is the economy's backbone because the average wage rate in the private sector is only 40 percent of the public sector's average rate. Thus with government attracting and retaining the best of the labor force, the private sector cannot compete with the public sector.

The public sector also dominated in terms of total wages throughout 1988-97. In 1988, public sector wages were 77.6 percent of the total and private sector wages only 22.4 percent. In 1997, the public sector's share was down

FSM PRIVATE AND PUBLIC SECTOR EMPLOYMENT AND WAGES

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Public Sector Wages (\$000)	48,762	47,531	51,720	58,666	58,579	65,667	68,278	66,321	66,256	63,145
Private Sector Wages (\$000)	14,039	15,224	18,688	19,792	25,872	25,892	27,192	26,200	23,945	24,027
Total Wages (\$000)	62,801	62,756	70,408	78,458	84,451	91,560	95,469	92,521	90,201	87,171
Public Sector Employees	10,405	10,490	10,105	10,922	9,789	10,792	10,590	10,796	9,771	9,917
Private Sector Employees	7,386	8,317	9,355	9,299	10,431	10,849	10,518	10,186	9,312	8,752
Total Payroll Employment	17,791	18,807	19,460	20,221	20,220	21,641	21,108	20,982	19,083	18,669
Average Public Sector Wages	4,686	4,531	5,118	5,371	5,984	6,085	6,447	6,143	6,781	6,367
Average Private Sector Wages	1,901	1,831	1,998	2,128	2,480	2,387	2,585	2,572	2,571	2,745
Average Economy-Wide Wages	3,530	3,337	3,618	3,880	4,177	4,231	4,523	4,410	4,727	4,669
Average Private Wages as % of Average Public Wages	40.6	40.4	39.0	39.6	41.4	39.2	40.1	41.9	37.9	43.1
Annual Growth Rate of Average Public Wages (%)	—	(3.3)	13.0	4.9	11.4	1.7	6.0	(4.7)	10.4	(6.1)
Annual Growth Rate of Average Private Wages (%)	—	(3.7)	9.1	6.5	16.5	(3.8)	8.3	(0.5)	(0.0)	6.8
Annual Growth Rate of Economy-Wide Wages (%)	—	(5.5)	8.4	7.2	7.6	1.3	6.9	(2.5)	7.2	(1.2)

Source: FSM Social Security Administration

only slightly to 72.4 percent while the private sector's share gained a small amount to 27.6 percent. These data give critics of US policy the ammunition to blast a system dominated by a public sector which does not create income and wealth, but merely redistributes them.

The gap between the average wages of the public and private sectors also showed little change in 1988-97. In 1988, the average annual private sector wages of \$1,901 were 40.6 percent of the average public sector wages of \$4,686. The ratio increased only slightly to 43.1 percent in 1997, when the average private sector wages were \$2,745 a year and the average public sector wages \$6,367 a year.

The 1988-97 employment data also show that public sector and private sector employment levels, especially after 1990, are closely linked, suggesting that FSM's private sector employment is a function of public sector employment. This close correlation gives credence to the view that FSM's private sector is merely a support system for its large public sector, rather than being an independent private sector that would normally be dominated by both production and distribution activities.

Generally, public and private sector employment levels complement each other and do not necessarily move in the same direction as closely as they do in FSM. The policy dilemma this correlation between the public and private sectors creates for FSM is unique: any reduction in the public sector's employment in the short run possibly means a proportional drop in the private sector's employment.

II.4 Fiscal Affairs, Foreign Trade and Balance of Payments

FSM is a sovereign nation, but it has opted not to have its own currency. Instead, it has adopted the US dollar

as its currency since the time of TTPI. The stability and security inherent in being a part of the US monetary system obviously compensate for the flexibility an indigenous currency may afford a nation in the management of its economic, financial and foreign exchange matters. There is no indication that FSM will soon alter its close link with the United States, or launch its own currency.

Any discussion of fiscal conditions and management in FSM needs to take into account the fact that the FSM national government and the state governments are distinct entities with financial histories independent of each other. Therefore, no generalizations should be made on the basis of information from any one state. The absence of detailed and timely data on the finances of the various states precludes a detailed analysis of each state's financial management. This brief discussion is limited to the financial condition and management of the FSM national government.

In 1989-99, the government managed its finances competently, in both operational and capital accounts. The government produced an operating surplus (revenues less spending) every year in 1989-99, ranging from a high of nearly \$22 million in 1990 to a low of \$4.1 million in 1998. Since 1998 was one of the more difficult years as the FSM government was in the midst of implementing the ADB-induced public sector reduction program, any operating surplus was a good sign. Preliminary figures show that the surplus rose to \$7.9 million in 1999.

After accounting for all spending, including public capital projects which normally cause governments to borrow and accumulate deficits, the FSM government amassed a reasonably large surplus in 1989-99. In fiscal year 1989, the government's overall balance of financial accounts showed a surplus of \$29.8 million. In 1998, the cumulative surplus was up to \$124.9 million, slightly lower

FSM COMBINED STATEMENT OF REVENUE & EXPENDITURES (\$000, FISCAL YEARS)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Revenues											
Federal Contributions	5,603.3	2,290.0	2,079.4	1,919.4	3,295.2	4,492.7	10,675.7	9,884.8	8,240.6	9,918.2	—
Compact Funds	13,390.8	21,639.8	7,203.2	12,751.3	12,966.6	13,181.8	13,325.3	13,468.8	11,549.8	11,722.8	—
Other (including FSM taxes & fees)	20,508.7	25,164.7	37,564.8	32,893.3	40,633.2	47,080.3	50,043.8	52,536.0	53,613.3	55,046.2	—
Total	39,502.8	49,094.5	46,847.3	47,564.0	56,894.9	64,754.9	74,044.8	75,889.6	73,403.8	76,687.2	61,770.5
Expenditures											
Executive Branch	19,234.4	17,460.5	18,879.9	18,429.4	21,685.0	22,578.3	27,755.1	26,945.2	23,485.2	27,676.2	—
Judicial Branch	620.6	581.9	662.5	723.6	729.9	784.4	888.3	887.5	952.3	917.3	—
Boards & Commissions	1,124.6	974.6	996.7	1,059.0	1,129.8	1,001.4	3,086.5	2,831.8	3,258.1	2,642.4	—
Legislative Branch	2,113.4	2,415.8	2,204.0	2,311.0	2,386.2	2,540.7	420.0	416.8	402.9	425.4	—
Public Auditor	298.5	244.3	335.5	315.6	351.4	457.1	4,838.3	3,135.8	5,796.6	5,359.4	—
Other National Programs	2,178.3	1,927.7	2,507.7	2,082.7	2,295.9	3,174.1	9,703.8	12,015.3	1,035.1	913.4	—
Other Legislative Appropriations	3,222.6	3,325.5	3,936.2	7,889.4	6,267.0	8,269.6	1,096.2	1,079.6	15,698.1	15,284.1	—
Other	279.5	180.6	4,719.3	4,795.2	5,451.7	12,150.7	13,052.6	16,885.7	15,951.2	19,336.3	—
Total	29,071.9	27,110.9	34,241.8	37,606.0	40,296.9	50,956.2	60,840.8	64,197.7	66,579.4	72,554.5	53,847.2
Revenues Less Expenditures	10,430.8	21,983.5	12,605.5	9,958.0	16,598.0	13,798.6	13,204.0	11,691.9	6,824.4	4,132.7	7,923.2
Other Sources (Uses)	(15,783.0)	(6,904.9)	(10,555.0)	(5,428.8)	(6,154.1)	(5,073.6)	(5,114.1)	(5,470.0)	8,323.8	(3,855.5)	—
Fund Balance, Beginning of year	35,186.0	29,833.8	56,713.0	58,763.5	63,292.7	72,396.3	81,121.3	89,211.3	95,433.2	114,178.4	—
Fund Balance, End of Year	29,833.8	44,524.7	58,763.5	63,292.7	73,736.7	81,121.3	89,211.3	95,433.2	125,150.2	124,928.9	—

Source: FSM Department of Finance

than in the year before. No figures for fiscal year 1999 were available.

At the state level, financial conditions and management have varied from state to state over the last decade. Chuuk generated adverse publicity for its inadequate financial management in recent years. Given the limited opportunities for large-scale production and distribution under current conditions, it may take time before it is possible to make a more informed judgement about Chuuk's economic conditions and financial management. However, it is clear that Chuuk is the state with the greatest need of both economic and financial vitality.

The states of Kosrae and Yap have rarely had serious financial problems, while Pohnpei's financial difficulties are already in the past.

FSM's use of the dollar and its close political and economic link with the United States has given the country a certain degree of immunity against foreign economic influences that only states and US territories enjoy. Also, were it not for direct US payments which cover its imports, FSM would likely be a perpetual debtor nation or forced into tolerating a lower living standard.

In 1998, total merchandise imports, including fuel, were \$82.5 million while total merchandise exports amounted to \$8.0 million, leaving a merchandise trade deficit of \$74.5 million.³ Although there are no reliable data on service exports

(e.g. tourist receipts), the small amount they are believed to generate would not cover much of the deficit. If FSM were to pay for imports out of domestic revenues, it would be forced to limit imports to the market value of its exports.

While a per capita GDP of about \$2,000 is much lower than that in either Hawaii or the rest of the United States, it is higher than in the majority of the Pacific's independent economies. As long as FSM maintains its close link with the United States and receives fixed payments and other aid, the balance of payment problems that plague developing nations (especially those who pay for high-priced finished goods with the low revenues of primary goods) should not be a serious concern for FSM.

There are no restrictions on imports and exports. Most consumer goods, including vehicles, are imported from Asia, mainly Japan, while most prepared foods come from the United States. Used Japanese vehicles with steering wheels on their right sides have become common on Pohnpei because they cost less to import. Free trade is a reality in FSM.

Whether or not FSM and its four states pursue a more aggressive agenda of import substitution will not materially affect the balance of payment picture in the near future. While its close link to the United States is an advantage in the context of balance of payments, it is also a constraint because the FSM government cannot exercise its own monetary policy, and its fiscal policy is practically dictated by Washington. Still, its connection to the US monetary and market systems gives the FSM government and business a certain stability and predictability of market.

³Federated States of Micronesia, *Statistical Yearbook 1999*, p. 61.

EXTERNAL DEBT, FISCAL YEARS

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Total External Debt													
New	19.9	91.9	19.3	28.6	2.2	0.3	0.8	11.7	11.8	3.8	2.2	—	—
Outstanding	19.9	111.7	128.7	145.6	138.8	127.4	118.4	113.7	109.6	98.2	85.7	66.5	53.8
Amortization	—	2.3	11.7	9.0	11.7	9.8	16.4	15.9	15.2	14.7	19.2	8.9	0.7
Interest	—	2.2	7.7	9.1	9.4	8.7	7.7	6.7	5.6	4.7	3.8	2.1	1.7
Principal Balance	20.0	109.0	117.0	137.0	127.0	118.0	102.0	98.0	94.0	84.0	67.0	58.0	53.0
External Debt as % of GDP	13.0	63.0	63.0	66.0	60.0	52.0	45.0	44.0	42.0	36.0	28.0	23.0	21.0
Debt Service as % of Exports	—	11.0	32.0	27.0	20.0	21.0	32.0	33.0	29.0	26.0	29.0	13.0	2.8

Source: FSM Department of Economic Affairs (Economic Management & Policy Advisory Team—EMPAT)

II.5 Forecast

Given the structure of the FSM economy, forecasting its future should be rather straightforward, except that the Compact negotiations, the key to FSM's economic future, are under way.⁴ A statement from a recent FSM government report succinctly captures the essence of these talks. "The outcome of the negotiations--both in terms of the level and the mechanism of future support--will shape the economic growth prospects of FSM for the foreseeable future."⁵ Under these circumstances, the usual forecasting parameters do not apply to FSM and any forecast of its economy at this stage is guesswork at best.

Since scant information on the negotiations limits the range and viability of any forecast, it may be more constructive to get a sense of where the negotiation should be headed and what they should target as achievable goals. The negotiations will cover two broad areas: rent (fixed payments to keep the economy going) and aid (to create income-generating assets that would produce income to replace fixed payments). A trust fund to create an income stream in the long run apart from funding for production activities may also be included.

Economic aid should focus on two principal issues:

(1) what can be produced within FSM's resources and, (2) how the process would lead to a greater share of the economy for the private sector. As the following sections show, specific production and distribution opportunities that are potentially viable presently exist. To realize them will require a far more creative approach than in the past.

The commitment to creating a production economy in FSM must begin with the knowledge that the indigenous entrepreneurial pool is limited. To reach a wider circle of entrepreneurs, both the FSM and state governments need to minimize interventions in market processes and open the door to more possibilities for both residents and outsiders.⁶

⁴The first round of talks occurred in Honolulu in November 1999 and the second round was scheduled for April 2000.

⁵Government of the Federated States of Micronesia, *FSM Report to the Consultative Group of Donors: Consolidating Reform and Enhancing Self-Reliance*, February 29, 1999, p. 22.

⁶Asian Development Bank, *Federated States of Micronesia: 1996 Economic Report*, p. 119.

This can best be done by revising local and national foreign investment and land use codes as well as incentive structures. The governments of FSM may require that foreign interests take local partners or use local resources, but it is critical to attract more foreign capital and entrepreneurs for future progress to occur.

III. ECONOMY BY SECTOR

III.1 Fishing and Fisheries

Beyond subsistence fishing and a small local market which includes restaurants, FSM exports fresh catches to Guam, US mainland, Japan, Taiwan and Korea. FSM has some of the Pacific's most fertile skipjack tuna habitat in any country's exclusive economic zone (EEZ) in the Pacific, perhaps the largest. Although reliable data on the stocks of other fish varieties such as yellowfin, bigeye and albacore tuna are not available, indications are that their current harvest levels are sustainable.

Fisheries dominate the domestic productive economy and offer great potential for expansion. The most effective way to make fisheries create more income is to generate higher levels of value added in FSM. This may mean fish processing, even canning, and selling more finished product rather than simply selling the right to fish in FSM's waters, as is the case now. Since fish is a commodity not in short supply and has many substitutes, it does not command high prices. As a result, fishing license fees from foreign boats catching fish in FSM's 200-mile EEZ are unlikely to generate revenues that would make a substantial contribution to national income. The capital to fund a fish processing plant might come from the United States or Asia, but it will take more than cursory efforts to attract the large sum needed.

Government intervention in fishing and fisheries management will do little to make the sector better or more efficient. To the contrary, higher levels of value added may be generated if government stays out of business management. The critical question in any case is whether or not FSM residents will be compelled to work in areas that may offer lower wages and demand hard work.

Once again, government in FSM is the biggest barrier to the private market's expansion because it pays, on average, 2.5 times more than the private sector. If government stays out of the business and FSM residents are willing to work what may often be manual jobs, fishing and fisheries can become FSM's comparative advantage in the same sense as car-making is to Michigan and mass tourism is to Hawaii.

III.2 Tourism

Tourist traffic tripled from fewer than 10,000 in 1984 to more than 30,000 in 1993, but it dropped to about 23,000 by the mid-1990s and stayed at that level through the late 1990s. In 1997, the average occupancy rate in FSM was reported to be 28 percent. Only Yap managed to achieve an occupancy rate of 50 percent in 1997.⁷ The islands offer possibilities for specialty tourism but with their attractions widely dispersed, none of them is a likely candidate for mass market development.

FSM's current tourist plant is inadequate and unable to compete with destinations such as Palau, for example. In 1997, the most recent year for which such data are available, FSM's tourist plant (hotel, motel and other accommodations) was 570 rooms, and most of it in small firms with no other activities to make the tourist experience memorable. Most hotels are small, family-owned firms catering to interstate visitors. Of all visitors from overseas, 60 percent are from the United States and 25 percent from Japan. Both American and Japanese markets can be expanded with appropriate marketing and adequate infrastructure.

FSM's diversity of ecosystems, marine habitats and world-class diving sites make it a suitable destination to capture a good share of the specialty tourist market. Eco-tourism is now a buzz word in the Pacific tourist industry. FSM has little to attract eco-tourism in the form of small groups of visitors whose main goal is socio-anthropological tours. On the other hand, if eco-tourism is comprised of tourists with a variety of independent motives in seeking authentic Pacific island settings with modern tourist facilities that are both safe and friendly to the environment, FSM has a good chance to capture some of the market.

A large market for divers and other specialty tourists is in East Asia which is recovering from the Asian financial crisis. At present the smaller states of Kosrae and Yap are less inclined to develop tourism on a scale that may be more feasible for the larger states of Pohnpei and Chuuk. However, if a consensus is reached on how to develop

tourism and how much of it to develop, there is a vast market in FSM's backyard to consider.

The key to making tourism an industry is to treat it as a business and make it as efficient and competitive as possible. Proper marketing of the destination and what it offers will be required, which means commitment of resources to attract both tourists and capital sources, and to offer tourists an experience they may be willing to repeat and talk to others about it. In Hawaii, Guam and CNMI, repeat tourists are critical components of the industry. Making tourism a business, however, also means accepting the influence foreigners will have on FSM's economy and culture.



III.3 Garment Manufacturing

The new garment factory on Pohnpei is an example of new economic activity stimulated primarily by preferential access to the US market. The Malaysian-owned factory which opened last year employs 170 persons, 66 of them local and the rest from the Philippines. Management believes 1,000 workers would optimize both production (exports) and income (local wages) in the first stage. If it succeeds, the factory may expand further or others may enter the market. Should expansion occur, the best way for FSM would be to employ more FSM residents, rather than import laborers from large low-cost, labor-surplus Asian markets.

A large number of foreign workers may make a difference in the national economy by means of providing non-wage income such as taxes, but they may also alter the local social and economic systems in other ways. There is no formula to determine the optimum level of foreign workers to minimize their impact on the local social structure. There is also no way to ensure a fixed-term turnover of aliens in order to limit their influence. The number of foreign workers should be determined by the total direct and indirect economic benefit FSM wants to obtain from manufacturing for sale in US market.

⁷Federated States of Micronesia, *Proceedings of the 2nd FSM Economic Summit*, Pohnpei, September 13-17, 1999, p. 61.



Since the United States allows preferential terms for FSM exports, FSM should take advantage of the provision. However, FSM would be well-advised to do so by implementing accepted labor practices and ensuring that quantities sold in the United States are at reasonable levels.

III.4 Farming

Other than for subsistence production, farming has been hampered by government intervention, small land holdings, lack of management skills and other difficulties. Still, there is a potentially viable farm market, especially on Pohnpei if the various landowners form cooperatives for both land use and production. There are parcels of land on Pohnpei that are suitable for production, but they are held by different owners who have dissimilar uses for these lands. As a result, most of these lands are not used productively. Forming land-use cooperatives (pooling adjacent parcels as if they were one) can be a remedy. One particular use with potential is that of pastureland to raise cattle for both the domestic and export markets.

Revival of the famed Pohnpei Pepper production may not require land use cooperatives, but production quantities and prices are dictated by market forces. Citrus fruit production for both fresh and processed products (juices and jams) certainly has some potential on many of the islands. To make farming of any kind a viable income source, however, a willing labor force must be available.

III.5 Undersea Mining

In the longer term, another potential area of income for FSM and other Pacific economies is undersea mining. The technology to exploit undersea mines while reducing the potential for environmental damage is being developed. Also, there has been substantial progress in finding uses for

the residue once an undersea ore is mined. Disposal of the residue (tailings) has been a major concern in the discussions so far. As the technology develops to make it possible, for instance, to convert tailings from manganese nodules into building industry products, the entire sea mining enterprise looks increasingly promising.

III.6 Land Lease Arrangement Revision

These and other income sources in FSM will grow more rapidly and others will emerge if changes are made to the institutional structure in which the private sector works. An area in need of attention is the regulatory environment, especially in the land lease market. The FSM constitution prohibits non-citizens from acquiring land, most of which is communally owned. In some states there are 25-year limits on leases. Most foreign investment projects require approval by both the

national and state governments.

Land lease matters may not appear as major obstacles to expanding the economy's productive capacity. However, land lease barriers, together with others such as foreign investment and building permits, discourage foreigners from investing their capital and skills without which the FSM economy cannot reach its potential. Foreign investors not only seek open markets and sufficient returns, they also seek efficient markets where the turnaround from conception to production is rapid. Fixed land lease term in most Pacific markets is now about 50-55 years. In keeping pace with other Pacific economies, a more liberal lease period of 55 years applicable in every state may be a significant incentive to attract foreign capital.

IV. WHAT LIES AHEAD

FSM is in a critical stage of economic and political evolution, especially in relation to the United States. Both sides know the limitations and potentials of what may and may not work to put the FSM economy on a track to greater self-sufficiency. As former colonial sponsors have found elsewhere in the Pacific, self-sufficiency in the Pacific island economies can be elusive, especially for small markets with few resources other than the ocean that surrounds them. The American experience is not that different. After 35 years of TTPI and 15 years under the Compact, FSM is more dependent on the United States today than ever before.

Physically and technologically, some of the conditions of the 1950s have changed little. The prospect of a commercial agricultural economy producing for mass markets is no more likely today than it was in the 1950s. Meanwhile, government jobs and other means of support from abroad have completely removed the incentive to

produce for home consumption. As a result, even the subsistence economy is not as large or diverse as it once was. The notion of FSM becoming a self-sufficient economy is not based on a realistic assessment of its current resources.

Institutionally, FSM is a rather closed economy, especially to foreign capital in areas other than basic activities such as banking and finance, transport and communication. Few joint ventures have been attempted. At the same time, FSM is in many ways an irrevocable extension of the American system, both politically and economically. FSM leaders are keenly aware of the pressure on US government to become efficient and less costly to American taxpayers.

These and other factors make FSM a unique dilemma for US policy-makers. For FSM to become even more Americanized, as many believe it should, it needs to adopt an economic change strategy based on two principal parameters: (1) institutional reform, (2) explicit and irrevocable commitment to market principles and openness, including complete transparency in the public sector.

Institutional reform would consist of streamlining all regulatory measures, especially those concerning foreign capital and land use. Commitment to market principles and openness would require a further reduction of the public sector's role in the economy in a reasonable and orderly manner so it becomes a smaller segment of the economy over a specified time.

Explicit commitment to these two areas would open the market to outside capital. The extent to which foreign capital would flow to FSM will still be a function of the market's viability in the long run. The United States can contribute meaningfully in this regard by supporting FSM's education, health services and public infrastructure. A healthy, educated and informed citizenry would make the transition to an open

market and political system easier, even if it takes longer. In putting FSM on a track to greater self-sufficiency, the United States should also support access to new technology for the benefit of the largest possible majority.

Financing specific production and distribution activities such as building a fish processing plant or more garment factories should be left to the private sector and market channels. The governments of FSM should gradually focus less on regulating and inhibiting economic activity and more on actively supporting it, especially through the private sector.

Addressing basic needs in these ways is the most effective means for the greatest possible majority of the FSM population to benefit from future standard of living improvements. But there is still much to be done, even in building basic infrastructure. Expanding and improving runways and harbors, for instance, may be among such projects which should be clearly specified with limits on funding and time frames.

Repair of some pieces of public infrastructure that affect public health, however, should be addressed more urgently. Most of the lagoon around the town of Kolonia on the Island of Pohnpei is contaminated with sewage because of inadequate sewage processing capacity on the island and poor enforcement of public sanitation rules. Contamination has not only closed the lagoon to swimming and other water activities for individuals, it may also have damaged the ecosystem that is an integral part of the town and its present and future economy. Restoration of the lagoon's vitality may also be a way to reduce future public health costs.

Increasing FSM's indigenous labor force and reducing its rates of unemployment and underemployment are further concerns. The current level of payroll employment in FSM is only 16 percent of the population. Given that subsistence production does not represent employment in the usual sense and there are few self-employed persons, FSM's present level of employment (work for money wages) as a percent of the population is one of the lowest in the Pacific. Since the economy does not generate enough jobs to absorb all those who are in the labor force, more and more people share the same level of fixed national income and, as in Chuuk, standards of living decline while population grows. The problems of unemployment and underemployment in FSM need to be realistically addressed before they become more severe.

With the United States supporting basic infrastructure, including that for human development, and FSM becoming a more open market, it is quite possible to increase both production and distribution at a reasonable cost, at reasonable rates and within reasonable periods. Human development in this context means not only preparing future generations for an open market, but enabling the existing labor force to participate more actively in the economy to make the transformation happen.

FSM COMMERCIAL BANKING ACTIVITY

	1994	1995	1996	1997	1998	1999
Assets						
Cash & Due From Local Banks	7,423	3,665	4,321	4,158	4,698	6,392
Foreign Assets (Due From						
Banks Abroad)	60,173	68,933	79,623	82,247	78,143	76,668
Total Liquid Assets	67,596	72,598	83,944	86,405	82,841	83,060
Loans						
Commercial Loans	20,701	20,662	19,558	19,690	20,632	22,555
Consumer Loans	37,241	30,173	28,193	26,284	27,728	32,174
Total Loans	57,942	50,835	47,751	45,974	48,360	54,729
Other Assets	1,902	2,944	2,725	3,118	4,829	3,540
Total Assets	127,440	126,377	134,420	135,497	136,030	141,329
Liabilities & Capital						
Demand Deposits	24,779	23,603	22,699	27,347	26,727	25,865
Savings Deposits	39,451	37,433	39,223	38,953	38,639	43,811
Time Deposits	49,316	52,988	59,459	54,803	53,954	55,774
Total Deposits	113,546	114,024	121,381	121,103	119,320	125,477
Other Liabilities & Capital	13,894	12,353	13,039	14,392	16,708	15,852
Total Liabilities & Capital	127,440	126,377	134,420	135,495	136,028	141,329

Source: FSM Banking Board

PACIFIC ISLANDS FACT SHEET

US DOLLAR-DENOMINATED ECONOMIES

	Population	Land Area (square miles)	Notable Geographic Characteristics	Capital/ Distance from (miles)	Currency	Major Languages
GUAM	163,373	212	One island. Major US naval base and regional trans-shipment center at Apra Harbor. In hurricane path.	Agana/ Honolulu 3,800 Tokyo 1,600	US dollar	English, Chamorro, also Tagalog, Japanese
COMMONWEALTH OF THE NORTHERN MARIANA ISLANDS (CNMI)	79,429	177	Saipan the largest island, Tinian and Rota next, 14 others in the chain. 125 miles north of Guam. US territory closest to Asia.	Garapan, Saipan/ Honolulu 3,700 Tokyo 1,500	US dollar	English, Chamorro, Carolinian
FEDERATED STATES OF MICRONESIA (FSM)	116,268	270	607 islands and atolls, Pohnpei 130 square miles, other major islands Kosrae, Yap and Chuuk. The 4 FSM states span 1,700 miles from east to west.	Kolonia, Pohnpei/ Honolulu 3,100 Hong Kong 3,100	US dollar	English, 8 major local languages
REPUBLIC OF PALAU	18,500	170	343 islands, the main group encircled by a hundred mile reef. Babeldaob 136 square miles. 8 other inhabited islands. Rock Islands.	Koror/ Honolulu 4,600 Tokyo 2,000 Hong Kong 1,700	US dollar	English, Palauan, Sonsorolese- Tobian
REPUBLIC OF THE MARSHALL ISLANDS (RMI)	50,840	70	34 coral islands, 870 reefs, highest elevation 33 feet above sea level, average elevation 7 feet.	Majuro/ Honolulu 2,300 Guam 1,800	US dollar	English, Marshallese dialects
AMERICAN SAMOA	58,900	76	5 islands, 2 atolls. Pago Pago Harbor. Home of newest US national park. In hurricane path.	Pago Pago, Tutuila/ Honolulu 2,600 Los Angeles 4,800	US dollar	English, Samoan
TOTAL/AVERAGE	488,632	975				

NON-DOLLAR ECONOMIES

FRENCH POLYNESIA	226,000	1,609	130 islands, mostly atolls in 5 archipelagoes. Tahiti the largest island, 400 miles square, maximum elevation 7,464 feet.	Papeete, Tahiti/ Honolulu 2,800 Los Angeles 4,100 Paris 10,400 Tokyo 5,900	French Pacific franc (F CFP)	French, Tahitian
NEW CALEDONIA	203,672	7,376	Main island, Grande Terre 250 miles by 30 miles (larger than the Hawaiian Islands together), mostly mountainous. Several small islands.	Noumea/ Honolulu 3,900 Paris 10,400 Brisbane 900	French Pacific franc	French, 30 Kanak dialects
WALLIS AND FUTUNA	14,800	106	2 main islands, highest elevation 2,493 feet.	Wallis Island/ Honolulu 2,700 Paris 10,000	French Pacific franc	French, East Uvean, East Futunan
PAPUA NEW GUINEA (PNG)	4,150,000	179,490	Eastern half of the island of New Guinea. Largest by far Pacific island-state land mass. Other main islands New Ireland, New Britain and Bougainville.	Port Moresby/ Honolulu 4,300 Cape York, Australia 300 Tokyo 3,100 Hong Kong 3,100	Kina	English, Tok Pigin, Hiri Motu, hundreds of vernaculars
COOK ISLANDS	19,600	92	15 widely dispersed islands including volcanic peaks and atolls. Rarotonga the largest island 26 miles square. In hurricane path.	Rarotonga/ Honolulu 3,000 Wellington 2,000	New Zealand dollar	English, Cook Islands Maori
SAMOA	168,000	1,158	4 inhabited islands, 5 uninhabited. Highest point 6,100 feet, Mt. Silisili on Savai'i. In hurricane path.	Apia/ Honolulu 2,600 Suva 700 Brisbane 2,500	Tala	English, Samoan

GDP (US\$ million current)	Per Capita GDP (US\$)	Major Income Sources	Political Status	Major Sources of External Investment	Major Sources of Future Income
3,065.8	18,766	Tourism, military, trade and services	US territory since 1898. Guam Organic Act of 1950 conferred U.S. citizenship. Some push for commonwealth status.	US, Japan, Korea	Tourism, services
664.6	8,367	Tourism, garment manufacturing, trade and services	After WWI under Japanese mandate. In 1947 became part of US Trust Territory of the Pacific. Since 1978 a Commonwealth of the US. Islanders are US citizens.	Japan, Korea, Hong Kong, US	Tourism, services
230.0	1,977	US payments, government services, fisheries, tourism	After WWI under Japanese mandate. In 1947 became part of a UN Trust Territory. Became sovereign in 1979. In compact of free association with US as of 1986.	US, Japan	Compact status being renegotiated. Fisheries development, tourism
129.3	6,989	US Compact payments, tourism	After WWI under Japanese mandate. In 1947 became part of US Trust Territory. Became sovereign in 1994, in compact of free association as of 1994. Compact ends 2044.	Japan, US	Compact money, tourism
102.1	2,009	US payments, Kwajalein Missile Range, government services, copra, fisheries	After WWI under Japanese mandate. In 1947 became part of a UN Trust Territory. Became sovereign in 1979. In compact of free association since 1986.	US, Japan	US military. Compact being renegotiated. Fisheries.
253.0	4,295	Tuna canneries, government services, remittances from Samoans overseas	US territory since 1899. Samoans are US nationals.	US	Canneries, remittances, US entitlements
4,430.6	9,067				
4,106.8	18,172	Payments from Metropolitan France, tourism, Tahitian pearls	French controlled from the 19th century. Overseas territory of France since 1957. Active independence movement.	Metropolitan France	French transfers, tourism, pearls
3,373.0	16,561	Payments from Metropolitan France, nickel, agriculture and ranching, tourism, aquaculture	1853 became a French possession. Overseas territory of France since 1946.	Metropolitan France	French transfers, nickel, tourism, agriculture, aquaculture
28.7	1,939	French transfer payments, trochus shells	French controlled from the 19th century. Overseas territory of France since 1961.	Metropolitan France	French transfers
4,957.0	1,194	Minerals, oil and gas, forestry, agriculture, tourism	Under Australian & German control before WWI. Administered by Australia after WWII. Independent within the British Commonwealth since 1975. The Bougainville secessionist movement ended by a formal treaty in April 1998.	Australia, UK	Minerals, oil, timber, fisheries, tourism
76.1	3,882	Government aid, services, tourism	Self-governing since 1965 in association with New Zealand. Cook Islanders are citizens of both Cook Islands and New Zealand.	New Zealand	Tourism
199.0	1,185	Agriculture, remittances from abroad, tourism, manufacturing	Under German control before WWI, New Zealand after. New Zealand trusteeship after WWII. Independent since 1962.	New Zealand, Japan	Agriculture, tourism, light manufacturing

PACIFIC ISLANDS FACT SHEET *(continued)*

	Population	Land Area (square miles)	Notable Geographic Characteristics	Capital/ Distance from (miles)	Currency	Major Languages
FIJI	815,045	7,055	320 islands. Viti Levu 4,000 miles square, Vanua Levu 2,100 miles square. Major islands are mountainous and forested to windward.	Suva/ Honolulu 3,100 Sydney 2,000 Tokyo 4,500	Fiji dollar	English, Fijian, Hindi
KIRIBATI	83,976	266	33 islands scattered 2,400 miles east to west, 1,300 miles north to south. Almost entirely low-lying atolls, Christmas Island the largest.	Tarawa/ Honolulu 1,300 Tokyo 3,900	Australian dollar	English, Micronesian
SOLOMON ISLANDS	393,000	11,197	850 mile long double island chain. 6 mountainous main islands, Guadalcanal 2,080 miles square.	Honiara, Guadalcanal/ Honolulu 3,960 Port Moresby 900	Solomon Island dollar	English, Solomon Islands Pijin, more than 80 vernaculars
TONGA	97,800	386	Main islands volcanic, some 150 coral atolls, 36 permanently inhabited.	Nukualofa/ Honolulu 3,100 Brisbane 2,000	Pa'anga	Tongan
VANUATU	185,000	4,707	80 scattered islands, several active volcanoes. Largest island Espiritu Santo 1,500 miles square, highest point 6,158 feet.	Port Vila, Efate/ Honolulu 3,500 Tokyo 4,100	Vatu	French, English, Bislama
NAURU	11,200	8	A single island with a 100 foot high central plateau of now nearly exhausted phosphate-bearing rock.	Nauru/ Honolulu 2,800 Banaba, Kiribati 200	Australian dollar	English, Nauruan
NIUE	1,745	101	Coral island rising 65 feet from the ocean and another 130 feet to a central plateau.	Alofi/ Wellington 1,800 Suva 800	New Zealand dollar	English, Niuean
TOKELAU	1,507	4	3 atolls with islets 10 to 16 feet above sea level. In hurricane path.	Nukunonu/ Honolulu 2,300 Wellington 3,800	New Zealand dollar	English, Tokelauan
TUVALU	10,900	10	5 atolls, 4 coral islands, maximum elevation 16 feet above sea level.	Funafuti/ Suva 700 Sydney 2,500	Australian dollar	English, Tuvaluan
TOTAL/AVERAGE	6,384,245	213,565				
GRAND TOTAL/ AVERAGE	6,869,555	214,540				
HAWAII	1,205,126	6,423	4 main islands. Island of Hawaii 4,028 miles square, highest point of Mauna Kea 13,796 feet. Mauna Loa and Kilauea on Hawaii both active volcanoes. Maui 727 miles square, Oahu 597 (Waikiki), Kauai 552. In hurricane path.	Honolulu/ San Francisco 2,400 Los Angeles 2,600 Washington 4,800 Tokyo 2,500	US dollar	English

SOURCES: Europa, *The Far East and Australasia*, 2000; Gary L. Fitzpatrick and Marilyn J. Medlin, *Direct-line Distances, International Edition*, New Jersey, 1986; International Monetary Fund, *International Financial Statistics*, March 2000; David Stanley, *Micronesia Handbook*, Chico, California, 1989; David Stanley, *South Pacific Handbook*, 5th Edition, Chico, California, 1993; State of Hawaii Department of Business and Economic Development, *Data Book 1995*,

GDP (US\$ million current)	Per Capita GDP (US\$)	Major Income Sources	Political Status	Major Sources of External Investment	Major Sources of Future Income
2,148.9	2,637	Sugar and other agriculture, tourism, forestry, fishing, mining, garment industry	Annexed by Great Britain in 1874. Became independent within the Commonwealth in 1970, rejoined the Commonwealth in 1997.	Australia, New Zealand, EU, Japan	Agriculture, tourism, mining, light manufacturing
76.0	905	Agriculture (copra), remittances, aid	Annexed by Britain in 1919. A republic within the British Commonwealth since 1979.	NA	Fisheries development
343.7	875	Agriculture, timber sales, fishing and fish canneries, aid	British protectorate as of 1873. Politically independent within the Commonwealth since 1978.	Australia, Japan	Agriculture, fisheries, tourism
177.0	1,810	Agriculture, tourism	British protectorate as of 1900. Independent monarchy within the Commonwealth.	NA	Tourism, agriculture
247.0	1,335	Agriculture and ranching, tourism, Offshore Finance Center, services	Anglo-French New Hebrides Condominium in 1906. Republic of Vanuatu within the British Commonwealth established in 1980.	Australia, Japan	Tourism, agriculture
368.0	32,857	Phosphates and investments from phosphates	From 1919 administered by Australia. Became an independent republic in 1968.	NA	Investments from phosphate
6.1	3,476	Subsistence activity, government aid	Self-governing since 1974 in free association with New Zealand.	NA	Tourism
1.2	796	Subsistence activity, government aid	Non-self-governing territory administered by New Zealand beginning 1925.	NA	Subsistence activities, government aid
9.0	826	Subsistence activity, government aid	Independent state within British Commonwealth since 1978.	NA	Subsistence activities, government aid
16,117.5	2,525				
20,562.2	2,993				
35,146.4	29,164	Tourism, services, trade, government	Annexed in 1898, became a US territory in 1900, became a state in 1959.	US, Japan, Australia	Tourism, defense, services, trade, government

Honolulu, 1996; Peter W. Thomson, *Trade and Investment in the South Pacific Islands*, Honolulu, 1989; World Bank, *World Development Report*, 1999; various Bank of Hawaii economic reports, 1992–2000, and other sources. (Rev. 4/00)

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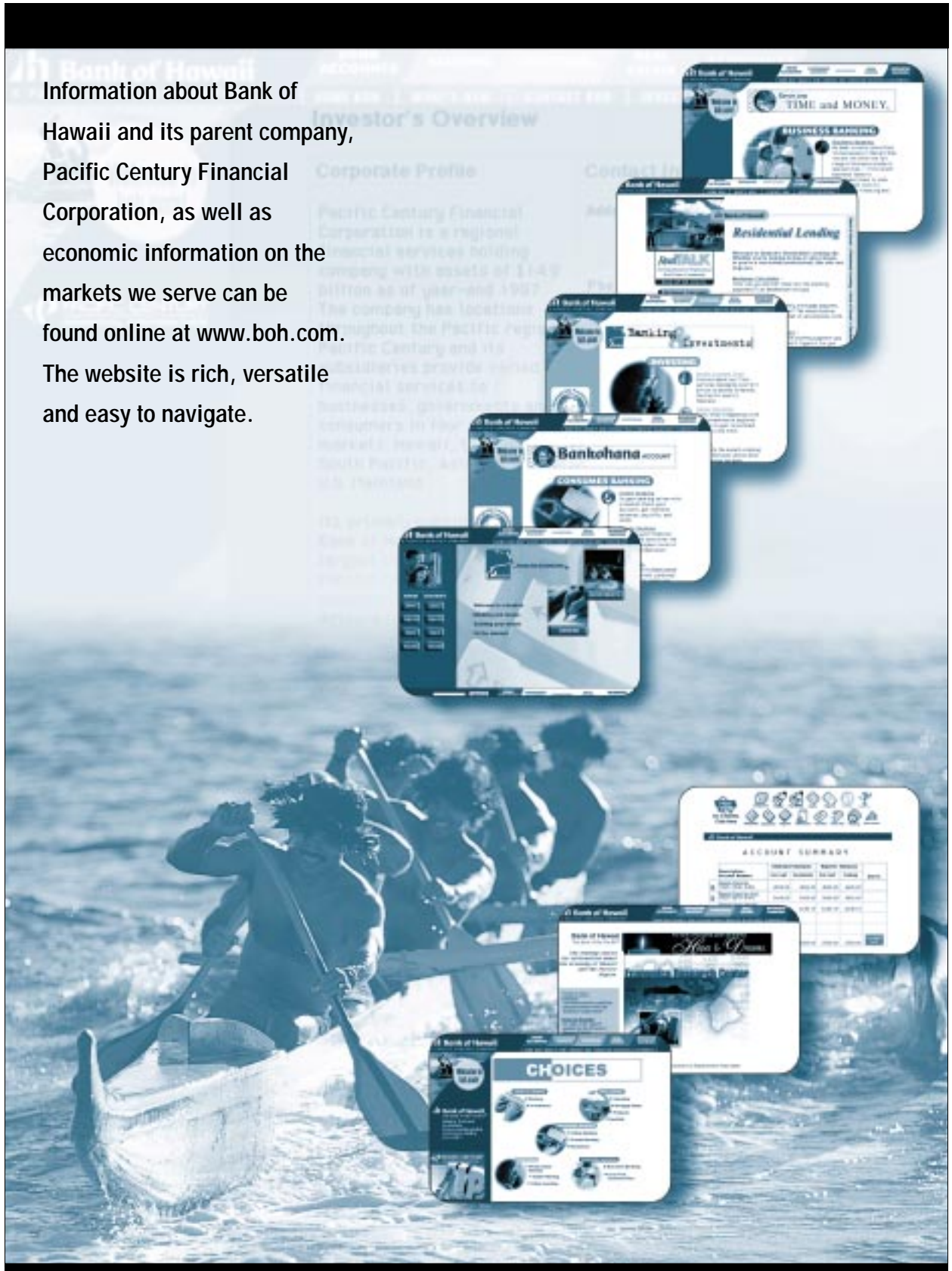
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