# THE FEDERATED STATES OF MICRONESIA

# TRADE POLICY

**January 2011**

**Division of Trade and Investment**
**FSM Department of Resources and Development**

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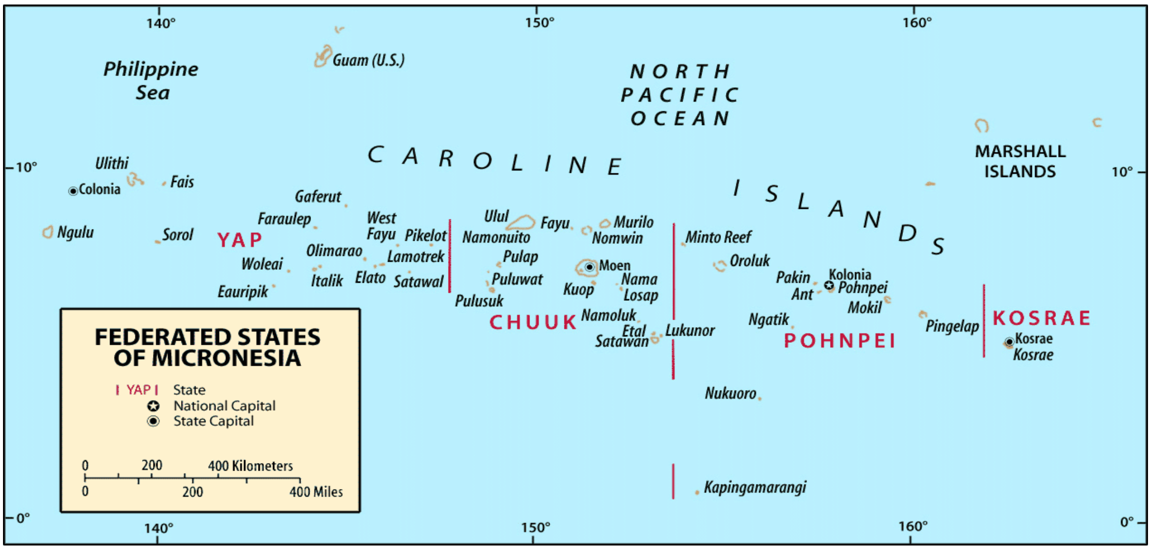
**LIST OF Acronyms**

| | |
|---|---|
| ACP: | African, Caribbean and Pacific |
| CA: | Cotonou Agreement |
| Compact: | Compact of Free Association |
| CEC: | Chief Executive Conference |
| DC: | Developed Countries |
| R&D: | Department of Resources and Development |
| HSA: | Department of Health and Social Affairs |
| DOJ: | Department of Justice |
| DOE: | Department of Education |
| FA: | Department of Foreign Affairs |
| F&A: | Department of Finance and Administration |
| TC&I: | Department of Transport, Communication and Infrastructure |
| EPA: | Economic Partnership Agreement |
| EPIC: | Economic Policy Implementation Council |
| EC: | European Community |
| EU: | European Union |
| EDF: | European Development Funding |
| EEZ: | Exclusive Economic Zone |
| FFA: | Foreign Fisheries Agency |
| FTA: | Free Trade Agreement |
| FAS: | Freely Associated States |
| FDI: | Foreign Direct Investment |
| FSM: | Federated States of Micronesia |
| GDP: | Gross Domestic Product |
| GSP: | Generalised System of Preferences |
| IPR: | Intellectual Property Rights |
| LDCs: | Least Developed Countries |
| MFN: | Most Favoured Nation |
| NTFC: | National Trade Facilitation Committee |
| NSA: | Non State Actors |
| NORMA: | National Oceanic Resources Management Authority |
| OEEM: | Office of Environment and Emergency Management |
| OCO: | Oceania Customs Organization |
| PIFs | Pacific Island Forum Secretariat |
| PACP | Pacific ACP |
| SPC: | Secretariat of the Pacific Community |
| SPS: | Sanitary and Phytosanitary Measures |
| SDP: | Strategic Development Plan |
| SPARTECA: | South Pacific Regional Trade and Economic Cooperation Agreement |
| SBOC: | Statistics, Budget and Economic Planning, Overseas Development Assistance and Compact Management |
| TBT: | Technical Barriers to Trade |
| UNCTAD: | United Nations Conference on Trade and Development |
| WTO: | World Trade Organisation |

## 1 SECTION ONE: BACKGROUND AND INTRODUCTION

The Federated States of Micronesia (FSM) consists of about 607 small islands (only 65 are inhabited) with a total land area of about 270.8 square miles (701.8 square kilometers) and an exclusive economic zone of over 1 million square miles (2 589 988 square kilometers). FSM is a loose federation of four States namely; Chuuk, Kosrae, Pohnpei and Yap with an estimate population of about 110 000 people. Chuuk has the largest population followed by Pohnpei, Yap and Kosrae. The FSM adopted its Constitution in 1979 and it is largely based on the US model, but unlike the US system, the major governmental functions other than the conduct of foreign affairs and defense are carried out by the State Governments.

Figure 1 **FSM Map**




FSM is a former United Nations (UN) Trust Territory and was under the US administration from 1947 to 1986. It became independent in 1986 and entered into a Compact of Free Association with the U.S. from 1986 to 2001. The Compact Agreement was amended and renewed in 2004 and Compact funding will end in 2023. By 2023, the Amended Compact Agreement would have provided more than $2 billion in direct economic assistance to FSM. The Compact also provides for a trust fund where the US and FSM will be making annual contributions and this is expected to be the main source of funding from 2024 onwards. With regards to trade, the Compact provides for duty free access to the US market for most goods and allows FSM citizens to work in the US freely. However, FSM has not fully utilised this market access arrangement.

FSM is a very small economy with a small population, small landmass, narrow resource base, limited economic opportunities, weak institutional capacities, lacks adequate and cheap financial capital, suffers from diseconomies of scale, faces severe transportation problems and is far away from major commercial markets. The island is also very vulnerable to external (global) shocks and natural disasters. This is the broader setting in which a Trade Policy is being formulated.

Table 1

**Population, GDP, and Trade in Goods and Services by country 2006 estimates**

| | | Population[1] (1000) (1) | GDP (2) mil | GDP per capita (US$) | Merchandise export (mil) | Merchandise imports(mil) | Goods balance | Service exports | Service imports | Service balance | Trade balance | Share of services in total exports | Goods exports as share GDP | Total exports as of share of GDP |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **FSM** | | **110 000** | **237** | **1.95 1** | **14.00 2** | **132.696** | **- 118.694** | | | | | | **5.7 %** | |
| | Share in World | 0.0016% | | | 0,001 3 | 0.00126 | | | | | | | | |
| | Share in PIC | 1.4% | 0.029 % | | | | | | | | | | | |
| Memo | | | | | | | | | | | | | | |
| | PNG | 6,187,108 | 4,908 | 759 | | | | | | | | | | |
| | Fiji | 831,263 | 2,711 | 2 053 | | | | | | | | | | |
| | Solomon Islands | 487,237 | 298 | 806 | | | | | | | | | | |
| | Vanuatu | 221,417 | 358 | 1 327 | | | | | | | | | | |
| | Samoa | 185,234 | 418 | 1 250 | | | | | | | | | | |
| | **FSM** | **110,218** | **237** | **1951** | | | | | | | | | | |
| | Tonga | 99,298 | 160 | 1 793 | | | | | | | | | | |
| | Kiribati | 93,706 | 79 | 732 | | | | | | | | | | |
| | RMI | 55,981 | 138 | - | | | | | | | | | | |
| | Palau | 20,044 | 142 | 6 822 | | | | | | | | | | |
| | Cook Islands | 13,572 | 176 | 4 521 | | | | | | | | | | |
| | Nauru | 10,131 | | 2 830 | | | | | | | | | | |
| | Tuvalu | 9,652 | 20 | 1 931 | | | | | | | | | | |
| | Niue | 1,591 | 12 | - | | | | | | | | | | |
| PIC Total (avg.) | | 8,326,452 | | | | | | | | | | | | |
| World | | 5.978 401[2] | | | | | | | | | | | | |

Source: SBOC, SPC website, WTO 2006 report and Statistics Division.

The data for FSM is not comprehensive. The Statistics Division needs to continue working with the Secretariat of the Pacific Community (SPC) to improve its statistics. There is also no data on trade in services; this should be addressed for FSM to be able to measure its trade performance. There is also a need to compile data on how each sector (agriculture,

[1] The data is based the SPC 2005 -2015 estimates http://www.spc.int/demog/en/index.html, WTO http://www.wto.org/english/res_e/booksp_e/anrep_e/wtr06-1a_e.pdf, FSM Department of Statistics and some extracts from the Secretariat of the Pacific Community (SPC).

[2] For 2006 it was 6,590,717,521, *U.S. Census Bureau, Population Division*

fisheries, manufacturing and services) contributes to GDP and how much foreign investment is received annually and in which sectors.

## 1.1 The rationale for a Trade Policy Framework

When FSM attained independence in 1986, it did not formulate a comprehensive Trade Policy to govern and guide the nation on how to conduct international trade. Aside from a patchwork of incoherent policies developed by specific sectors and the outdated provisions in the FSM Code (Title 38 dealing with International Trade),[3] FSM does not have a comprehensive framework to regulate trade. The closest reference to the Trade Policy is in the 2004 Strategic Development Plan (SDP) which requires FSM to “adopt trade and tax policies consistent with improving the international competitiveness of FSM-based producers”.

In 2005, the Economic Planning and Implementation Council (EPIC) adopted a resolution calling for the establishment of a National Trade Facilitation Committee with representation from the Government (National and State governments), the private sector, NGOs and other stakeholders. The NTFC was mandated to formulate a Trade Policy, educate leaders and policy makers in States about trade agreements and develop a coherent trade strategy for FSM including consideration of the Pacific Island Countries Trade Agreement (PICTA), the Pacific Agreement on Closer Economic Relations (PACER) and the relations with the US.

The significance of a Trade Policy was further reiterated by the Chief Executive Conference (CEC) in July 2006 and endorsed by EPIC again in December 2006. The CEC expressed concern that FSM was engaging in several trade-related activities without a Trade Policy and called for the establishment of a Trade Policy to guide and facilitate trade. The relevant State and National Government entities were directed to collaborate in this area and come up with a Trade Policy. This is the context in which this Trade Policy was formulated.

One of the issues hampering FSM’s effective participation in international trade is that there is poor coordination between government departments, the private sector and the civil society. The institutional support for trade is very weak. This hinders the formulation, negotiation and implementation of trade policies and agreements. Therefore, FSM needs a comprehensive Trade Policy to guide the nation on international trade.

A Trade Policy framework also helps to avoid ad hoc decision making and sometimes conflicting rules and policies. In order for FSM to create a good trade and investment climate, it needs a comprehensive Trade Policy, which is applied consistently to ensure certainty, predictability and credibility among its trading partners. Frequent Trade Policy changes or reversals are inimical to free and fair trade and hampers development.

[3] FSMC, Title 38 section 201 and 202 dealing with international trade restricts FSM from exporting goods which would have been originally imported from the US with a few exceptions such as obtaining permission from the high commissioner or an export license from the US department of Commerce.

Another reason why a Trade Policy is needed is that the global trading system is undergoing enormous metamorphosis and FSM needs to formulate a Trade Policy to promote and protect its interests in trade. FSM needs to develop a position and strategy with regard to PICTA, PACER, the Economic Partnership Agreements (EPAs), the US and the World Trade Organisation (WTO). A Trade Policy helps the country to be proactive in international trade negotiations rather than being reactive.

The Trade policy will also help with identifying the constraints in the production and export sector and recommend solutions on how to address the production and supply-side constraints. The pre-eminent objective of a Trade Policy should be to create an environment that is conducive for private sector development, to identify and address supply-side constraints and also to identify offensive and defensive interests in regional and international trade negotiations. The Trade Policy should focus on promoting exports in agriculture, fisheries and services (mainly tourism and labour mobility) amongst other things. The long-term strategy of the Trade Policy should be value addition, diversification of the export basket, addressing product standards, consolidation of the existing markets, finding new markets and assisting exporters to access these markets.

The Trade Policy should not be drafted in a vacuum but must take into account other social, cultural and environmental goals. Trade is not an end in itself but a means to achieve export-led economic growth, which in turn will lead to employment, increased standards of living and hardship alleviation.

The Trade Policy should encourage private sector development and the government should not compete with the private sector but facilitate private sector development and promote investment. FSM needs to develop a long term vision on trade to guide the nation in exploiting its full potential in trade and participate effectively in the global trading system. It is in this context, and in pursuance of the abovementioned objectives that this Trade Policy is being formulated.

## 1.2 Vision

The long term vision of the Trade Policy is to:

> Encourage and facilitate local and foreign direct investment in agriculture, fisheries, tourism, human resources development and other supporting services to enable the private sector to produce value added, quality and competitive goods and services both for the local and the export market, in order to promote export-led economic growth, self reliance and sustainable development, with the ultimate objective of creating employment, alleviating hardship and raising the living standards of FSM citizens.

### 1.3 Institutional Framework

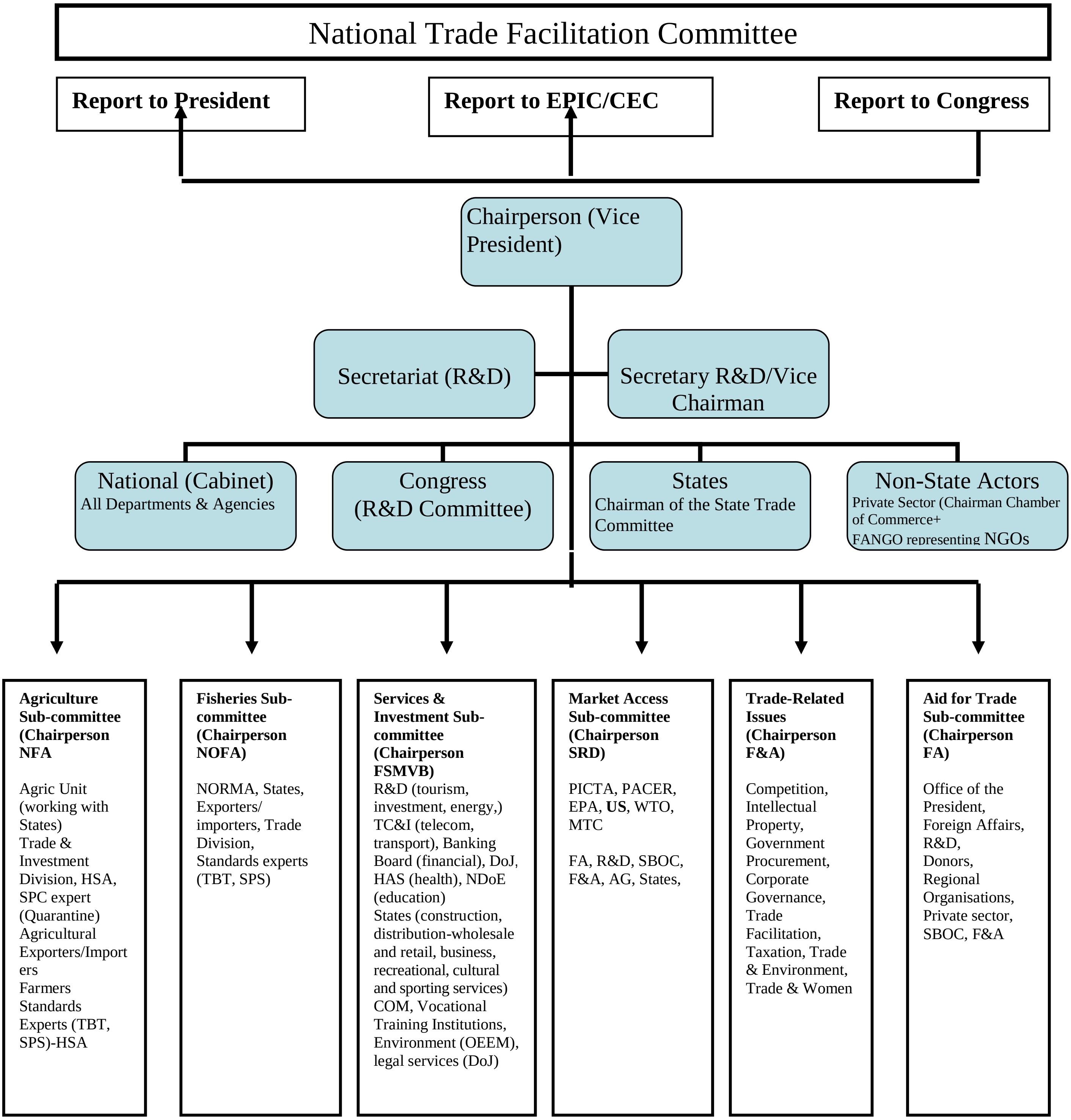
The President signed the Executive Order No: 34 which created the National Trade Facilitation Committee (NTFC) on the 14th of January 2008. The NTFC is chaired by the

Vice President who reports to the President, Congress and EPIC/CEC. The Secretaries and Directors of the National Government departments and offices are ex officio members of the NTFC. The current members are the Secretary of the Department of Foreign Affairs (DFA), Resources and Development(DR&D), Finance and Administration, Justice (DOJ), Transportation, Communication and Infrastructure (TC&I), Health and Social Affairs (HSA), Education (DOE), National Oceanic Resources Management Authority (NORMA), Office of Statistics, Budget and Economic Planning, Overseas Development Assistance and Compact Management (SBOC), Office of Environment and Emergency Management (OEEM) and one Non-Governmental Organization (NGO) representing the collective interests of this sector in the FSM. At the State level, the members of the NTFC are the Chairman of the State Trade Facilitation Committee and one private sector representative, representing the collective interests of all the business community from each State.

The Chairperson of the NTFC may establish sub-committees composed of technical experts in various fields to further the work of the Committee. The Chairperson of such a sub-committee becomes a member of the NTFC ex-officio. The Draft Trade Policy recommends that the chairperson of the National Offshore Fisheries Association (NOFA) be the chairperson of the fisheries subcommittee, and the Chairperson of the FSM Visitors Bureau be the Chairperson of the tourism sub-committee and the DR&D to be the interim chair of the sub-committee on agriculture pending the establishment of a National Farmers Association. The NTFC will assist with identifying FSM's trade needs and priorities and facilitate the implementation of the Trade Policy including the relevant trade agreements. The Secretary for Foreign Affairs/SBOC should be the chairperson of the sub-committee on Aid for Trade.

The National Trade Facilitation Committee must have a legal basis and the same must apply to the State Committees. This will ensure that the Trade Policy will be implemented and people will be held to account for the areas they are responsible for. This is important to ensure continuity of the office, institutional memory and implementation. There are also six sub-committees which will be dealing with specialised issues. The membership of these committees is open but the chairperson must have special skills in the area concerned. The DR&D must set aside budget for the people from the States to come for the NTFC meetings which should be held on a quarterly basis or when the need arise.

Figure 2


National Trade Facilitation Committee
Report to President
Report to EPIC/CEC
Report to Congress
Chairperson (Vice President)
Secretariat (R&D)
Secretary R&D/Vice Chairman
National (Cabinet)
All Departments & Agencies
Congress
(R&D Committee)
States
Chairman of the State Trade Committee
Non-State Actors
Private Sector (Chairman Chamber of Commerce+
FANGO representing NGOs
Agriculture Sub-committee (Chairperson NFA
Agric Unit (working with States)
Trade & Investment Division, HSA,
SPC expert (Quarantine)
Agricultural Exporters/Importers
Farmers
Standards Experts (TBT, SPS)-HSA
Fisheries Sub-committee (Chairperson NOFA)
NORMA, States, Exporters/ importers, Trade Division, Standards experts (TBT, SPS)
Services & Investment Sub-committee (Chairperson FSMVB)
R&D (tourism, investment, energy,)
TC&I (telecom, transport), Banking Board (financial), DoJ, HAS (health), NDoE (education)
States (construction, distribution-wholesale and retail, business, recreational, cultural and sporting services)
COM, Vocational Training Institutions, Environment (OEEM), legal services (DoJ)
Market Access Sub-committee (Chairperson SRD)
PICTA, PACER, EPA, US, WTO, MTC
FA, R&D, SBOC, F&A, AG, States,
Trade-Related Issues (Chairperson F&A)
Competition, Intellectual Property, Government Procurement, Corporate Governance, Trade Facilitation, Taxation, Trade & Environment, Trade & Women
Aid for Trade Sub-committee (Chairperson FA)
Office of the President, Foreign Affairs, R&D, Donors, Regional Organisations, Private sector, SBOC, F&A

FSM needs a list of all investors, exporters, importers, and a database of the key stakeholders must be maintained. A trade website must also be created to allow information sharing and discussion of problems affecting producers, importers and exporters.

### 1.3.1 General Duties and Responsibilities of the members of the National Trade Facilitation Committee

**Secretary of the Department of Resources and Development (DR&D) or designee**

The department serves as the secretariat to the NTFC and is responsible for coordinating development and Trade Policy issues relating to marine, agriculture and tourism, the three key priority sectors. The DR&D is in charge of international trade and facilitates trade and investment matters with States. The department also serves as the interim Chair for the sub-committee on Agriculture pending the establishment of a National Farmers Association (NFA).

**Secretary of the Department of Justice (DoJ) or designee**

The Department of Justice is responsible for looking at the legal issues pertaining to trade agreements such as PICTA, PACER, EPA, US and also to improve the registration of businesses, enforcements of contracts and upholding the rule of law to create a good environment for business. It is also responsible for dealing with labor and immigration issues that affect trade and investment.

**Secretary of the Department of Foreign Affairs (DFA) or designee**

The Department should assist with mobilizing Aid for trade from FSM's trading partners to implement the Trade Policy, promote commercial diplomacy and ensure that its overseas missions are staffed with officials who are knowledgeable on trade, investment and tourism promotion and find markets for the goods and services that are produced in FSM. There is also a need for the DFA to assist FSM producers and exporters with joining organizations that will assist exporters to access export markets.

**Secretary of the Department of Finance and Administration (DF&A) or designee**

The Department needs to ensure that the tax reform goes ahead smoothly to ensure that the negative effects of trade liberalization are minimized. The Customs and Tax Administration is also responsible for reviewing the customs legislation to comply with international trade obligations especially tariff reduction schedules, customs surveillance to ensure compliance with rules of origin. It is also the responsibility of this department to facilitate trade and to ensure that all the red tape that is inhibiting imports and exports is removed and this includes working with regional and international customs organizations such as the World Customs Organization, Oceania Customs Organization (OCO), and WTO to upgrade customs procedures and standards to facilitate trade.

**Secretary of the Department of Health and Social Affairs (DHSA) or designee**

The Department is responsible for establishing or upgrading a Competent Authority to ensure that fish and fish products and other food products meet the requirements of import countries, particularly the EU. This requires a lot of technical and financial resources but most of the funding can be obtained from the donor community. There is also a need to strengthen the functions of the department to ensure that FSM is protected from unsafe imports of food, drugs and other products.

**Secretary of the Department of Education (DoE) or designee**

Education plays a vital role in trade and its role is rarely acknowledged in economic development. For any nation to prosper in trade there must be a good education system especially the production of relevant skills that are needed to turn around the economy. Areas such as mathematics, science and ICT are some of the areas that warrant attention. There is also a need to prioritize Technical and Vocational Education Training Centres (TVET) to enable the nation to develop the skills that are needed in the economy and also export the surplus skills and earn remittances.

**Secretary of the Department of Transportation, Communications and Infrastructure (TC&I) or designee**

Transportation is a key issue in FSM particularly for exporters. The department of TC&I needs to work with all the stakeholders to address the transportation (air, maritime-MSC,) problems. Telecommunication is also another issue that affects the FSM business environment and the relevant policies need to be put in place to address these problems in order to promote trade and investment. Another critical area that is under the management of TC&I is the Infrastructure Development Plan (IDP). There is a need to ensure that the right infrastructure is put in place to reduce the costs of doing business in FSM. Quality infrastructure related to tourism, fisheries and the agricultural sector need to be prioritized in order to promote trade in these sectors.

**Director of Statistics, Budget and Economic Planning, Overseas Development Assistance and Compact Management (SBOC) or designee**

There is a need to ensure that trade statistics in general and on GDP, investment, services and remittances is improved to enable FSM to monitor progress and take the necessary remedial action. The Budget allocation must be sensitive to projects that are aimed at facilitating trade in tourism, fisheries and agriculture and Compact funding in general and under the Private Sector Development should fully support these priority areas. The Overseas Development Assistance division should work with Foreign Affairs and DR&D to secure Aid for Trade from FSM's trading partners to support trade and investment activities highlighted in the Trade Policy. The unit responsible for Compact management must ensure that trade and investment activities are prioritized in Compact funding and there is also a need to improve the trade preferences that were given to FSM because these preferences have been eroded and have lost their value. The division that is responsible for economic planning needs to review the SDP and to ensure that it is implemented properly.

**Director of the Office of Environment and Emergency Management (OEEM) or designee**

Development in a small island is prone to natural disasters and global shocks. These are serious challenges and the office of EEM needs to be vigilant in protecting the environment because the threats of climate change have the effect of wiping out all the economic gains that FSM would have made through trade and investment. There is a clear link between trade and environment and this theme is gaining prominence at the global level and the Office of the EEM needs to monitor these developments to ensure that trade and economic endeavour is undertaken in a sustainable manner.

**Executive Director for National Oceanic Resources Management Authority (NORMA)**

NORMA in collaboration with the fisheries industry, DR&D and the States are responsible for the fisheries policy and the management of oceanic resources to ensure that these resources are not depleted and also to ensure that FSM obtains the best value from its resources.

**FSM Alliance of Non-Governmental Organizations (FANGO)**

FANGO is an umbrella organization responsible for coordinating all the input and comments from the NGOs and defending these interests in the NTFC. NGOs can also send their comments or input via their State Trade Facilitation Committees (STFC).

**State members of the NTFC**

The Chairman of the STFC is responsible for coordinating with the NTFC including the Department of R&D. All the trade information is sent directly from the national government to the sates via the chairman of the STFC who is obliged to share the information with all the state stakeholders. The chairman of the STFC can also convene the meeting of the STFC to discuss trade and investment issues and formulate the state’s position on various trade including PICTA, PACER, EPA and the US. The role of the private sector members of the NTFC is to ensure that the interests of the business community are fully represented at the NTFC and also in all the trade agreements that are negotiated.

**Congress**

In order to improve understanding of the key trade issues, it was recommended that the R&D Committee be actively involved in the formulation and implementation of the trade policy. This is important because Congress will be responsible for approving the ratification of various trade agreements and allocating funding that is needed to implement the Trade Policy.

**Sub-Committees**

The Vice President can establish specialized sub-committees to deal with technical issues and formulate plans on issues such as agriculture, fisheries, tourism/services/investment, market access, trade-related issues and Aid for Trade. The Chairman of the sub-committee can work closely with interested stakeholder and present their recommendations to the NTFC.

## 1.4 Schedule of Work

The Department of Resources and Development organised a national brainstorming workshop to gather views from all the stakeholders in October 2006. This was followed by consultations in all the four States from January to March 2007, where all the relevant stakeholders including the private sector, civil society and the academia were invited. Based on these consultations, a first draft Trade Policy was prepared and submitted to all the relevant stakeholders for comments in June 2007. These comments were incorporated into the second draft which was presented in January 2008. After receiving further comments from the stakeholders, the Trade Policy was presented to the members of the National Trade Facilitation Committee in June 2008. The Trade Policy has been submitted to the President for his consideration and submission to Congress, EPIC/CEC. This exercise will be transparent and inclusive in order to allow all the stakeholders to participate freely and contribute to the Trade Policy.

## 1.5 Structure of the Trade Policy

The Trade Policy is structured as follows: Section One looks at FSM and the Trade Policy Framework covering the introduction, the rationale of the Trade Policy, the vision of the Trade Policy, the institutional framework, the schedule of work and the structure of report. Section Two reviews the state of FSM's economic setting with a focus on how this environment has affected trade and economic growth. It also provides a brief overview of the Strategic Development Plan. The SDP is critically important because the Trade Policy must be mainstreamed into the overall development framework and vice versa. Section Three will look at the participation of FSM in international trade and its performance in merchandise and services trade. Section Four examines the Trade Policy environment in FSM with a particular focus on its domestic policies and other trade-related issues. Section Five looks at trade negotiations and market access arrangements. Section Six concludes the report with some recommendations on how to address supply side constrains affecting production capacity, how to improve FSM's market access and how to build the institutional capacity to implement the Trade Policy to address all the trade-related issues.

## 2 SECTION TWO: THE ECONOMIC SETTING

During FY1987 to FY1995, FSM registered a strong growth in real GDP from about US$163 million to about $224 million and real GDP per capita grew from about US$1,800 in 1987 to about US$2,100 in FY1995. The economy adjusted to increased Compact flows and grew by an annual average rate of 3.9% in real terms. The Government contribution to GDP grew by an average of 1.4% whilst the private sector[4] recorded an impressive annual growth of 6.5%. FSM managed to adjust to the first step-down in Compact funding in FY1992, because expenditures had not fully adjusted upward to the new levels of funding and access fees from fishing were high (more than $15 million in 1992 and more than $20 million in 1993/4).

The second step-down in FY1997[5] forced the government to implement an Early Retirement Program under the auspices of the ADB Public Sector Reform Program Loan, with the objective of reducing the level of public servants to an affordable level. By 1999, the workforce was reduced by 23% against a target of 27% and the wage bill had been cut by 29% against a target of 35% through reductions in the number of hours in the working week. The Government's contribution to GDP declined by an average annual rate of 7.2% between FY1995 and FY1997 and total GDP fell at an annual rate of 6.7% and the private sector declined by 10.2% annually over the period.

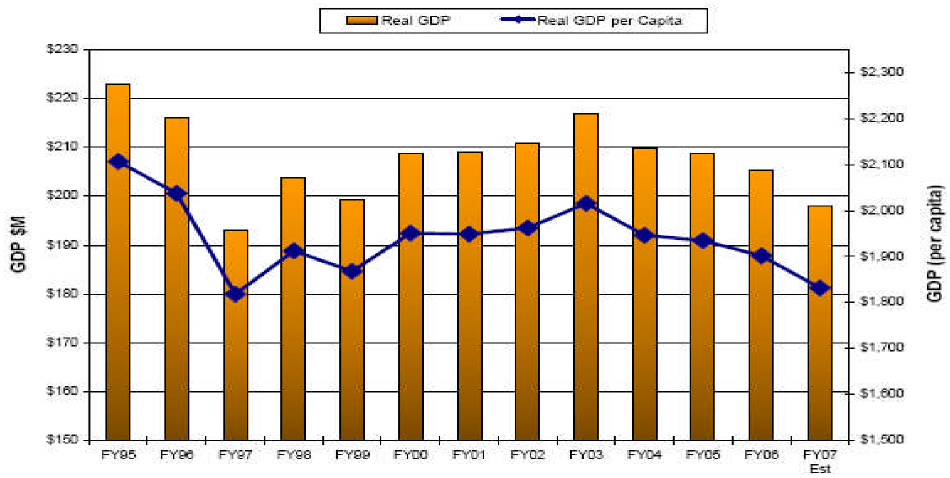
In FY2000, the FSM economy grew by 9.6% in real terms because the adjustment to the second step-down was complete and the Chuuk crisis was resolved. However, from FY2000 to FY2003, the economy grew only by an average rate of 0.5% partly as a result of the injection of the bump-up funds. From FY1987 to FY2003, GDP grew by 1.7% per annum, and the public sector expanded by 0.7% per annum while the private sector registered an annual average growth of 2.1%.

The uncertainty in the Compact negotiations, the return of financial crisis in Chuuk, led investors to maintain a "wait and see" approach and this stifled further economic growth. In FY2004, the economy went into recession as the level of Compact receipts fell from $84 million to the new lower negotiated levels of $76 million. From FY03 to FY06 GDP contracted by 0.9% , public sector by 0.7% and private sector contracted by 1.5%.

The overall economic performance from FY 1995 to FY 2007 has been disappointing; the economy declined by - 0.2% (Chuuk and Kosrae annual decline of -0.6%, Pohnpei -0.1 and Yap 0.5%).

[4] However, this did not reflect growth in the traded goods sector or emergence of significant export activities.
[5] Access fees were $15 million in 1997 and $10 million in 2002.

Figure 3

| **FSM GDP** |
|---|
|  |
| Source: 2008 FSM National Government: Compact Annual Report. |
| Note: GDP current and constant price estimates. |

The table below compares GDP per capita growth between 1995 and 2007. GDP per capita for FSM in 1995 was $2,107 and has declined to $1, 832 in 2007. In 1995, Pohnpei had the highest GDP per capita but in 2007 Yap was leading.

Table 2

| **Reap GDP per Capita (US$ 1998 constant prices)** | | | | |
|---|---|---|---|---|
| | **FY95** | **FY07** | **Percent growth FY 95 -07** | **Annual Average % growth 95-07** |
| Chuuk | 1,292 | 999 | -22.7% | -2. 1% |
| Kosrae | 2,478 | 1,969 | -20.5% | -1.9% |
| Pohnpei | 3,018 | 2,725 | -9.7% | -0. 8% |
| Yap | 2,993 | 2,969 | -0.8% | -0.1% |
| FSM | 2,107 | 1,832 | -13.0% | -1.2% |
| Source: 2008 FSM National Government: Compact Annual Report. | | | | |

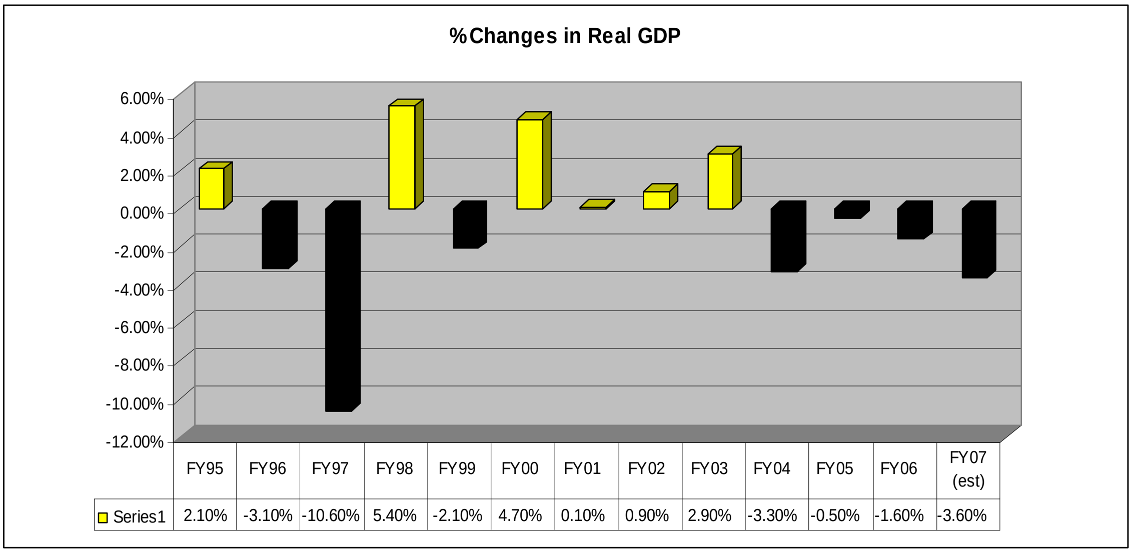
The table below shows FSM's average real GDP growth per annum from 1995-2006. It also shows how government and private sector contribution to GDP was affected by the fluctuations in Compact funding. From 1995-2006, FSM GDP grew only by 0.1% but the worst years were 1995-1997 where GDP growth was -6.7%. There was a positive growth in GDP to about 1.7% during the final phase of Compact I (1997-2003) partly due to bump up funds but the growth from 2003 to 2006 was negative (-0.9%) indicating the difficulties FSM faced in adjusting to the new Compact arrangements.

Table 3

| **Average real GDP growth per annum by state and economic sector** | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FY1995-FY2006 | | | 2nd Step-Down FY1995-FY1997 | | | Final Phase Compact I FY1997-FY2003 | | | Compact II FY2003-FY2006 | | |
| | GDP | Gov | Private | GDP | Gov | Private | GDP | Gov | Private | GDP | Gov | Private |
| Chuuk | 0.2 | -1.6 | 0.7 | -12.5 | -14.3 | -30.6 | 3.4 | 2.6 | 8 | -2.2 | -1.9 | -5.7 |
| Kosrae | -0.1 | 0 | -1.2 | -3.1 | -0.9 | -2.2 | 2.6 | 2.6 | 2.5 | -4.2 | -3.8 | -7.8 |
| Pohnpei | -0.1 | -0.7 | -1 | -6.8 | -4.6 | -7.5 | 0.9 | -0.2 | -0.4 | 0.1 | -1 | 2.1 |
| Yap | 0.9 | -0.5 | 1.2 | 1.9 | -2.9 | 3 | 0.2 | -0.2 | 1.9 | 0.5 | 5.8 | -2.8 |
| **FSM** | **0.1** | **-0.9** | **-0.3** | **-6.7** | **-7.2** | **-10.2** | **1.7** | **0.7** | **2.1** | **-0.9** | **-0.7** | **-1.5** |
| Notes 1. Growth rates computed using least squares. 2. Pohnpei inclusive of national government. | | | | | | | | | | | | |
| Source: 2006 FSM National Government: FY 05 Compact Annual Report. | | | | | | | | | | | | |

The Chart below shows percentage changes in real GDP with 1997 recording the most negative growth (-10.6 %) and 2004 to 2007 (the Compact II era) also in the negative. Since 2003, the GDP has actually declined by 8% overall. This is mainly as a result of difficulties to adjust to the new Compact requirements, reduced Compact funding levels, decline in the public sector as a result of the phase out of the use of the capacity building sector grant to fund non-conforming purposes, reduced public expenditures in Chuuk in FY07 and this has also adversely affected the private sector.

Figure 4




Source: 2008 FSM National Government: FY 07 Compact Annual Report.

### 2.1.1 Economic Performance by State

**Chuuk State**

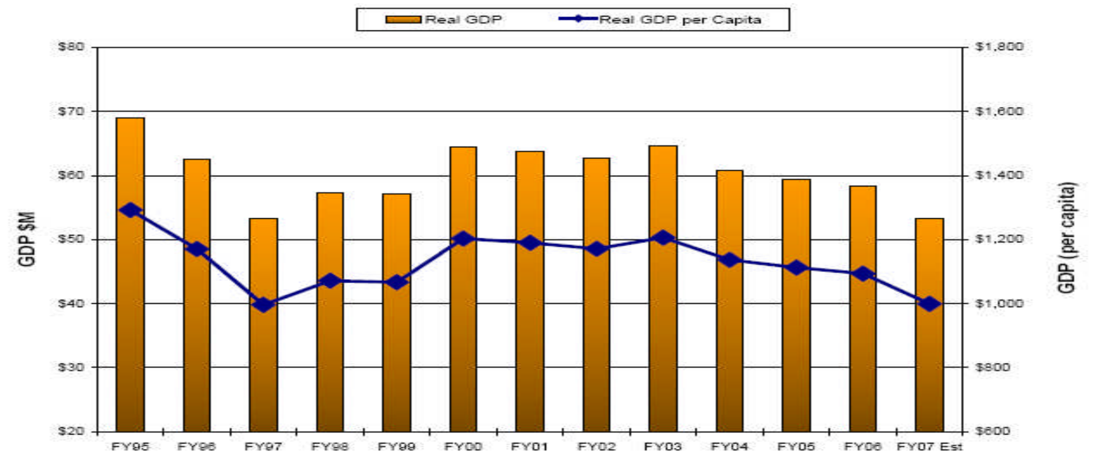
In the mid-1990s, Chuuk suffered a severe financial crisis due to weak fiscal management and accumulated debts of over $17 million in FY1996. The State launched a recovery program supported by an early retirement program with conditional financial support from the National Government and by FY2000, the State had recovered fully. The State economic activity increased by 15% in FY2000 after several years of negative growth between FY1996–FY1998. However, the tight fiscal discipline in Chuuk lasted for only four years. The State suffered another financial crisis and failed to sustain the recovery initiated in FY2000. This was worsened by Typhoon Chata'an in 2003 and the Federal Emergency Management Agency (FEMA) had to compensate households for the destruction caused. The injection of funds by FEMA boosted state GDP growth by 4.3%.

The major factors which contributed to economic decline by about 8.4% in FY2004, include the adjustment to the reduction in funding after the bump-up funds ran out in FY2003, reduction in Compact funds, Typhoon Chata'an in 2003 and the loss of the energy grant when the Compact was amended, which resulted in reduced public enterprise value addition. The State continued to suffer from the financial crisis and delays in vendor payments adversely affected private sector profitability. This resulted in an 11% drop in private sector activity in FY2004 and public enterprise value added fell by 12% whilst government activity fell by 12%.

However, in 2005 the State adjusted to the financial circumstances of the amended Compact and GDP grew by 1%. The State utilities corporation benefited from a one time only FEMA hazard and mitigation project grant, but the sector continued to be plagued by inefficiencies and power outages. Activity in both private and public sectors fell by 0.6% and 1.1%, respectively, in FY2005. Chuuk State suffered another financial crisis in 2007 and GDP declined to about $53.3 million in 2007, from about $60.8 million in 2004, the lowest GDP since 1995 (same as in the 1997 crisis). The financial crises suffered by Chuuk had a negative impact on economic growth and this hindered private sector development and export promotion.

Figure 5

**Chuuk State GDP**




Source: 2008 FSM National Government: Compact Annual Report

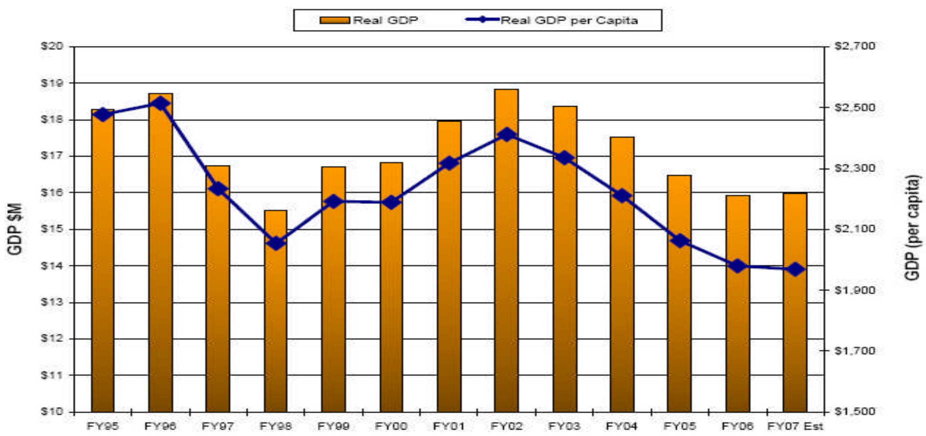
**Kosrae State**

The state of Kosrae is heavily dependent on public sector activity and has failed to generate an active private sector. A sharp increase in wages eroded the gains of reform. Kosrae also experienced some difficulties during the first year of implementing the Amended Compact Agreement and GDP dropped by 5.2%, while public expenditures fell back from their prior bump-up levels to the reduced amounts of the Amended Compact. The loss of the energy grant adversely affected public enterprise profitability, which resulted in a 23% decline in the sector's contribution to GDP. Government activities fell by 4.4% and the flow on impact resulted in a decline in the private sector by 6.6%.

In FY2005, utility prices were doubled to compensate for the loss in the energy grant to restore viability in the sector. However, this did not help much and the contribution of the public enterprise sector (largely utilities) fell by a further 11%. While the private and public sector GDP stabilized in nominal prices, in real (constant) prices State GDP fell by 6.6% and government GDP by 5.4%. In 2007, Kosrae was reported to be bankrupt but has since taken some drastic measures to remedy the situation. GDP declined from $17.5 million in 2004 to $16 million in 2007.

Figure 6

**Kosrae State GDP**




Source: 2008 FSM National Government: Compact Annual Report

**Pohnpei State**

Pohnpei was also affected by the second step-down and GDP declined by an annual average of 6.7% during FY1995–FY1997. From FY1997 through FY2001, economic activity stagnated and GDP rose by only 0.4% over the four-year period. The State was unable to sustain the private sector growth and an inward-oriented policy environment coupled with high levels of investment in unprofitable public enterprises contributed to economic stagnation. However, Pohnpei managed to maintain a good fiscal policy subsequent to the reforms initiated in FY1996.

In FY2002, economic growth was strong and GDP grew by 6.2 % as the State fully utilized the available bump-up funds and benefited from an additional increase in resources after the final repayment of the Medium Term Notes (MTN) in FY2001[6].

Pohnpei managed to implement the first year of the Amended Compact without any undue adverse impact, and GDP grew by 0.3%. The State had transitioned the use of the energy grant from subsidising utility prices in the mid 1990s and thus avoided the associated reduction in public enterprise valued added or the need to raise tariffs. Pohnpei was able to adjust to the new Compact regime without suffering major adjustment shocks mainly because it hosts the National Government, which was largely unaffected by the decline in Compact resources, and also because its economy is more developed and had higher revenue efforts.

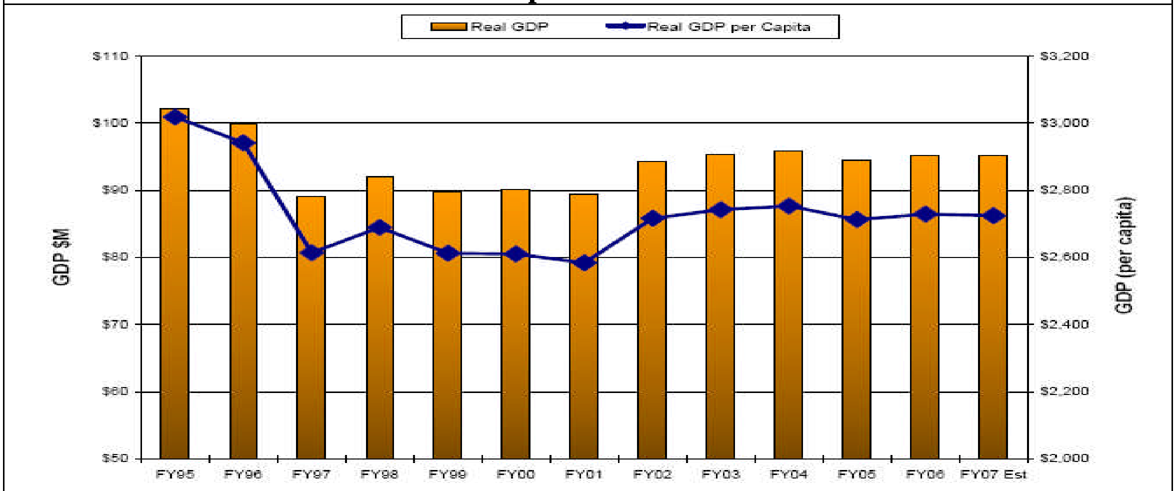
However, in FY2004 the State and National Government contracted by 0.5%, but the private sector was relatively buoyant and expanded by 3.8%. In FY2005, the economy managed to grow in nominal prices with expansion in the private sector due to increased

[6] The State issued a series of MTNs, or Compact-backed bonds, in the early 1990s to fund investment in public enterprises.

building and construction projects and in government services. From 1995 to 2006 the contribution of the private sector to GDP was always higher than government contribution. The GDP in 2004 was $95.9 million and in 2007 it was $95.1 million.

Figure 7

**Pohnpei State GDP**




Source: 2008 FSM National Government: Compact Annual Report

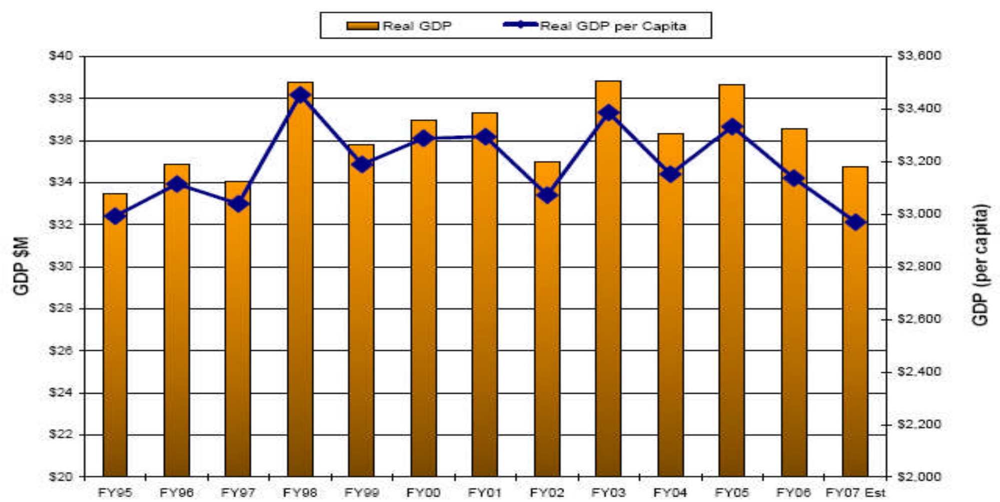
**Yap State.**

Among all the four States, Yap achieved the highest rate of economic growth during Compact 1. It is interesting to note that even though the State underwent a public sector contraction similar to the other States after the second step-down, the private sector managed to remain vibrant and assisted the State in maintaining positive GDP growth during FY1995–FY1997 and through the end of Compact 1. Yap managed to maintain stable fiscal policies and a liberal policy environment.

However, the introduction of the new Compact regime saw a significant reduction in the State economy by 6.2% in FY2004. The reduction was largely due to the impact of Typhoon Sudal in April 2004 rather than any negative adjustment to the new regime. This was further exacerbated by the closure of the two garment factories as a result of preference erosion amongst other things. The government value added expanded by 2.5% but the private sector remained stagnant, while subsistence production for own consumption contributed 4.6% of the overall reduction in real GDP.

Yap had also adjusted in the mid 1990s and had transitioned the use of the energy grant to subsidize utility prices. The main drawback in the State’s performance has been a lack of transformation of the loss-making public enterprise sector. In FY2004, reduced profitability in the fishing sector led to a 17% decline in public sector value added. In FY2005, the economy rebounded by 10.6% fuelled by the infusion of FEMA funds to support rehabilitation and reconstruction. Additional funds from FEMA enabled the public sector to grow by 20.3%, and increased profitability in utilities due to a hike in water charges enabled the public enterprise sector to record a real growth of 9%. Like Pohnpei, the State of Yap had a strong private sector whose contribution to GDP was higher than government contribution from 1995 to 2006. In 2004 GDP was $36.3 million compared to $34.7 million in 2007.

Figure 8

| Yap State GDP |
|---|
|  |
| Source: 2008 FSM National Government: Compact Annual Report. |

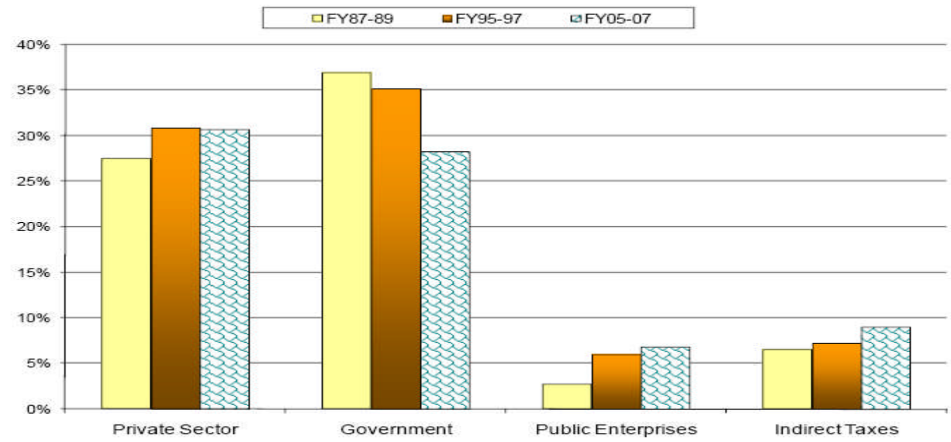
### 2.1.2 The Structure of the FSM Economy

The FSM economy is dominated by a large public sector with a dependent private sector that produces largely non-traded goods and provides services to the government and its employees. During the first half of Compact 1, the private sector expanded by about 6.3% but the share of the private sector has subsequently declined by 1%. Since the beginning of Compact 1, the Government contribution to the economy has declined significantly by 7.2% because of the reforms that were meant to downsize the government during the second step-down, and the lower Compact funding. However, the reform saw the creation of a number of public sector enterprises in fisheries, power and telecommunications (which were formerly government departments). It is common knowledge that most of these public enterprises have either failed or are performing poorly. The above trend basically underscores the well known economic principle that government should not be involved in business but should create a good environment for the private sector to develop the economy. From FY 05 to FY 07 the private sector contribution to the economy is slightly higher than the government contribution.

Aside from the private and public sectors, households and indirect taxes form a significant proportion of economic activity in FSM. The household sector represents the production of non-marketed goods and home ownership. The share of households declined during the early period but has subsequently grown in importance suggesting greater production for own consumption. The share of indirect taxes increased throughout the Compact from 6.6% of GDP during the FY1987-FY1989 period to 9% in 2007. This is mainly as a result of the reform of the national customs tax regime to cater for declining Compact revenues.

Figure 9

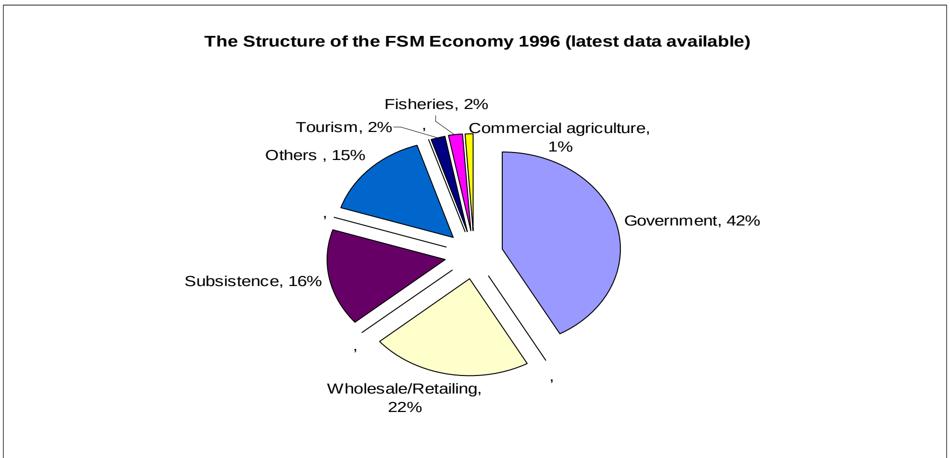
**The Structure of the FSM Economy**




Source: 2008 FSM National Government: Compact Annual Report.

In 1996 (the latest data available), the government had the largest contribution to GDP, followed by wholesale and retail and subsistence. Fisheries and tourism contributed about 2% each and commercial agriculture 1%. This shows that the sectors that are supposed to fuel exports growth currently do not contribute much to GDP and a lot needs to the done to improve exports in these priority sectors. There is also a need for SBOC to collaborate with relevant agencies to produce recent data to enable policy makers to assess how each sector has been contributing to GDP.

Figure 10




2006 FSM National Government: FY 05 Compact Annual Report.

### 2.1.3 Employment

An ADB assessment of hardship and poverty in the FSM (*The Federated States of Micronesia: Hardship and Poverty Status Discussion Paper*, The Pacific Department ADB, 2004) indicates that FSM faces significant hardship. The discussion paper based on the 1998 Household Income and Expenditure Survey (HIES) shows that approximately 27.9% of households reported incomes below the estimated basic needs poverty line of US$768 per capita per annum (US$5,693 per household per annum). The highest level of hardship and income poverty is 32.9% for Chuuk, and 30% for Pohnpei, while Yap and Kosrae recorded 14% and 12% respectively. However, according to the analysis that was done by the Division of Statistics in August 2007 based on the 2005 HIES, the average incidence of basic needs poverty is estimated at 27.5% accounting for 36.7% of the population. Pohnpei recorded the highest poverty incidence of 31.4% of households and 42% of the population and 27.9% in Chuuk. The situation in Yap and Kosrae has deteriorated significantly. In Yap, the incidence of poverty increased from 14.4% in 1998 to 22% in 2005 and in Kosrae it increased from 12.3% to 27.9%.

The increasing monetization of the society is placing a huge burden on the poor and opportunities for earning cash are very few. The challenge that FSM faces is to increase employment or economic opportunity in urban centers and also in rural areas. The ultimate objective of a Trade Policy is to boost trade in rural and urban areas with a view towards increasing employment, alleviating hardship and raising the standard of living in FSM. This is a major challenge since there are high levels of unemployment in FSM. For example, between FY95 -FY05, employment has stagnated and over 1,200 jobs have been lost. Even though the private sector employment reflects larger employer in labor market as indicated in figure 11 below, government wages are currently more than two and a half times those of the private sector. This condition stifles private sector development as it is difficult to attract the best brains in the private sector.

It should also be noted that Pohnpei is the only State which imposes a minimum hourly wage for the private sector; that is set at $1.35. Lack of formal employment and hardship has resulted in FSM citizens migrating to the US and other countries where there are better paying jobs. In many countries, remittances play a significant role in the economy[7]. If each of the estimated 8,000 FSM citizens working abroad were to sent back $1,500 to family and friends on the island, the sum of remittances would total $12 million, or about the same amount that the nation is now obtaining each year from fishing license fees. FSM needs to measure the amount of remittances coming into the country and put in place measures to encourage effective use of remittances[8].

From FY1995 to FY2007, formal sector employment based on Social Security Administration data contracted by an annual average rate of 0.6 or 7 percent over the whole period, and was unable to provide enough jobs for new job seekers. Employment in the fisheries sector declined from 658 workers in 1995 to about 246 workers in 2007,

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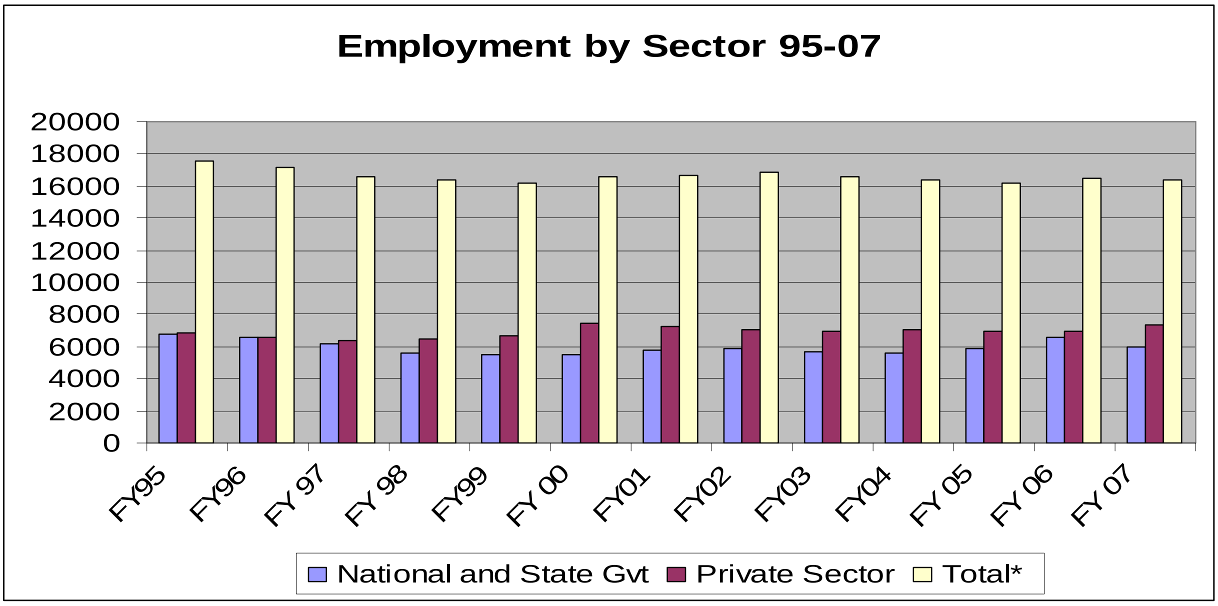
[7] Tonga derives about 45% of its total income (GDP) from remittances, while Samoa obtains 25% from remittances.

[8] Incentives can include the right to vote, and retention of land rights in the islands.

manufacturing from 822 workers in 2001 to 110 workers in 2007, tourism from 949 workers in 2000 to 865 workers in 2007, public administration declined from 8,428 in 1995 to 6,829 in 2007 and agriculture from 36 workers in 1995 to 25 workers in 2007. Public administration, wholesale and retail trade and repairs, transport storage and communication, education, hotels and tourism and construction employed the highest number of people in 2007.

Figure 11

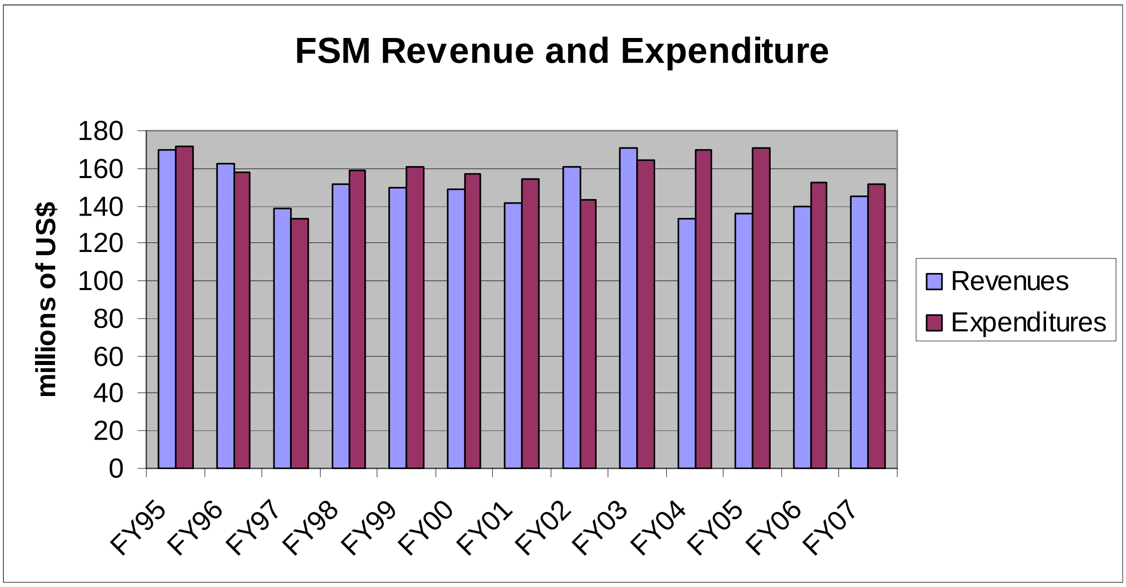



Source: 2008 FSM National Government: Compact Annual Report.

### 2.1.4 Fiscal Policy

FSM has maintained a favorable external debt profile and debt service ratio remain very favorable by international standards. However, with regards to revenue and expenditure, the situation is disappointing. With the exception of 1996, 1997, 2002 and 2003 expenditure always exceeded revenues.

Figure 12




Source: 2008 FSM National Government: Compact Annual Report.

The major source of revenue for FSM is the Compact Agreement. In 2005, grants from abroad constituted about 63% (83.9 million) of total revenue (135.9 million), 21% (29.2 million) from tax, and 10% (13.3 million) from fishing access fees; other (other non-tax revenue plus dividend and interest income) constituted 7%.

Table 4 below shows that the contribution of grants to GDP decreased from 53% in 1995 to 35% in 2005, whilst the contribution of tax revenue to GDP increased from 10% to 12% over the same period. However, the contribution of grants to total revenue only declined slightly from 66% in 1995 to 63% in 2005. It is unfortunate that the bulk of the money (131.4 million) in 2005 was spent on current expenditure (goods and services such as wages, salaries, travel and other) and very little (11.4 million) was spent on capital expenditure (acquisition of fixed capital and multipurpose development projects). This is set to continue, and current expenditure in 2007 is estimated to be 96% and only 4% on capital expenditure.

Table 4

**The Contribution of Grants and Taxes to the FSM Economy**

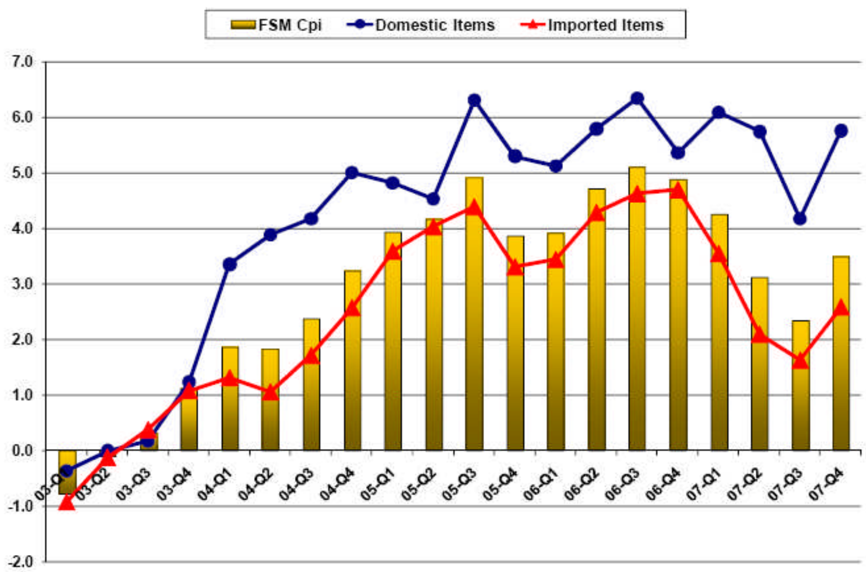
| | Grants as a percentage of GDP | Grants as % of total Revenue | Tax revenue as a % of GDP |
|---|---|---|---|
| 1995 | 53% | 66% | 10% |
| 2000 | 45% | 65% | 13% |
| 2005 | 35% | 63% | 12% |

Source: 2005 Economic Review.

Inflation is also threatening to destabilize the fiscal situation and raise the cost of doing business in FSM as the cost of locally produced goods is higher than imported items. The annual inflation rate for the fourth quarter in 2007 was 3.5% (imports: 2.6%, domestic: 5.6%). For Kosrae it was 4.7%, for Chuuk and Yap it was 4.4% and 1.8% for Pohnpei. High inflation was caused by food imports, import taxes on beer and tobacco increase (in 2005), increase in utility tariffs in Kosrae and Chuuk to compensate for the loss of subsidy, energy crisis, food crisis. The major import items affected are canned foods, fuels, rice and motor vehicles (imported items constitute about 75% of consumer spending). Some of the domestic items affected include fresh fish, local produce, bakery goods, taxi fares, electricity (domestic products constitute about 25% of consumer spending). The major cost was fuel, light and water: 10.8% and services 6.1%. Services inflation was as high as 10.2% in Chuuk and as low as 1.9% in Yap but Yap had the highest inflation on fuel, light etc…(23.2%) compared to 7% for Chuuk.

Figure 13

**Inflation 03-07**




Source: 2008 FSM National Government: Compact Annual Report.

According to Table 5, the funding under the Amended Compact Agreement has been substantially reduced. Annual grant assistance starts at $76.0 million in the initial 3-year period 2004-2006. This will steadily decline from 2007 to 2023 as an additional $0.8 million each year will be taken from the grant portion and deposited in a Trust Fund along with an annual deposit of $16.0 million by the US.

The annual grant is allocated to education, health, private sector development, capacity building in the public sector, environment and public infrastructure. Private sector development is not being prioritized yet this is the sector that is critical for FSM's long term sustainable development.

According to the 2007 IMF report, under one scenario called the conservative investment strategy, the Compact Trust Fund will fall short of what is needed to replace expiring Compact grants. Compact grants are estimated to be about 19.5% of GDP in FY2023, while the income from the trust fund would only be 12¼ % of GDP in the following year. After 2024, investment income would continue to be well below the FY2023 Compact grant levels. A loss of such a significant amount of revenue would negatively affect economic growth and will force the government to make huge cuts on spending. This means that ways of generating revenue must be found now to avoid this bleak scenario. One way of achieving economic growth and raising revenue is to reform the tax regime and promote exports and this is where a Trade Policy becomes important.

Table 5

| **Annual Compact Grants and the Trust Fund** | | | | |
|---|---|---|---|---|
| | Annual grants | Audit Grant | Trust Fund | Total |
| 2004 | 76.2 | 0.5 | 16 | 92.7 |
| 2005 | 76.2 | 0.5 | 16 | 92.7 |
| 2006 | 76.2 | 0.5 | 16 | 92.7 |
| 2007 | 75.4 | 0.5 | 16.8 | 92.7 |
| 2008 | 74.6 | 0.5 | 17.6 | 92.7 |
| 2009 | 73.8 | 0.5 | 18.4 | 92.7 |
| 2010 | 73 | 0.5 | 19.2 | 92.7 |
| 2011 | 72.2 | 0.5 | 20 | 92.7 |
| 2012 | 71.4 | 0.5 | 20.8 | 92.7 |
| 2013 | 70.6 | 0.5 | 21.6 | 92.7 |
| 2014 | 69.8 | 0.5 | 22.4 | 92.7 |
| 2015 | 69 | 0.5 | 23.2 | 92.7 |
| 2016 | 68.2 | 0.5 | 24 | 92.7 |
| 2017 | 67.4 | 0.5 | 24.8 | 92.7 |
| 2018 | 66.6 | 0.5 | 25.6 | 92.7 |
| 2019 | 65.8 | 0.5 | 26.4 | 92.7 |
| 2020 | 65 | 0.5 | 27.2 | 92.7 |
| 2021 | 64.2 | 0.5 | 28 | 92.7 |
| 2022 | 63.4 | 0.5 | 28.8 | 92.7 |
| 2023 | 62.6 | 0.5 | 29.6 | 92.7 |

Source: The Amended Compact Agreement.

## 2.2 FSM's Strategic Development Plan

The Federated States of Micronesia is heavily dependent on US aid, which is delivered through the Compact Agreement. FSM should seize the opportunity provided by the Amended Compact Agreement and use the funding wisely to achieve sustainable economic growth and development. In order to achieve these goals, FSM formulated the Strategic Development Plan (SDP) in 2004 which identifies the overall development strategies and policies over 20 years. The main objective of the SDP is to achieve economic growth and self-reliance. It calls for FSM to adopt trade and tax policies consistent with improving the international competitiveness of FSM-based producers. Of particular importance to the Trade Policy is the section that deals with Private Sector Development. The policy makers recognised that economic growth hinges on developing a vibrant private sector capable of producing goods and services that can be traded competitively in the global market.

Agriculture, fisheries and tourism have been identified in the SDP as the priority sectors for economic growth. However, no concrete steps have been taken through annual budget allocations to support the private sector to develop export capacity in these priority sectors. Positive measures need to be taken to promote export-led economic growth and sustainable development.

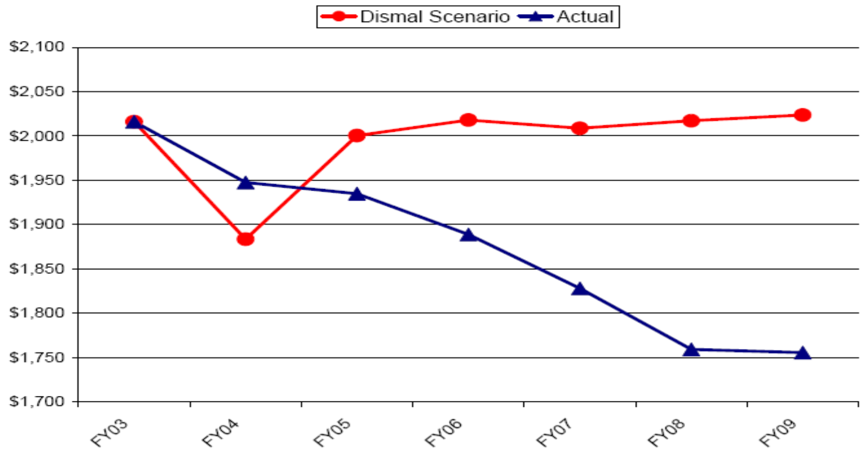
Three options were presented during the economic summit and FSM adopted the Sustained Growth Strategy (SGS) which requires FSM to improve the environment for the private sector, implement a regulatory regime that encourages private entrepreneurship, streamline foreign investment and establish a transparent and liberalized regime. Under this strategy, the public enterprises must be reformed and all non-performing enterprises must be liquidated, corporatized or privatized. This will stimulate private sector interest in the economic activities. Efforts must be made to improve access to land through better management and administration, legislation that supports long-term leasehold and mortgage leases for the commercial banks to lend to the private sector. The bankruptcy law and a modern but simple commercial code must be implemented. Support services to develop Micronesian business skills and entrepreneurship should be put in place. Tax reform is a central component of the sustained growth strategy as the FSM changes the culture of tax administration to an incentivized modern system. Greater domestic resource mobilization and revenue effort is required to support the sustained growth strategy. The public service must also be modernized and "right" sized to provide efficient and effective services to the nation that supports the private sector.

All the issues highlighted above must be addressed without fail for FSM to achieve economic growth and self reliance. A Trade Policy will only work if the SDP is properly implemented. As indicated above, a Trade Policy should not be considered in a vacuum but must fit into the broader development context and the Trade Policy must also feed into and promote the development strategies. If what has taken place during the past four years as discussed in the section on FSM's economic performance is anything to go by, then FSM is very far away from achieving the SDP goals. At the moment, the growth performance would put the FSM somewhere far below the dismal scenario. There is no doubt that the experience with implementing the Amended Compact has been a difficult one. However, if anything is to be achieved, the SDP needs to be operationalized and Compact resources must be channelled towards good projects which will help the nation to achieve sustainable development.

Despite some references to the need to promote private sector development in the SDP, there is no concrete action on the ground to match this; even the Compact funding structure is not fully supportive of private sector development. Little funding has been directed towards the three priority sectors namely, agriculture, fisheries and tourism and this raises the question whether they are really priority sectors for the FSM.

Figure 14

**SDP: 1998 Prices in US$ and GDP per Capita.**




Source: 2008 FSM National Government: Compact Annual Report.

## 2.3 Trade Policy by Sector

As indicated above, economic performance in the priority sectors of agriculture, fisheries and tourism is disappointing. For FSM to achieve economic growth and development it is vital to develop export competitiveness in agriculture, fisheries and tourism and the private sector must play a critical role in this process. This section will review the developments in the three sectors and analyse the challenges that have inhibited trade in these sectors with a view towards rectifying the errors of the past and finding lasting solutions to export promotion.

### 2.3.1 Agriculture

The challenge for policy analysis in FSM is that there is no adequate data on the primary economic sectors for a detailed analysis. There are no indicators on agricultural production and information on agricultural exports is limited. However, the general information that is available shows that about 80% of the FSM population depend on subsistence or semi-subsistence farming for their livelihood (ADB: 2005). In 1998, income derived from subsistence activities amounted to 31.5% of aggregate household income[9]. Subsistence agriculture made a substantial contribution to GDP in 1998; GDP for agriculture, hunting

[9] Household Income & Expenditure Survey. FSM Division of Statistics. 1998.

and forestry was estimated at $30.3 million per year or 17% of total GDP[10]. The value of local agriculture increased from 18% to 26% over the period of Compact 1.

However, production for the export market is very small. Agricultural exports in 2002 were valued at $1.43 million, but increased to $2. 791 million in 2007. Commercial agriculture for these exports was developed by the private sector and the government only provided supporting services such as quarantine. The government made some investments into copra (Coconut Development Authority), black pepper, broiler chicken, and layer poultry but most of these ventures have not been successful.

Copra production fluctuated between 1997 and 2003, but declined thereafter. 1998 was the best year for copra (900 tons). Before 2001, Yap and Pohnpei accounted for about 70% of total copra production. In 2003, Pohnpei and Yap productions comprised 78% and 13% respectively, whilst Chuuk produced only 9%. No copra production was reported for Kosrae in 2003. In 2006, Pohnpei produced about 136 tons, Yap 50 tons[11] and there was no production in Chuuk and Kosrae. As is the case in many Pacific island countries, copra production, has disappeared due to inefficiencies and low prices[12] (Economic Review: 2005). The other problems affecting the industry include the ageing coconut tree stock with limited replanting, irregular collection and slow payment to farmers, reduction of subsidy allocations by the National Government (dropped by 62% from $200,000 in 2002 to $75,000 in 2005). It was also reported that some ship-owners do not want their companies to put copra into their containers because of its bad smell. The main market for copra is Bangladesh. FSM should consider the possibility of sending its copra to Fiji for eventual exportation to Singapore as is the case with Solomon Islands and Vanuatu.

The Coconut Development Authority (CDA) in Pohnpei is running a pilot virgin coconut oil project and if this entity is privatized, it has enormous potential to boost exports. The CDA also produces jam, coconut milk, virgin oil and ice cakes and there is potential to make soap and bio-fuel at commercial scale[13]. The major problems affecting the coconut industry include lack of industrial space, transport problems and low producer price paid to the outer islands due to low subsidies from Congress, inadequate funding and lack of capacity to meet the export volumes. If these problems are addressed, FSM has potential to establish a viable processing plant and produce virgin coconut oil for the domestic and export market especially the US, which is a lucrative market for virgin coconut oil. The other potential markets are Japan and Germany. Coconut oil is special because it is healthy

[10] Chris Lightfoot and Francis X. Hezel, S.J: 2005. The Myths of Economic Development in the FSM *Micronesian Counselor Number 59.* This study indicates that about 45% of the FSM population engage subsistence agriculture and household production, and the monetary value of local production is estimated to be about $50 million a year, or one-fourth of the total value of the FSM economy.

[11] Production in yap was affected by natural disasters.

[12] According to the ADB report 2005, the farm-gate price of copra was reduced from 13 cents/lb ($260 per ton) to 5 cents/lb ($100 per ton) in September 2004. A subsidised price of 10 cents/lb ($205 per ton) – still a 23% drop in price was agreed after widespread opposition. It costs an additional $205 per ton to transfer the copra to Pohnpei making the FOB price still higher than the world price of around $350/t.

[13] Chuuk used to produces soap and coconut oil but the machine has broken down. The main issues at the plant relate to marketing and management problems and only one chemist used to service Chuuk and Pohnpei.

and can also be used for body massage as a fragrance. The other area where FSM needs to focus attention on is the extraction of crude oil from coconut.

Commercial exports in FSM are generally niche agricultural industries that pop up when occasion offers and which can expand or contract according to market conditions, the cost of production and delivery. In the early 1990s, for instance, bananas became a sizeable export but have dropped sharply in recent years. Exports of bananas from Pohnpei to Guam have been affected by high air freight costs and this makes it difficult for these bananas to sell in Guam. Another problem is that exporters cannot produce enough bananas to fill the big containers. Penetrating the US market after 9/11 is now difficult because of security reasons. For example, if you were not a known shipper to the US before 9/11, it will be difficult for you to export to the US now.

Pohnpei pepper, used to be an important export product some years ago, but the production capacity is now low. It is reported that a very successful high-end pepper product failed, when the government intervened on behalf of disgruntled pepper growers who wanted processors to buy all of their harvest, instead of only the best pepper. The other problem is that a government-financed and operated pepper processing plant competed with the private sector pepper manufacturer, leading to the collapse of that industry. It is alleged that poor government decisions and the emergence of a strong sakau market contributed to the demise of the pepper exports.

The earlier exports have declined but other new products have replaced them. For example, sakau exports were about $415,595 in 2007, while the exports of betel nuts have risen to about $2,224,146 in 2007. Sakau (kava) and betel now top the list of agriculture exports. Most of the sakau crop is consumed locally but about 272,000 kg are exported annually. The main markets for sakau and betel nuts are Guam, Hawaii, RMI and Saipan. These crops are grown mainly by traditional, semi-subsistence farmers.

Another example of opportunistic exports is exports of cooked food, which now brings in more money than copra. Chuukese pounded breadfruit (kkon) and Pohnpeian banana pudding (pihlohlo), among other island foods, are being distributed and marketed to the growing FSM emigrant population overseas. Bananas, breadfruit, cassava and taro can be processed into flour, chips and can be dried and stored for future use. Pandanus is another product which has potential and RMI is exporting this product successfully. Guam, RMI and Saipan are also potential markets for root crops. There is also a market in Japan for dried leaves and root crops which can be used for medicinal purposes. Bottled processed noni has been doing better in niche export markets especially in Japan. There is also potential to grow vegetables and supply the fishing industry and the local market. If the private sector can be supported to add value to these products, there is a chance that exports of these products will increase slightly.

The forestry sector is another sector that needs to be promoted especially the woodwork industry. FSM has quality Mahogany trees, which can be used to make quality furniture but this potential is not being fully exploited. The major challenge for this sector is that the producers lack equipment (truck/bulldozer) and it has been difficult for them to get finance from FSMDB. The industry is also being affected by cheap imports from China and it was recommended that there should be high import duties on imports from China.

The majority of agriculture exports are sourced from Yap, and Pohnpei and exports in Chuk and Kosrae are very small. However, the private sector in Kosrae indicated that they are producing sakau for export to Hawaii and Saipan. They are also growing noni for the Japanese market. Another product that has potential in Kosrae is vanilla. The private sector in Kosrae has problems with equipment and also wants the Government to be involved in promoting sakau to ensure quality control. There is need for marketing assistance to penetrate the pharmaceutical market in the US. Most of the agricultural products such as betel nuts, oranges, bananas, coconut and seafood are being subjected to stringent entry requirements by the US and this problem needs to be resolved. The private sector also requested that the quarantine permit be issued for 5 years (6 months is too short). The country should work with organizations such as the United Nations Conference on Trade and Development (UNCTAD) which can assist with identifying and developing niche markets for its traditional and commercial crops.

A major trade concern for agricultural products is that the import bill for food is burgeoning because many people are moving away from local foods and prefer imports. The room for import substitution is limited. In 2002, food imports totalled $28.2 million and only about $1.4 million of fruit and vegetables could be grown locally as is indicated in Table 6 below. Imports of rice and noodles amounted to $5.9 million in 2002. This means that these two are becoming the major staple foods. Food and beverages imports in 2007 accounted for about $40.1 million (30.0% imports). Meat and fish imports totaled $11.8 million (8.3 percent of total imports) and were composed of poultry ($4.2 million), canned meat ($3.2 million), canned fish ($2.4 million), beef meat ($0.9 million), pork meat, ham, etc. ($0.8 million), fish ($0.1 million), non-fish seafood ($0.1 million), and other meat ($0.03 million). Other major food items that were imported include rice ($5.9 million), fruit and vegetables ($2.5 million), sugar and confectionary ($2.5 million), bread, cakes, biscuits, etc. ($1.9 million), ramen, noodles, pasta (1.7 million), milk and cream ($1.2 million), ice cream ($0.7 million). Beverages totaled about $6.0 million (4.2 percent of the total imports), including, soft drinks ($2.7 million) beer ($2.4 million), spirits ($0.4 million), water ($0.4 million) and wine ($0.2 million). This overdependence on imports renders the country insecure in terms of food production. It is recommended that FSM should look at local foods that can be grown to replace or supplement imports.

Table 6

| Imports of “substitutable” fruit and vegetables: 2000–2002 (US$) | | | |
|---|---|---|---|
| Product/Year | 2000 | 2001 | 2002 |
| Eggs | 218,229 | 423,858 | 444,386 |
| Cabbage, lettuce, etc | 100,762 | 127,369 | 187,539 |
| Citrus fruits | 31,174 | 60,664 | 57,147 |
| Onions, etc | 153,200 | 229,624 | 179,388 |
| Potatoes | 44,896 | 69,113 | 102,498 |
| Fruit juice | 117,321 | 213,928 | 194,132 |
| Other fruit & vegetables | 231,643 | 171,270 | 252,420 |
| Total: | 897,225 | 1,295,828 | 1,417,510 |

Source: 2004 SDP

Table 7

| Sustained Growth Scenario | | | | |
|---|---|---|---|---|
| **Subsistence Agriculture** | | | | |
| Ave. growth rate (2005-2023) | 9.62% | | | |
| Year: | 2010 | 2015 | 2020 | 2023 |
| Growth rate: | 6.0% | 6.0% | 6.0% | 6.0% |
| Total subsistence agric. ($m) | 38.83 | 51.47 | 68.88 | 82.03 |
| **Commercial Agriculture** | | | | |
| **a) Agric. export receipts** | | | | |
| Ave. growth rate (2005-2023) | 33.53% | | | |
| Growth rate: | 11% | 11% | 11% | 11% |
| Plus: | | | | |
| Coconut export growth: | 18% | 18% | 18% | 18% |
| **Total Agric. Exports ($m)** | **30.19** | **53.61** | **96.57** | **138.60** |
| **b) Food import substitution** | | | | |
| % replaced by 2023 | 97.24% | | | |
| Growth rate[1]: | 23% | 23% | 23% | 23% |
| Net Food Imports ($m) | 1.18 | 0.44 | 0.16 | 0.11 |

Source: SDP

In the sustained growth scenario in table 7 above, over the period from 2005-2023, subsistence agriculture is expected to grow by 9.6%  annum, exports by 33.5% and 97% of the readily replaceable products will be locally produced. The sustained growth scenario expects population growth to be 1.5%. Processing coconut to oil is expected to play a vital role in increasing agricultural exports. Imports of readily replaceable products are expected to increase by 5% annually, taking tourism into account. The SDP makes excellent projections but no concrete action has been taken on the ground to operationalize these goals. Contrary to the 2010 SDP projection that coconut exports will be about $30 million, the total merchandise exports in 2007 as is shown table 8 below barely exceed $16 million and total agricultural exports are about $2, 791 million.

Table 8

| Total Agriculture Exports 00-07 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Description** | **2000** | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** |
| **Agriculture Produce:** | | | | | | | | |
| Copra | 186,380 | 200,908 | 210,676 | 0 | 174,942 | 0 | 0 | 0 |
| Banana | 71,918 | 32,606 | 25,897 | 257,384 | 86,846 | 45,359 | 6,467 | 1,359 |
| Citrus | 44,417 | 22,615 | 27,886 | 29,130 | 8,470 | 4,726 | 4,292 | 16,626 |
| Kava | 151,522 | 160,403 | 241,253 | 120,848 | 132,221 | 134,769 | 283,642 | 415,595 |
| Betel Nuts | 625,233 | 907,710 | 887,654 | 445,516 | 351,321 | 403,204 | 1,871,627 | 2,224,146 |
| Piper leaves | 17,658 | 20,845 | 25,039 | 28,190 | 6,137 | 6,560 | 34,046 | 61,253 |
| Root Crops | 29,927 | 16,537 | 3,605 | 10,998 | 17,873 | 11,211 | 61,862 | 6,476 |
| Other Farm Produce | 12,483 | 5,657 | 6,577 | 27,033 | 11,080 | 6,036 | 11,742 | 65,976 |
| **Total Agriculture Produce** | **1,139,538** | **1,367,279** | **1,428,586** | **919,099** | **788,890** | **611,865** | **2,273,678** | **2,791,431** |

Source: 2008 International Trade Publication, SBOC.

FSM needs to develop the capacity to supply the local and overseas markets. Investments in agriculture should be encouraged and the cargo services for export of agricultural produce must also be improved. Quarantine issues should be resolved through trade agreements. For agriculture to succeed, FSM needs to improve the training facilities and research in agriculture.

FSM used to produce poultry and livestock and other agriculture products under various government projects. However, most of these projects failed mainly because of government interference, mismanagement, the unsustainable size of the projects and a number of challenges in the export markets. Currently, the major focus of the agriculture sector in most States is to produce for the local market first and the export market later. The States have learned from their past experiences and are now focusing on small scale projects which are manageable. Products such as vegetables, eggs and poultry can be produced in various States especially for the local market.

With regards to the poultry industry, the major constraint is that the chicks cannot be imported from Hawaii due to the stringent rules set by Continental Airline, and this makes it impossible to replace the stock for egg-layers. It is also difficult to get poultry and livestock feeds, and this has severely affected the production of chicken, eggs and livestock locally. However, one farmer in Pohnpei buys growers from Australia and mixes it with local feed (bread fruit/banana) to produce chicken feed.

In some States, pork production is mainly for subsistence purposes but this can also be done at a commercial scale and slaughter houses may need to be established. While feasibility studies for slaughter house and poultry production conducted in the 90s revealed that it was not feasible, the States should explore further and reassess the commercial viability of these projects. There is also an opportunity in Pohnpei to venture into pig farming and sell meat on commercial basis.

The other challenge for FSM is how to get the farmers organized to ensure that they can work together and produce products in large quantities and in a consistent manner. It is heartening to note that farmers in various States are getting organized to produce various crops and this may help to meet the quantity required for the market. The Chuuk Department of Agriculture is also supporting communities with banana seedlings from Kosrae and the objective is to supply the export market in a consistent manner. States should improve their technical assistance programmes and teach the local citizens about the importance of agriculture and encourage them to venture into creative projects where they can utilize the readily available agricultural products. Pohnpei State for example has pilot farms, farmer's services, long and short term trainings and agricultural development plans.

Exporters need help in terms of marketing and also in increasing the volume of the exports. The private sector also needs technical and financial assistance with farming equipment. There were also complaints that the application procedures to get money from the FSMDB are cumbersome, the interest rates are too high (9%) and it takes too long before one gets the money. The agricultural land is not being fully utilized because of lack of technical and financial assistance. It was also noted that the Japanese market needs a container of most agricultural products such as karat bananas, about 5-10 tons of ginger (but the farm in Pohnpei is only producing about 2 tons) and pepper every month. If small farmers cooperate, they will be able to produce in bulk and export in large volumes.

The main reason why commercial agriculture is not developed is because farmers perceive the returns from agriculture to be very low and slow to materialize compared with other activities such as fishing, tourism, non-traded services and government employment. Skewed wages in the public sector which are inflated by Compact assistance has turned the terms of trade against agriculture and makes agricultural production less attractive. Lack of interest in agriculture and the land tenure system have also affected commercial farming. The other limitations to increasing agricultural exports include infrequent transportation links, insufficient freight space in air-transport (priority is given to passengers) and high freight costs, uncertainty in shipment schedules, low volume of goods locally produced, inconsistency in the supply of these goods, and the limited knowledge and skills of local producers. Some of the constraints to agricultural production and exports include disconnections between producers and buyers, lack of meaningful incentives to stimulate investment in the agriculture sector, stringent quarantine and standards requirements from the importing countries and inadequate local consumption attitude.

Furthermore, the States also complained that there is limited budget for the government department to provide assistance (e.g. equipment) to the private sector to engage in these economic activities. The little amount that is allocated to agriculture is used mainly for personnel and little goes to cover field support to farmers. According to the 2005 ADB report, the College of Micronesia Cooperative Research and Extension Service affiliated with the USDA Land Grant Program is responsible for providing technical support, but out of a budget of $0.75 million, 97% goes to salaries.

Commercial agriculture is risk business due to variations in climate and markets and many farmers are denied loans because of the high risk involved in the business. Reliable access to inputs especially seed and fertilizer is a problem and people lack business and farming skills.

Anecdotal evidence also suggests that Pohnpei has lost a large proportion of its virgin forest to the cultivation of sakau and this is thought to have caused increased runoff, sedimentation, and chronic reef degradation. For agriculture to be sustainable, measures must be taken to prevent environmental harm.

All the problems identified above, need to be addressed urgently in order to promote agriculture production and exports. FSM should also utilize the marketing services that are provided by the Pacific Islands Forum Secretariat (PIFS) under the Pacific Islands Trade and Investment Commission (PITIC) offices based in Auckland, Sydney, Beijing, and Tokyo.

### 2.3.2 Fisheries

The marine resources of FSM are contained within an Exclusive Economic Zone (EEZ) covering over one million square miles extending from 135° to 165° east longitude and from 10° north to 1° south latitude in the western Pacific Ocean. The States are responsible for the oversight and management of near shore and coastal resources to 12 miles, whilst the management of offshore oceanic resources is the responsibility of the National Government. Thus the marine and fisheries resources can be divided into coastal and near shore fisheries; and marine and oceanic resources. The Marine Resources Act of 2002 (MRA) was passed into law as Title 24 of the FSM code. This law established the National Oceanic Resource Management Authority (NORMA) as the national agency responsible for the management of oceanic resources from 12–200 miles in the FSM economic zone.

#### (a) Marine and Oceanic Resources

The Pacific Islands nations produce about 2.7 million tons of tuna a year or about 64% of the global tuna harvest. The value of the tuna caught within the Western and Central Pacific EEZ is about $1.2 billion a year but the Pacific is only getting about 5% of this. The Western and Central Pacific Fisheries Commission has the largest tuna resources in the world and 98% of the total Pacific tuna harvest comes from FSM, Papua New Guinea, Kiribati, Solomon Islands, Nauru, Tuvalu and RMI. FSM has diverse tuna fishery, which ranges from subsistence and artisanal operations to industrial scale long line, pole and line and purse seine fishing. The main oceanic target species are skipjack tuna (katsuwonis pelamis), yellow fin tuna (thunnus albacares) and big eye tuna (thunnus obesus). However, big eye and yellow fin are facing over-fishing.

FSM has no capacity to fish in its EEZ and the majority of the fish in the EEZ is caught by licensed distant water fishers from the United States, Japan, People's Republic of China (PRC), South Korea and Taiwan. FSM has benefited immensely from fishing royalties especially during FY1994 and FY1996, when fishing royalties averaged $21 million per annum; however, receipts have fallen to an average of $12.3 million during FY2004–FY2006. It should be noted that the access fees in the Atlantic are much higher than in the Pacific and Pacific islands countries need to work together to demand higher fees for the tuna harvested in their EEZs and use the licenses to ensure that they derive the maximum benefit from their resources.

Table 9

| **Fishing Right Fees and Transhipment, FSM, CY 2000-CY 2007 (US Dollars)** | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Description** | **2000** | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** |
| License Fee | 14,029,701 | 11,307,836 | 10,677,410 | 13,473,183 | 11,942,113 | 12,608,412 | 13,808,521 | 14,757,221 |

Sources: NORMA, SBOC, Division of Statistics.

The annual catch in FSM has been fluctuating and some of these changes may be attributed to climate changes. During a La Niña period (1995), surface tuna schools are most active in the Western Pacific Ocean in the area of the FSM EEZ. However, during El Niño periods as was the case in 1998, the surface schools concentrate more to the eastern part of the central Pacific. In 1995, FSM catches grew steadily to 253,174 metric tons (mt) and declined significantly to 83,268 mt in 1998. The total catch declined from 235, 621 mt in 2005 to 139,119 mt in 2007 and the catch by the Japanese fleet has declined rapidly.

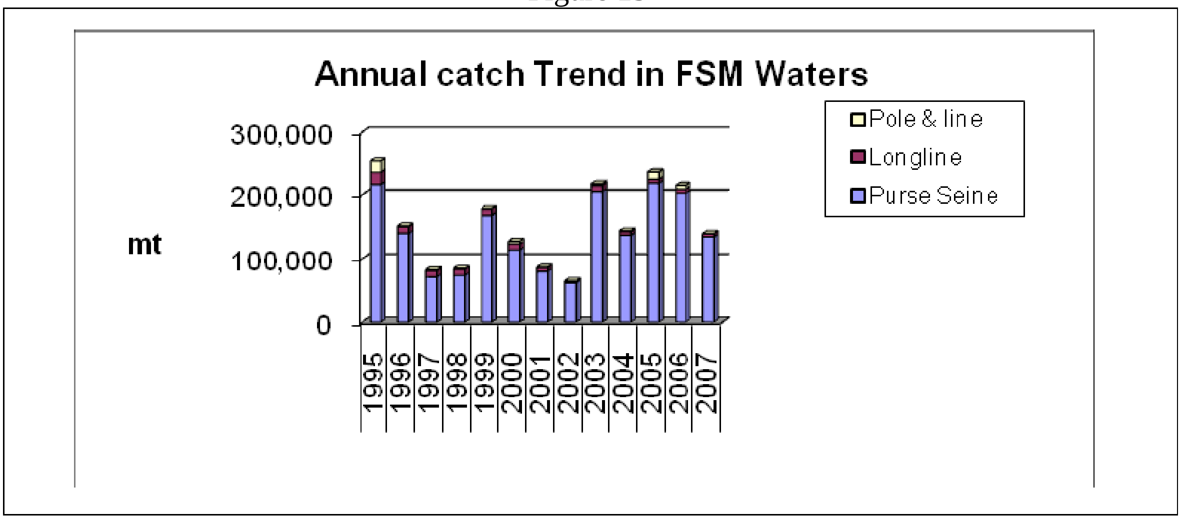
Table 10

**Tuna Catches in the FSM EEZ 1995 – 2007**

| | Purse Seine | Longline | Pole & line | Total |
|---|---|---|---|---|
| 1995 | 216,294 | 18,724 | 18,156 | 253,174 |
| 1996 | 139,731 | 11,081 | 1,054 | 151,866 |
| 1997 | 70,572 | 9,597 | 1,003 | 81,172 |
| 1998 | 73,027 | 9,216 | 1,026 | 83,269 |
| 1999 | 168,127 | 9,791 | 555 | 178,474 |
| 2000 | 114,372 | 9,125 | 3,814 | 127,311 |
| 2001 | 79,171 | 5,221 | 687 | 85,079 |
| 2002 | 61,101 | 2,820 | 83 | 64,004 |
| 2003 | 205,389 | 9,364 | 2,562 | 217,315 |
| 2004 | 137,139 | 5,328 | 1,384 | 143,851 |
| 2005 | 218,419 | 6,106 | 11,096 | 235,621 |
| 2006 | 202,752 | 6,116 | 6,032 | 214,900 |
| 2007 | 134,489 | 4,630 | * | 139,119 |

Source: NORMA

Figure 15




Source: NORMA

Table 11

**Annual number of foreign fleet vessels (by flag and gear type) licensed to fish in FSM EEZ 03-07**

| | Longline | | | | | Pole & Line | | | | | Purse Seine | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Country** | **2003** | **2004** | **2005** | **2006** | **2007** | **2003** | **2004** | **2005** | **2006** | **2007** | **2003** | **2004** | **2005** | **2006** | **2007** |
| Chinese, Taipei | 71 | 69 | 31 | 38 | 27 | - | - | - | | | 36 | 34 | 33 | 34 | 34 |
| South Korea | - | - | - | | | - | - | - | | | 26 | 28 | 27 | 28 | 28 |
| United States | - | - | - | | | - | - | - | | | 26 | 22 | 14 | 13 | 21 |
| Japan | 81 | 88 | 104 | 78 | 66 | 37 | 30 | 37 | 26 | 8 | 33 | 34 | 34 | 36 | 35 |
| Peoples Republic of China | 24 | 27 | - | 8 | 11 | - | - | - | | | 4 | 8 | 8 | 9 | 10 |
| Vanuatu | - | 9 | - | | | - | - | - | | | | 11 | 8 | 8 | 14 |
| Papua New Guinea | - | - | - | | | - | - | - | | | 8 | 9 | 2 | 4 | 10 |
| Belize | 2 | 2 | 2 | | | - | - | - | | | | | - | | |
| Kiribati | - | - | - | | | - | - | - | | | 1 | 1 | - | 1 | 1 |
| FSM | 20 | 22 | 20 | 24 | 29 | - | - | - | | | 11 | 6 | 6 | 5 | 4 |
| Rep. of Marshall Islands | - | - | - | | | - | - | - | | | 1 | 3 | 1 | 2 | 4 |
| New Zealand | - | - | - | | | - | - | - | | | - | 4 | - | | |
| Philippines | - | - | 1 | 1 | | - | - | - | | | 1 | 1 | - | | |
| Netherlands Antiiles | | | | | | | | | | | | | | 1 | 1 |
| Solomon | | | | | | | | | | | | | | 2 | |
| **Total** | **198** | **217** | **159** | **149** | **133** | **37** | **30** | **37** | **26** | **8** | **147** | **161** | **133** | **143** | **162** |

Source: NORMA

The long-line fleet has gone down from a total of about 217 in 2004 to about 133 in 2007, pole and line has gone from 37 in 2003 to 8 in 2007 but the purse seine fleet has increased from 133 in 2005 to 162 in 2007.

The FSM long line fleet comprises vessels from Japan, China, Taiwan and FSM. The vessels target deep swimming large yellow fin and big eye tuna, primarily for fresh chilled export to Japan. In 1996, fish accounted for about 82% of total exports and 69.1% in 2007. However, FSM has not fully exploited its vast marine resources and its contribution to GDP is below expectations. FSM needs to exploit fully the potential opportunities associated with its fisheries resources. The country could derive more economic benefits if it promotes investment and value addition in the fisheries sector, particularly in integrated fishing and canning and improve other related services.

FSM is a member of the Oceanic Fisheries Program of the Secretariat for the Pacific Community and the Forum Fisheries Agency (FFA). It is also a party to the 1982 Nauru Agreement Concerning the Management of Common Interest and the 1994 Federated

States of Micronesia Arrangement for Regional Fisheries Access. FSM has also signed and ratified a bilateral Fisheries Partnership Agreement with the European Union. Since the European vessels have not yet started fishing in FSM, it is difficult to ascertain the impact of this agreement. However, given the changes in the tuna market and the fact that the European vessels have over fished the Indian Ocean, FSM needs to review the benefits that it received from the bilateral agreement with Europe and seek an opportunity to improve the Agreement for the benefit of its citizens. In future, the value of tuna will become more important as a result of the introduction of new management measures.

It should be noted that since 2000, the Pacific Islands domestic based sashimi tuna industries have experienced a downturn across the region. Operators in Fiji, Samoa and Tonga have experienced declining catch levels (despite increasing fishing effort) and they face increasing competition from international suppliers to the principle market in Japan. The sashimi tuna market prices have tended to remain flat. In addition, the impact of the Asian economic crisis and the SARS epidemic has also had a negative impact on sashimi market prices. The 9/11 security issues, increases in fuel prices and airfreight costs have also affected the profit margins in sashimi tuna long lining.

The supply of tuna for canning from purse seine fishing is essentially a commodity trade and is thus subject to significant market price variations. The very high regional catch levels of the late 1990's saw bulk tuna prices reduced to as little as $350 per mt in 1999 and 2000. Prices have subsequently stabilized in 2003–04 to 750 - $850 per mt. The fishing industry is highly competitive and high-risk as it is subject to the vicissitudes of the volatile global market. It operates on small margins of profit and requires large economies of scale; the fishing fleets must be flexible and mobile, always ready to move when circumstances demand. Another problem is that island people may not be willing to serve on fishing boats for a long period than their counterparts in Asia. For the private sector to enter into this risky industry, the government must put in place all the required supporting facilities and incentives. However, lessons from the past experiences must be used to develop working fisheries development plans.

The history of the fishing industry in the FSM is littered with failed projects and very few success stories. In the early 1990s, FSM embarked on a strategy of substantial public sector investment in fisheries facilities and enterprises. There were a number of joint ventures with foreign partners in purse seine fishing operations in Chuuk, and similar but direct public sector investment in Pohnpei and Yap was undertaken. All the four States invested in freezing, storage, transhipment plants, coupled with air shipment of sashimi-grade tuna to Japan by the National Government. The Micronesian Long-Line Fishing Corporation, a long-line fishing company, was set up with the Asian Development Bank (ADB) loan finance for eventual sale to the private sector. As typical with many public sector investments, very few of these public sector fisheries enterprises were profitable. Most of these operations are moribund or continue to operate at a loss. Infrastructure in Yap, Kosrae and Chuuk is shut down and that of Pohnpei is under-utilized.

The main reasons why these companies failed include poor planning and management, inadequate equipment and inexperience. In order to address some of these problems, the public sector enterprises in the fisheries sector should be transformed and run on a purely private and commercial basis. The National Government divested its ownership shares in the Caroline Fisheries Corporation, which is now wholly owned by the Pohnpei State government. Coupled with the establishment of an enabling environment, divestment will promote private sector development. FSM needs to promote foreign investment and value addition in this sector. The States need to work with the National Government and NORMA to make it easy for foreign investors to invest in the fisheries sector. The government role should be limited to resource management, creating an environment which is conducive for private sector development, provide hard infrastructure and facilities such as adequate supply of fuel, power, potable water, sanitary waste disposal, good port facilities and shipping terminals, access roads and docking facilities. The private sector must be responsible for all commercial fisheries investments and operations. Once the supporting facilities and trained personnel are available, there is a good chance that successful fishing ventures can be established.

Transporting harvested tuna to Asia and other distant countries for processing is very expensive in fuel and lost fishing time. There are over 20 tuna processors in Thailand and another 12 in Korea. These countries do not have tuna resources of their own and are dependent on the tuna harvested in the Western and Central Pacific. Their cheap labour and efficient vessel and vessel repair services make it possible for them to produce effectively than Europe and Japan. Table 12 below shows the production costs of tuna cases in selected countries.

Table 12

| **The Cost of Producing a case of tuna in selected countries** | | |
|---|---|---|
| Country | Product | Cost (€/case) |
| Spain | Yellow fin in veg oil | 27.1 |
| Italy | Yellow fin in olive oil | 35.7 |
| Seychelles | Yellow fin in veg oil | 25.9 |
| Thailand | Yellow fin in veg oil | 23.0 |
| Thailand | Skipjack in brine | 17.3 |

Thailand is the main supplier of the US market and has established plants in the Philippines. The EU, led by Britain is a high value market for canned tuna. FSM should build its industries and supply these markets. The focus should not be on large fishing operations but the private sector should establish shore based tuna industries and FSM should put some conditions on the licenses they issue to foreign boats to discharge some of their fish to FSM based canneries[14]. This will ensure a steady supply of fish to the shore

[14] Peter Wilson. 2007. A tuna Industry in Micronesia? Micronesian Counselor. Issue 66

based processing facilities and provide more jobs than the fishing itself. Further jobs will be created by servicing the vessels[15].

FSM has another advantage in the form of duty free access to the US, which gives it a 12% marketing advantage over Asian processors. If it signs the Economic Partnership Agreement (EPA), it can also export to the EU duty free with a 20.5% -24% marketing advantage over some Asian competitors. Since labor costs are 6-8% of the total costs of a case of tuna, FSM has the potential to compete with Asian countries. In principle, island based canneries have the potential to obtain the raw product 10-20% cheaper than distant processors as it costs about $100-120 a ton to deliver the tuna to distant plants. This is a huge advantage because the costs of tuna are about 60% of the total cost of a case of tuna. However, in the long run, the Pacific industries must be competitive and not depend solely on preferences.

The major issue for FSM will be to establish the necessary facilities that are required in order to meet export requirements. Such facilities include a Competent Authority, a laboratory and training the people to operate these facilities. It will be difficult to export to the EU without meting the sanitary and phyto-sanitary standards (SPS) and the technical barriers to trade (TBT) requirements. FSM boats are also required to meet the EU requirements and all the product processing methods must comply with the EU sanitary requirements.

### (b) Coastal and Near shore Fisheries

Another area that has been considered is aquaculture. Ten years prior to the 2000 fisheries consortium, a review of aquaculture in FSM concluded that aquaculture will not be a significant revenue earner for the FSM[16]. After at least 20 years of investment and technical support, there is still not a single commercial aquaculture enterprise in FSM. Most aquaculture specialists in FSM agree that the future development of aquaculture in the country will revolve around high-value export products such as pearls, aquarium life, sponges and perhaps organisms with pharmaceutical properties. The National Aquaculture Centre in Kosrae is trying to produce some clams and crabs for the US, EU (UK, Netherlands, and Germany) and Chinese markets. The government needs to assist the private sector with documentation (e.g. the Euro 1 form) required for exports. There were also calls for the government to adhere to CITES requirements.

The fisheries sector in the States is also struggling. Chuuk used to export tuna for the sashimi market in Japan through the Chuuk Fishing Tuna Incorporated but exports have ceased and most of the reef fish is sold domestically for local consumption. The fishing facility (CFTI) is no longer in operation due to lack of raw materials amongst other things. Chuuk State is also promoting aquaculture and is in the process of establishing an

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15 The services that are required include fuel, food, net and vessel repair and recreation. The Government of Guam reported that these services come to more than $400,000 a trip or $2 million a year per vessel.

16 Anon. Evaluation of aquaculture projects and production of an aquaculture development plan for the Federated States of Micronesia. Report prepared for the FSM National Office of Planning and Statistics. Australian Planning and Training Associates (APTA) Pty.Ltd. 1990

aquaculture association. At the moment, there are no restrictions on aquaculture commercial activities in Chuuk and the State is working closely with experts from Hawaii to develop fisheries and aquaculture exports. There are also efforts to conserve and manage the fisheries resources to ensure sustainability. However, there is no current data on fish catches or production but anecdotal information suggests that reef fish is being exported in large quantities by air to Guam and some species are almost depleted.

Yap used to export reef fish to Guam but this trade has been restricted in order to conserve resources. Fishing is currently being done for local consumption. However, in future the YFA would like to export fish to key markets such as Guam, Saipan, Hawaii, US and Japan. It also plans to diversify into loining and aquaculture. The major problem in Yap is that the fishing facilities were affected by the typhoon Sudal in 2004 and YFA currently has only one fishing vessel donated by Japan (OFCF). YFA's operation started in October 2006 and according to the data available in March 2007, it had made about 22 trips catching about 24,000lbs of fish worth about $35,000. Some of the constraints affecting YFA are lack of financial support to enable YFA to operate fully and produce for the export market, inadequate fishing vessels, no Board of Directors for YFA and transport problems.

Some of the few products exported by Pohnpei include pelagic tuna, trochus cell, reef fish, crabs, lobsters, amongst other varieties. Currently, there is one company which started operations in Pohnpei since 2006. The company is responsible for processing tuna into loins and exporting to Hawaii and the unprocessed fish goes to US or Japan. It has access to cargo services and seems to be doing well and has plans to enter into value addition. Some of the constraints facing the company relate to the high cost of diesel, poor catch, the need for a diesel pipe at the fishing wharf, high costs of clearing (1-2hrs is too long). The company recommended FSM to remove customs clearance for those that are fishing inside the EEZ as is the case in Majuro. They also want the customs procedures to be simplified, and for officials to come at the same time and not at different times. It was also indicated that the company has its own air cargo which is not always full and can accommodate bananas to Guam at $3/kg. The company complained that it takes 1-2 months to get a workers permit and this should be addressed urgently. Lack of vegetables and fruits was also cited as another area that warrants attention.

The key issues affecting the fishing industry include transportation costs, lack of freight space, stringent quarantine and certification requirements, inadequate processing plants, inadequate offloading facilities, improper ice-plant, and lack of funds for improving the fisheries infrastructure.

The State of Pohnpei recommends that tuna caught in the region should be processed within the region and urges the FSM government to open up international tuna markets and to support value addition. There is a need to ensure that the tuna industry remain competitive even after the preferences are gone. This requires an objective assessment of the sufficiency of major factors of production such as suitable land, water, labor, electricity, transportation infrastructure and accessibility to year-round fishing grounds. Pohnpei appears to have a comparative advantage in these factors.

The State of Pohnpei recommended that boats should be required to tranship fish inshore and not in the EEZ or high seas but at the ports. This brings revenue and is desirable in terms of monitoring and accuracy. Sound management and conservation of inshore marine resources and environment is vital for the livelihood and lifestyle of the people. In this regard, the State is promoting investment in marine products that can be managed such as sponge, coral, black pearl, mangrove crabs and fish farming. Investment in these areas must meet sound environmental and conservation requirements.

Commercial fishing, drift net fishing in the State waters and importation of endangered species is prohibited. Scientific or experimental research on marine life in State waters is allowed subject to special permit issued by the Director of Land and Natural Resources. It should also be noted that the transhipment fee of no less than 10 cents has not been implemented as this may chase away boats. In an attempt to address the constraints facing industry development, the Pohnpei Commercial Tuna Longline Operator Association was formed in 1998 with four members but its effectiveness has been questioned.

Kosrae has had no commercial export of fish since 1999 when the Pacific Tuna Industry closed. However, there are other fisheries projects which provide opportunities for exports. These include giant clam and crab farming. Previous attempts in the past to implement the value-addition did not succeed mainly because of weaknesses in the transportation sector and insufficient raw materials. It was further constrained by the difficulty in linking the processors with the fishing boats, the irregularity of freight arrangements, inadequate port facilities, and prohibitive investment costs. Table 13 below shows exports of reef fish and marine products.

Table 13

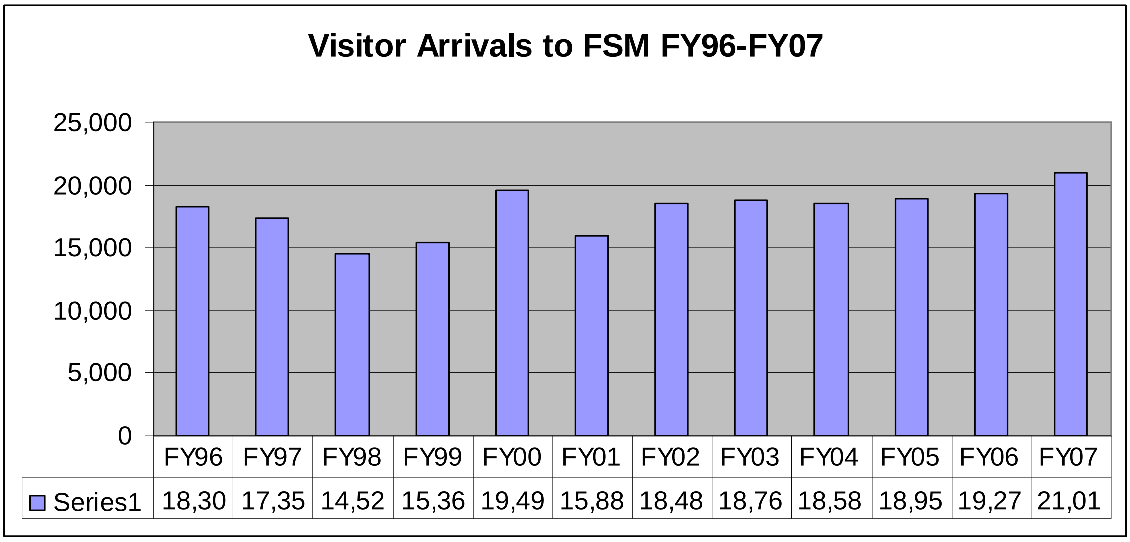
| Exports of Marine products 2000 – 2007 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Marine Products:** | | | | | | | | |
| **Offshore Fish** | **2000** | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** |
| Purse Seiner (domestic license) | 4,850,900 | 6,212,328 | 5,454,868 | 2,368,895 | 7,206,011 | 9,670,269 | 5,465,828 | 11,155,265 |
| Purse Seiner (domestic based foreign license) | 0 | 0 | 635,717 | 1,064,767 | 0 | 0 | 0 | 0 |
| Longliner (domestic license) | 4,957,718 | 4,368,581 | 1,524,487 | 7,957,251 | 2,070,220 | 1,417,127 | 0 | 0 |
| Longliner (domestic based foreign license) | 2,333,942 | 1,519,085 | 1,181,177 | 1,947,816 | 930,519 | 591,280 | 0 | 0 |
| Reef Fish | 75,273 | 100,823 | 109,512 | 733,022 | 55,650 | 520,382 | 241,421 | 841,376 |
| Crab/Lobsters | 172,339 | 177,948 | 206,480 | 41,442 | 25,369 | 45,362 | 19,831 | 39,163 |
| Trochus shell | 0 | 0 | 21,037 | 0 | 0 | 0 | 430,970 | 78,255 |
| Live Clams | | | | | | | 17,349 | 29,780 |
| Other Marine Products | 41,836 | 2,837 | 4,561 | 0 | 90 | 225 | 38,506 | 157,480 |
| **Total Marine Products** | **12,432,008** | **12,381,602** | **9,137,839** | **14,113,193** | **10,287,859** | **12,244,645** | **6,213,906** | **12,301,318** |

Source: 2008 International Trade Publication, SBOC.

### 2.3.3 Tourism

Tourism is one of the priority sectors that have potential in FSM. Annual tourist arrivals have been fluctuating in the region of around 19, 000. In FY1996, there were 18,305 visitors but this declined to 14,526 in FY1998 mainly because of the downturn in Japanese and Asian tourists. The tourism industry is slowly recovering and tourist arrivals reached a peak of 21,015 in 2007. FSM also needs to prepare fully and ensure that the tourism industry also benefits from the military build up in Guam.

Figure 16



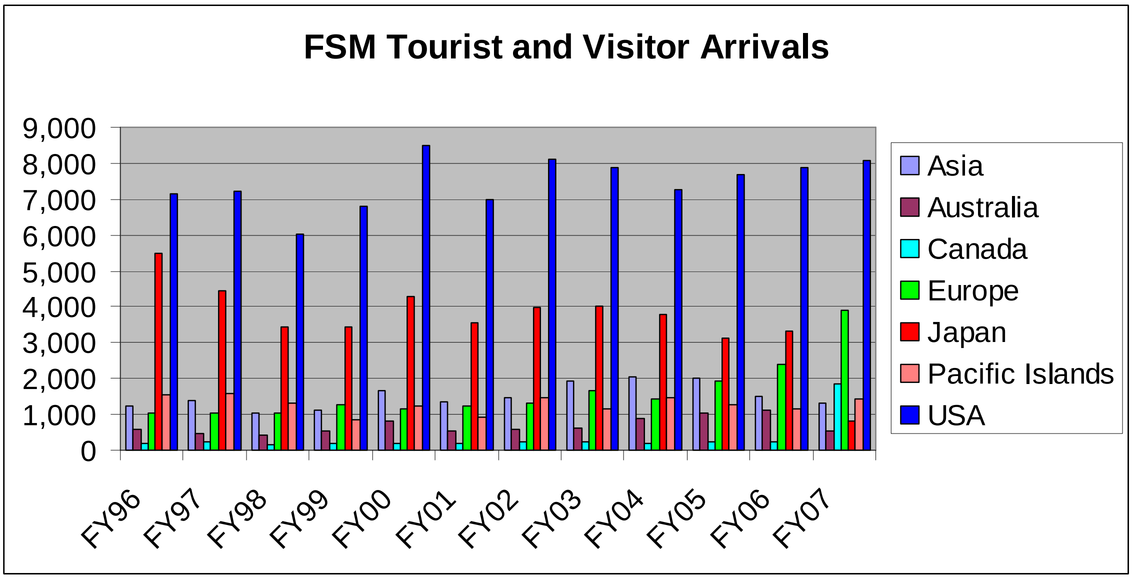

Source: 2008 FSM National Government: Compact Annual Report.

The main export markets for FSM tourism are Japan and the USA, which account for over two-thirds of all arrivals and these are the markets that have been worst affected by the problems facing the international industry. The major problems affecting the Japanese market include the slow recovery from the economic difficulties it has been suffering since the late 1990s, threats of terrorism and health concerns. Japanese tourist arrivals declined by 5% between 2000 and 2003. The US market has not recovered from the slowdown that began before September 11 and arrivals to the FSM are down by nearly 8% over the three year period[17]. However, the European market is steadily growing in importance for the FSM and over the 2000-2003 period it increased by almost 11%.

There has been a major decline in Japanese, Australian tourists but a major increase in European and Canadian tourists.

[17] SDP.2004

Figure17




Source: 2008 FSM National Government: Compact Annual Report.

The key problems affecting the tourism industry include lack of infrastructure, poor quality facilities, inadequate promotion, insufficient investment in the sector, transportation problems which are exacerbated by the distance from potential markets and high flight costs. Many hotels operate at low capacity levels and the standard of some accommodation facilities is unattractive to international travellers. However, despite all these challenges, FSM has great potential as a niche market for eco-tourism and diving. While tourism has enormous potential for economic growth in FSM, it must be noted that its performance is contingent on a number of local and international factors. Some require policy interventions and others require administrative action and improvements in tourism-related infrastructure. The government should assist with infrastructure and policy direction and the private sector should play a vital role in this sector.

FSM should focus on marketing cultural tourism, eco-tourism, water-based tourism, diving and various special interests (e.g. bird watching, social anthropology, traditional plant medicines etc…). Most tourists want to visit places that are unique to their own, that are natural and environmentally clean and FSM offers one of the finest diving environments on earth.

The country needs to adopt policies that encourage investment in up market tourism. For tourism to be a success story, it needs support at the highest political level and at all the chains from production to marketing and promotion. The products that are offered to tourists must be diversified and all the services that are provided to tourists and residents alike must improve. Issues such as electricity, safe water, health services, hotel accommodation, airport facilities, and immigration/emigration procedures warrant some attention. Some of the hotels require refurbishment and new hotels catering for certain ‘high class’ tourists are needed. This should be accompanied by appropriate training of hotel staff to meet international standards. The airports need some attention, particularly the runways. The same applies to roads and road transport. There should be provision for public transport, walking and cycling pavements to certain places of strategic importance to tourists. There should be provision of safe marine transport to the other outer islands and all the facilities must be improved. Another important issue is to promote the use of local foods and sell local products to tourists.

In Chuuk, about 90% of tourists come for wreck diving. Chuuk has the largest collection of world war ship wrecks situated in one area. The State has about five small islands with pristine resources and different types of marine species that are being developed as tourist attraction sites and one of them is fully booked up to 2008.

The Chuuk Visitors Bureau (CVB) has employed a multi-lingual marketing officer and is trying to promote quality tourism as opposed to mass tourism. Most tourists come from America, Europe and Japan. The average tourist arrival is about 4, 500 per year and tourists normally stay for a week spending about $223-300 a day.

The CVB is also trying to ensure that farmers and fishermen benefit from tourism. Some of the activities that the CVB is involved in include promoting handicraft, storytelling, cultural dances, land touring activities (more tour guides will be trained) and local food production and consumption.

The major challenges affecting tourism include negative publicity of Chuuk State, poor state of the road, land disputes, inadequate power supply, poor sewer system, poor water supply facilities, inadequate dock facilities and small airport runway. The sum of States exceeds the FSM total because visitors may pass through more than one State.

Table 14

**Chuuk State**

| | FY1996 | FY1997 | FY1998 | FY1999 | FY2000 | FY2001 | FY2002 | FY2003 | FY2004 | FY2005 | FY2006 | FY2007 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Asia | 232 | 692 | 328 | 437 | 557 | 249 | 303 | 381 | 492 | 444 | 315 | 515 |
| Australia | 163 | 122 | 67 | 153 | 283 | 109 | 189 | 226 | 376 | 434 | 501 | 354 |
| Canada | 45 | 72 | 50 | 55 | 62 | 62 | 103 | 85 | 60 | 76 | 72 | 120 |
| Central America | 1 | 10 | 27 | 19 | 14 | 6 | 4 | 9 | 8 | 3 | 3 | |
| Europe | 297 | 409 | 350 | 535 | 510 | 313 | 477 | 423 | 512 | 510 | 583 | 952 |
| Japan | 731 | 1,181 | 901 | 1,023 | 2,045 | 1,277 | 1,690 | 1,057 | 1,699 | 904 | 1,233 | 1,344 |
| New Zealand | 28 | 13 | 19 | 39 | 31 | 10 | 32 | 48 | 57 | 70 | 49 | 48 |
| Other | - | 9 | 7 | 7 | 17 | 5 | 9 | 4 | 9 | 14 | 7 | 50 |
| Pacific Islands | 63 | 160 | 128 | 112 | 130 | 107 | 162 | 178 | 173 | 214 | 213 | 296 |
| Philippines | 179 | 299 | 313 | 384 | 487 | 297 | 355 | 375 | 487 | 442 | 499 | 651 |
| South America | 4 | 9 | 6 | 9 | 16 | 11 | 7 | 3 | 6 | 8 | 5 | |
| USA | 1,789 | 2,602 | 1,898 | 2,339 | 2,705 | 1,810 | 2,735 | 2,810 | 2,412 | 2,467 | 2,524 | 2,634 |
| **Total** | **3,532** | **5,578** | **4,094** | **5,112** | **6,857** | **4,256** | **6,066** | **5,599** | **6,291** | **5,586** | **6,004** | **6,964** |

Source: 2008 FSM National Government: Compact Annual Report.

The Yap Visitors Bureau (YVB) plays a vital role in promoting tourism in Yap State. About 80% of tourists come for diving, whilst culture and nature constitute about 20% of tourist arrivals. The diving activities include manta ray diving, mandarin fish diving, wall/cavern/soft coral diving and shark feeding. Cultural activities include traditional dances, cultural day activities, canoe sailing/traditional navigation, village activities/stone-path/stone money banks, local weaving, handicrafts making, local food, local medicine/massage therapy and home-stays/story telling. The activities which fall under nature include land tour, sight-seeing, trail hiking, bird watching, star gazing, the beaches, kayaking/sport-fishing, snorkeling/sun-tanning, war relics, and local and foreign shrines.

Yap has resolved to concentrate on high value or quality tourism as opposed to mass tourism. Most tourists come from North America, followed by Europe and Japan. The average annual spending is about $2, 420, 800. Yap State has projected a 15% annual increase in tourist arrival and this projection must be complemented by an increase in hotel rooms.

Table 15

**Yap State**

| | FY1996 | FY1997 | FY1998 | FY1999 | FY2000 | FY2001 | FY2002 | FY2003 | FY2004 | FY2005 | FY2006 | FY2007 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Asia | 425 | 397 | 295 | 245 | 517 | 452 | 373 | 540 | 451 | 347 | 225 | 261 |
| Australia | 77 | 97 | 57 | 72 | 71 | 69 | 88 | 143 | 137 | 163 | 125 | 256 |
| Canada | 89 | 99 | 68 | 82 | 70 | 67 | 65 | 81 | 80 | 77 | 85 | 94 |
| Central America | 12 | 11 | 2 | 9 | 9 | 12 | 10 | 5 | 4 | 3 | 6 | |
| Europe | 423 | 415 | 428 | 533 | 666 | 624 | 596 | 810 | 584 | 1,124 | 1,269 | 508 |
| Japan | 1,208 | 997 | 745 | 837 | 867 | 699 | 707 | 741 | 556 | 533 | 866 | 728 |
| New Zealand | 29 | 25 | 26 | 40 | 22 | 18 | 37 | 27 | 19 | 33 | 34 | 46 |
| Other | 13 | 11 | 18 | 20 | 31 | 24 | 12 | 13 | 15 | 24 | 22 | 57 |
| Pacific Islands | 299 | 448 | 225 | 235 | 190 | 195 | 159 | 175 | 206 | 227 | 200 | 336 |
| Philippines | 229 | 206 | 155 | 181 | 206 | 176 | 179 | 203 | 279 | 375 | 314 | 491 |
| South America | 13 | 10 | 2 | 13 | 23 | 4 | 6 | 1 | 19 | 10 | 6 | |
| USA | 2,111 | 2,373 | 1,982 | 2,138 | 2,341 | 2,382 | 2,097 | 2,122 | 2,193 | 2,177 | 2,426 | 2,234 |
| **Total** | **4,929** | **5,089** | **4,003** | **4,405** | **5,013** | **4,722** | **4,329** | **4,861** | **4,543** | **5,093** | **5,578** | **5,011** |

Source: 2008 FSM National Government: Compact Annual Report.

The State has been engaged in some promotional activities such as joint marketing and promotional campaign efforts at trade-shows or travel fairs, conducting destination seminars and workshops, inviting press and travel agent complimentary tours, leaflets, brochures and maps in foreign versions, websites in foreign versions, foreign speaking staff on the front line, developing and designing local products and gourmet appeal to the foreign tastes and perceptions. It also seeks to establish and strengthen roles and functions of public relations representatives in foreign regions. Some of the activities that are aimed at marketing tourism include collaborating and maintaining close ties with the FSM Overseas Missions in Foreign Countries, building and strengthening a welcoming system and directional signs, maintaining and strengthening students and researchers exchange programs between foreign countries.

The major constraints in tourism relate to expensive travel costs to Yap, infrequent flight schedules, poor channel facilities (the size of the channel is too small for cruise ship), inadequate funding to develop tourism infrastructure, poor maintenance of cultural sites, poor banking and telecommunication, stringent visa requirements in Guam, language barrier, lack of participation in regional tourism organizations and insufficient marketing.

The national objective for FSM in 1997 was to achieve annual visitor arrivals of 100,000 with an average length of stay of 5 days, generating about $40-50 million dollars per year in foreign exchange earnings. Pohnpei State was expected to benefit from 20-25% of market share. However, the current annual level of visitor arrival is about 7,500 for Pohnpei with 3.4 days as average length of stay, generating about $4-5 million per year– a far cry from the initial target. The major problem for FSM in general and Pohnpei State in particular, is that despite several Economic Summits endorsing tourism as a priority sector, these tourism plans have not been fully implemented. Pohnpei is currently developing its tourism marketing plan. In order to exploit the benefits of tourism in Pohnpei, it is important for everyone including the government officials to be educated about the potential that tourism has for the economy. Government support is needed for the nation to realize its full potential. Pohnpei's magnificent ruins at Nan Madol may be genuinely one of the man-made wonders of the world and this has the potential to attract more tourists.

Table 16

**Pohnpei State**

| | FY1996 | FY1997 | FY1998 | FY1999 | FY2000 | FY2001 | FY2002 | FY2003 | FY2004 | FY2005 | FY2006 | FY2007 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Asia | 668 | 360 | 538 | 556 | 682 | 732 | 875 | 1,161 | 1,343 | 1,389 | 1,086 | 776 |
| Australia | 497 | 302 | 374 | 366 | 506 | 359 | 361 | 335 | 414 | 528 | 574 | 610 |
| Canada | 96 | 47 | 51 | 60 | 71 | 67 | 65 | 85 | 87 | 90 | 95 | 140 |
| Central America | 3 | 8 | 38 | 8 | 13 | 24 | 12 | 6 | 10 | 3 | 6 | |
| Europe | 419 | 293 | 334 | 281 | 317 | 337 | 269 | 544 | 364 | 336 | 627 | 1,109 |
| Japan | 3,701 | 2,428 | 1,853 | 1,565 | 1,496 | 1,727 | 1,802 | 2,375 | 1,548 | 1,745 | 1,372 | 1,871 |
| New Zealand | 83 | 73 | 105 | 68 | 58 | 55 | 105 | 87 | 144 | 140 | 127 | 119 |
| Other | 7 | 15 | 17 | 14 | 20 | 5 | 25 | 32 | 26 | 17 | 20 | 51 |
| Pacific Islands | 880 | 489 | 481 | 363 | 453 | 375 | 877 | 622 | 707 | 588 | 696 | 707 |
| Philippines | 509 | 294 | 460 | 422 | 599 | 538 | 633 | 598 | 783 | 881 | 912 | 877 |
| South America | 5 | 7 | 7 | 3 | 12 | 7 | 10 | 13 | 25 | 15 | 26 | |
| USA | 3,171 | 2,218 | 2,184 | 2,263 | 2,440 | 2,812 | 3,484 | 3,279 | 3,001 | 3,352 | 3,415 | 3,728 |
| Total | 10,039 | 6,534 | 6,442 | 5,969 | 6,667 | 7,038 | 8,518 | 9,137 | 8,452 | 9,084 | 8,956 | 9,988 |

Source: 2008 FSM National Government: Compact Annual Report.

There is a need to promote ecotourism and other activities that involve grassroots and village level groups and improve food security. Pohnpei needs to increase the length of stay by developing a number of products for tourists. The State also supports the World Park concept. There is a need to review all the laws affecting tourism to ensure sustainable tourism development. Despite having passed a somewhat-restrictive investment law, Pohnpei encourages foreign investment in the tourism industry because foreign investors can assist and improve international marketing of tourism. The parks and recreational facilities need to be improved and tourism services standardized. The target of 5% annual increment in tourist arrivals should be achieved to increase hotel room occupancy. It is also important to streamline the functions and roles of government and NGOs tourism agencies.

In Kosrae, the Kosrae Visitors Bureau is responsible for promoting tourism. The average spending per day by tourists is about $125.00, by businesses is $95.00 and visiting family relatives is about $45.00 (the average for the three categories is about $92.50). Based on these figures, the value of Kosrae tourism earnings for 2005 was about $770.000, which is about 3% of GDP (19mil). About $64 000.00 was allocated for promotional activities in 2006 and $53 000.00 in 2007.

The major constraints in tourism relate to expensive travel costs to Kosrae, infrequent flight schedules, insufficient marketing, lack of landowner education on the potential of specific tourism projects, poor water supply, inadequate participation in regional tourism marketing (PATA, SPTO).

Table 21

**Kosrae State**

| | FY1996 | FY1997 | FY1998 | FY1999 | FY2000 | FY2001 | FY2002 | FY2003 | FY2004 | FY2005 | FY2006 | FY2007 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Asia | 111 | 74 | 95 | 122 | 114 | 115 | 74 | 96 | 103 | 98 | 47 | 79 |
| Australia | 63 | 64 | 63 | 86 | 71 | 95 | 110 | 61 | 82 | 85 | 78 | 161 |
| Canada | 36 | 18 | 24 | 22 | 34 | 28 | 26 | 25 | 24 | 18 | 25 | 25 |
| Central America | 4 | 5 | 4 | 4 | 7 | 7 | 6 | 4 | 2 | 1 | 1 | |
| Europe | 155 | 84 | 76 | 100 | 131 | 119 | 121 | 105 | 108 | 97 | 346 | 193 |
| Japan | 297 | 220 | 263 | 339 | 244 | 163 | 235 | 213 | 315 | 272 | 199 | 359 |
| New Zealand | 9 | 14 | 21 | 21 | 20 | 16 | 19 | 23 | 23 | 20 | 12 | 23 |
| Other | 5 | 4 | 1 | 3 | 8 | 3 | 4 | 4 | 9 | 5 | 6 | 7 |
| Pacific Islands | 377 | 622 | 559 | 249 | 616 | 298 | 375 | 272 | 482 | 319 | 154 | 174 |
| Philippines | 160 | 142 | 97 | 156 | 170 | 160 | 141 | 156 | 156 | 124 | 152 | 195 |
| South America | 1 | | | 1 | 9 | 3 | | | 4 | | | |
| USA | 1,293 | 998 | 841 | 1,039 | 2,273 | 1,170 | 1,133 | 1,034 | 927 | 970 | 855 | 839 |
| **Total** | **2,512** | **2,245** | **2,044** | **2,142** | **3,697** | **2,177** | **2,244** | **1,993** | **2,236** | **2,009** | **1,875** | **2,055** |

Source: 2008 FSM National Government: Compact Annual Report.

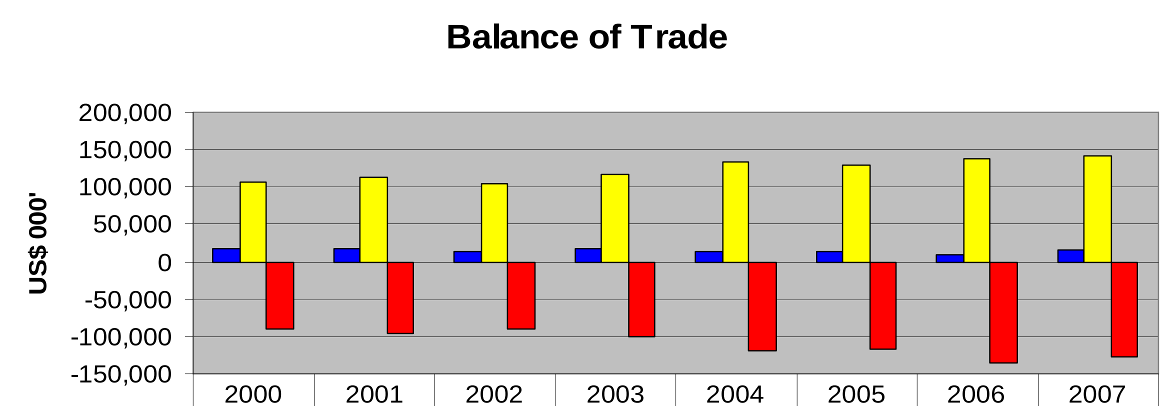
# 3 SECTION THREE: PARTICIPATION OF FSM IN INTERNATIONAL TRADE

This section will cover FSM performance in merchandise trade, classification of imports, import markets, FSM's tariff structure, export performance, composition of exports, export markets and measures to promote exports. It will also look at trade in services, both imports and exports and the general FSM regulations affecting trade in services including investment and what needs to be done to promote trade in services and investment in FSM.

## 3.1 Trade in goods

FSM's performance in merchandise trade has been disappointing. Its balance of trade has always been in the negative (deficit). In 2007, the value of merchandise exports from FSM constituted about $16,189 million and imports were about $142,659. Figure 18 shows FSM's trade performance from 2000 to 2007.

Figure 18




| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|
| Exports | 16,788 | 18,401 | 14,441 | 18,206 | 14,002 | 12,984 | 8,893 | 16,189 |
| Imports | 106,760 | 113,834 | 104,290 | 117,924 | 132,696 | 130,214 | 137,993 | 142,659 |
| Deficit | -89,972 | -95,433 | -89,894 | -99,718 | -118,694 | -117,230 | -134,572 | -126,470 |

2008, International Trade Publication: SBOC

### 3.1.1 Classification of Imports

Table 22 below shows that food and beverages dominate the import bill representing about $40.1 million of imports in 2007 (30.0 percent of total imports). The major items in this category include meat and fish imports ($11.8 million, 8.3% of total imports). This includes poultry ($4.2 million), canned meat ($3.2 million), canned fish ($2.4 million), beef meat ($0.9 million), pork meat, ham, etc. ($0.8 million), fish ($0.1 million), non-fish seafood ($0.1 million), and other meat ($0.03 million). Other major food items imported include rice ($5.9 million), fruit and vegetables ($2.5 million), sugar and confectionary ($2.5 million), bread, cakes, biscuits, etc. ($1.9 million), ramen, noodles, pasta (1.7 million), milk and cream ($1.2 million), ice cream ($0.7 million). Beverages totalled $6.0 million (4.2 percent of the total imports), including, soft drinks ($2.7 million), beer ($2.4 million), spirits ($0.4 million), water ($0.4 million) and wine ($0.2 million). It is clear that a huge chunk of FSM's funds are spent on food and beverages rather than importation of industrial and capital goods that can be used for production of value added goods and services.

Table 22

**FSM Annual Imports by Broad Economic Category Classification (BEC Level 1): CY 2000-2007.**

**CIF value ($US '000)**

| | **BEC1** | **2000** | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** |
|---|---|---|---|---|---|---|---|---|---|
| 1 | Food And Beverages | 20,839 | 35,327 | 33,884 | 41,438 | 41,547 | 38,702 | 41,070 | 56,037 |
| 2 | Industrial Supplies N.e.s. | 19,525 | 20,171 | 20,064 | 26,559 | 29,782 | 21,386 | 26,201 | 219 |
| 3 | Fuels And Lubricants | 16,177 | 18,730 | 14,782 | 14,093 | 20,892 | 22,152 | 27,621 | 33,628 |
| 4 | Capital Goods (except Transport Equipment) | 8,554 | 10,665 | 11,167 | 8,944 | 11,057 | 11,975 | 14,730 | 16,992 |
| 5 | Transport Equipment, Parts and Accessories | 7,115 | 9,831 | 6,530 | 8,792 | 9,678 | 8,343 | 9,432 | 3,328 |
| 6 | Consumer Goods Not Elsewhere Specified | 9,577 | 14,573 | 14,584 | 17,202 | 18,390 | 17,583 | 17,811 | 3,982 |
| 7 | Goods Not Elsewhere Classified | 24,973 | 4,536 | 3,279 | 994 | 1,451 | 10,074 | 1,127 | 27,601 |
| | **FSM Total** | **106,760** | **113,834** | **104,290** | **118,023** | **132,796** | **130,214** | **137,993** | **142,659** |

2008, International Trade Publication: SBOC

### 3.1.2 Import Markets

In 2007, 41.2% of imports came from the US Mainland, 14.4% from Guam (transhipment), 8.7% from Singapore, 8.5% from Japan, 6.3% from Hong Kong, 4.1% from Australia, 4.1% from Korea, 3.8% from China, 3.6% from Philippines, 1.1% from Taiwan, 1.0% from Thailand, and 0.6% from New Zealand.

Table 23

| FSM Annual Imports by Main Countries of Origin: CY 2000-2007. | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **CIF value ($US '000)** | | | | | | | | | |
| **Region** | **Country** | **2000** | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** |
| Americas | U.S.A | 38,235 | 44,128 | 43,569 | 48,180 | 51,901 | 47,430 | 54,754 | 58,785 |
| Asia | China | 1,828 | 277 | 736 | 2,052 | 2,386 | 3,527 | 4,399 | 5,444 |
| | Hong Kong | 5,003 | 4,912 | 4,171 | 5,778 | 7,684 | 6,155 | 5,024 | 8,955 |
| | Japan | 12,867 | 12,684 | 11,100 | 12,957 | 15,213 | 12,556 | 13,158 | 12,067 |
| | Korea | 3,963 | 3,213 | 2,943 | 4,793 | 5,618 | 5,115 | 8,055 | 5,820 |
| | Philippines | 1,711 | 2,735 | 3,064 | 5,066 | 5,879 | 4,575 | 6,003 | 5,083 |
| | Singapore | 780 | 803 | 1,013 | 1,926 | 5,215 | 6,352 | 6,353 | 12,413 |
| | Taiwan | 6,886 | 3,971 | 5,010 | 5,631 | 4,502 | 2,209 | 1,725 | 1,559 |
| | Thailand | 286 | 675 | 829 | 1,035 | 1,679 | 1,232 | 1,723 | 1,425 |
| Oceania | Australia | 7,109 | 9,932 | 8,621 | 8,394 | 7,489 | 5,064 | 5,777 | 5,844 |
| | New Zealand | 682 | 376 | 414 | 806 | 1,169 | 1,407 | 1,155 | 898 |
| | Guam | 25,726 | 28,696 | 21,024 | 17,972 | 18,560 | 20,931 | 25,970 | 20,512 |
| | Other | 1,683 | 1,431 | 1,797 | 3,433 | 5,502 | 13,660 | 3,899 | 3,853 |
| | **FSM Total** | **106,760** | **113,834** | **104,290** | **118,023** | **132,796** | **130,214** | **137,993** | **142,658** |

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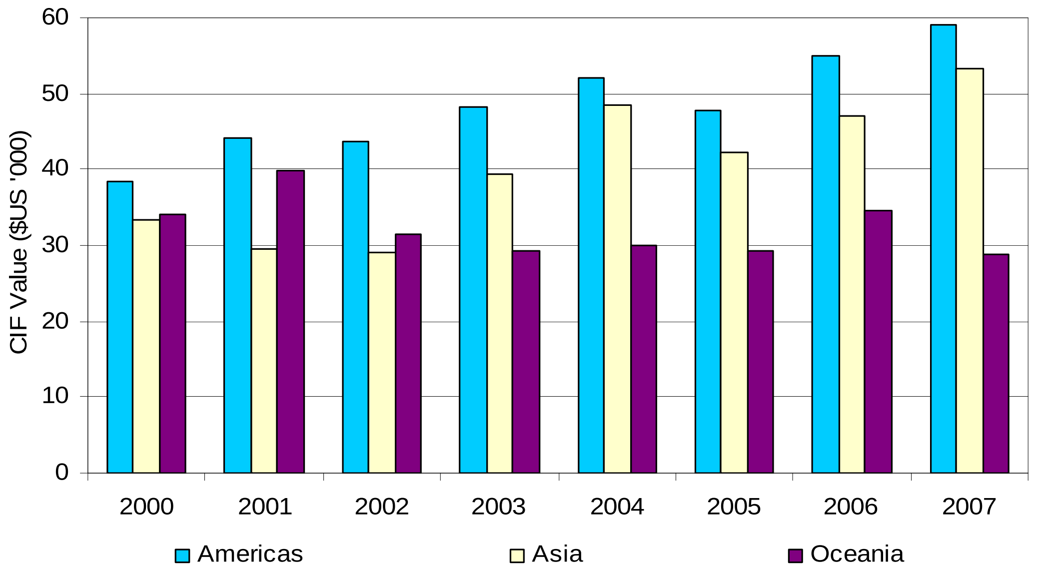
Figure 19

**Imports by main Regions**

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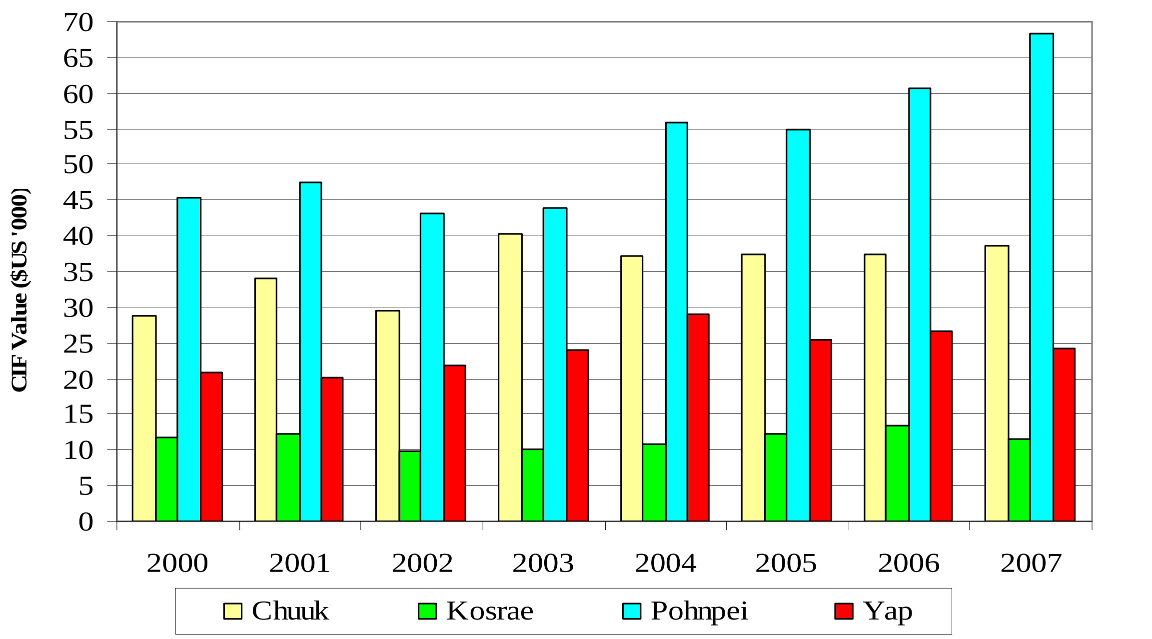
### 3.1.3 Imports by State

The chart below shows that most of the imports go to Pohnpei, followed by Chuuk, then Yap and Kosrae.

Figure 20

**Imports by State**

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### 3.1.4 FSM's tariff structure

FSM's tariffs are divided into five bands of 50%, 30%, 25%, 4% and 3%. Based on the 2003-2005 average, tobacco and cigarettes imports were valued at $112,646 and the duty collected was about $32,123. The import value of products which attract a 30% import duty such as wine, grape must, vermouth and other beverages amounted to $235,758 and duty collected was about $55,381. Products attracting a 25% duty such as live, frozen or chilled fish, crustaceans, lobsters, trout, shrimps, crabs, molluscs, coffee, tea, kava, waters, perfumes cosmetics and toilet preparations, hair preparations, oral or dental hygiene, perfumery and other soaps had an import value of $4,812,283 attracting a duty of about $1,308, 920.

Most products in the 4% band include animal products, plants, roots, flowers, copra, oil cake, cement, minerals, petroleum gases, acids, medicaments, medicals, pharmaceutical goods, fertilizer, room perfumes, other soaps, photographic film, rubber, wood, paper, fabrics, cotton, yarn, carpets, textiles products, clothing, glass, machinery, electronic and motor vehicles were valued at $59, 042,918 but only $2,419,749 duty was collected.

Those products in the 3% band are largely foods items such as meat, smoked or dried fish, dairy products, eggs, animal products, vegetables, nuts, fruits, spices, cereals, starch, oil seeds, vegetable oils, meat/fish/crustaceans preparations, food preparation and juice had an import value of $31,743, 479 and a duty of $1,422,674 was collected.

Cigarettes containing tobacco levied at $25 per THS were valued at $1,698,513 attracting a duty of $757,175. Alcohol, spirits, whiskies, rum and tafia, gin and geneva, vodka, liqueurs, cordials and spirits were valued at $275,901 but the duty collected at $12 per gallon amounted to $326,154 which was higher than the value of goods. Beer made from malt was valued at $2,756,799 and attracted a duty of $911,683 at $0.7045 per gallon. Gasoline, aviation fuel including kerosene, diesel and other petroleum oil were valued at $15, 838,134 attracting a duty of $715,051 at $0.05 per gallon. The table below summaries the FSM tariff structure and the 03-05 average value of import and the duty collected.

Table 24

| **03-05 Average** | | | | |
|---|---|---|---|---|
| Products | % of total imports | Import Duty | Import Value | Duty Collected |
| Tobacco, cigarettes | 0.1 | 50% | 112,646 | 32,123 |
| cigarettes containing tobacco | 1.5 | $25/THS | 1,698,513 | 757,175 |
| Wines and other beverages | 0.2 | 30% | 235,758 | 55,381 |
| Alcohol and wines | 0.24 | $12 per Gal | 275,901 | 326,154 |
| Beer made from malt | 2.4 | 0.7045 per L | 2,756,799 | 911,683 |
| **Total Alcohol and Tobacco** | **4.4** | | **5,079,617** | **2,082,516** |
| Live, frozen or chilled fish, and other luxury products | 4.1 | 25% | 4,812,283 | 1,308,920 |
| Industrial products, machinery and electronics | 50.6 | 4% | 59,042,918 | 2,419,749 |
| Food products | 27.2 | 3% | 31,743,479 | 1,422,674 |
| Fuel | 13.6 | $0.05 per Gal | 15,838,134 | 715,051 |
| **Total of all other imports** | **95.6** | | **111,436,814** | **5,866,394** |
| **Total of all imports** | **100** | | **116,516,431** | **7,948,910** |

From the table above, it is clear that tobacco, alcohol and wines are heavily taxed. The 03-05 average import value of these products was $ 5,079,617 attracting a duty of 2,082,516. The other products with an import value of $ 111,436,814 generated only $5,866,394 in import duty. This is mainly because tariffs on these products are very low. When engaging in liberalization, it is wise to exclude all the high revenue generating products such as alcohol and tobacco and start by liberalizing products with low tariffs. FSM has an import based economy and that is the reason why tariffs are so low. Currently, there are no infant industries that are being protected. However, in future FSM may need tariffs to protect the agricultural, fisheries, textiles and other products. These products should be excluded from trade liberalisation to maintain policy space. It should also be noted that it is difficult to identify products that may need protection in future because of constant global changes.

### 3.1.5 Export Performance

Table 25 below shows that FSM's export performance has been very poor. Fish is the major export commodity which accounted for about 69 % in 2007. This shows that the country is very vulnerable as it depends on a single commodity for its exports. Garment products used to be the second highest export product constituting about 21%[18], but betel nut is now the second major export product since 2005. Agricultural exports increased from $612,000 in 2005 to a peak of $2,791,431 in 2007 mainly as a result of betel nuts and kava. The major drop was noticeable in citrus, banana and copra. On other exports, the greatest decline was in garments, which fell from a peak of $4,391,000 in 2001 to $82,000 in 2005. Handicrafts also increased from $4,000 in 2004 to $148,098 in 2007 and cooked food increased from $12,000 in 2004 to $796,870 in 2007.

Table 25

| FSM Exports-FOB value $000 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Description** | **2000** | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** |
| **Agriculture Produce:** | | | | | | | | |
| Copra | 186,380 | 200,908 | 210,676 | 0 | 174,942 | 0 | 0 | 0 |
| Banana | 71,918 | 32,606 | 25,897 | 257,384 | 86,846 | 45,359 | 6,467 | 1,359 |
| Citrus | 44,417 | 22,615 | 27,886 | 29,130 | 8,470 | 4,726 | 4,292 | 16,626 |
| Kava | 151,522 | 160,403 | 241,253 | 120,848 | 132,221 | 134,769 | 283,642 | 415,595 |
| Betel Nuts | 625,233 | 907,710 | 887,654 | 445,516 | 351,321 | 403,204 | 1,871,627 | 2,224,146 |
| Piper leaves | 17,658 | 20,845 | 25,039 | 28,190 | 6,137 | 6,560 | 34,046 | 61,253 |
| Root Crops | 29,927 | 16,537 | 3,605 | 10,998 | 17,873 | 11,211 | 61,862 | 6,476 |
| Other Farm Produce | 12,483 | 5,657 | 6,577 | 27,033 | 11,080 | 6,036 | 11,742 | 65,976 |
| **Total Agriculture Produce** | **1,139,538** | **1,367,279** | **1,428,586** | **919,099** | **788,890** | **611,865** | **2,273,678** | **2,791,431** |
| **Marine Products:** | | | | | | | | |
| Offshore Fish | | | | | | | | |
| Purse Seiner (domestic license) | 4,850,900 | 6,212,328 | 5,454,868 | 2,368,895 | 7,206,011 | 9,670,269 | 5,465,828 | 11,155,265 |
| Purse Seiner (domestic based foreign license) | 0 | 0 | 635,717 | 1,064,767 | 0 | 0 | 0 | 0 |
| Longliner (domestic license) | 4,957,718 | 4,368,581 | 1,524,487 | 7,957,251 | 2,070,220 | 1,417,127 | 0 | 0 |
| Longliner (domestic based foreign license) | 2,333,942 | 1,519,085 | 1,181,177 | 1,947,816 | 930,519 | 591,280 | 0 | 0 |
| Reef Fish | 75,273 | 100,823 | 109,512 | 733,022 | 55,650 | 520,382 | 241,421 | 841,376 |
| Crab/Lobsters | 172,339 | 177,948 | 206,480 | 41,442 | 25,369 | 45,362 | 19,831 | 39,163 |
| Trochus shell | 0 | 0 | 21,037 | 0 | 0 | 0 | 430,970 | 78,255 |
| Live Clams | | | | | | | 17,349 | 29,780 |
| Other Marine Products | 41,836 | 2,837 | 4,561 | 0 | 90 | 225 | 38,506 | 157,480 |

[18] The garment factory in Yap closed in 2004. It is important to note that the garment factory in Yap was amongst other things affected by the expiry of the WTO Multi-Fibre Agreement and to a certain extent by the US rules of origin.

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Total Marine Products** | **12,432,008** | **12,381,602** | **9,137,839** | **14,113,193** | **10,287,859** | **12,244,645** | **6,213,906** | **12,301,318** |
| **All Others:** | | | | | | | | |
| Powder Lime | 1,680 | 6,997 | 12,502 | 1,700 | 1,235 | 793 | 8,876 | 16,863 |
| Garment Products | 3,010,249 | 4,391,265 | 3,590,644 | 3,171,961 | 2,901,847 | 82,168 | 0 | 0 |
| Handicrafts and Souvenirs | 9,360 | 11,305 | 10,996 | 0 | 3,720 | 3,689 | 80,137 | 148,098 |
| Cooked food | 190,747 | 232,061 | 250,760 | 77 | 11,584 | 33,117 | 335,318 | 796,870 |
| Others | 4,304 | 10,344 | 9,778 | 339 | 7,468 | 8,158 | 10,425 | 11 |
| Scrap Metal | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 135,050 |
| **Total All Others** | **3,216,340** | **4,651,971** | **3,874,679** | **3,174,077** | **2,925,854** | **127,925** | **434,756** | **1,096,892** |
| **Total** | **16,787,886** | **18,400,852** | **14,441,104** | **18,206,369** | **14,002,603** | **12,984,435** | **8,922,341** | **16,189,640** |

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Figure 21 below shows export composition in 2007 and tuna accounted for 69.1%, followed by betel nuts, reef fish, cooked food and kava.

Figure 21

Export Composition in 2007

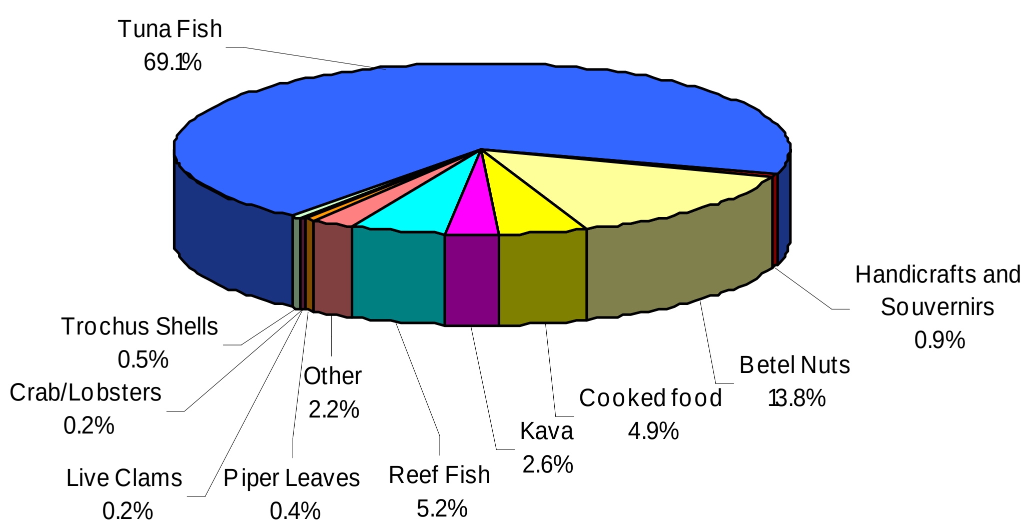


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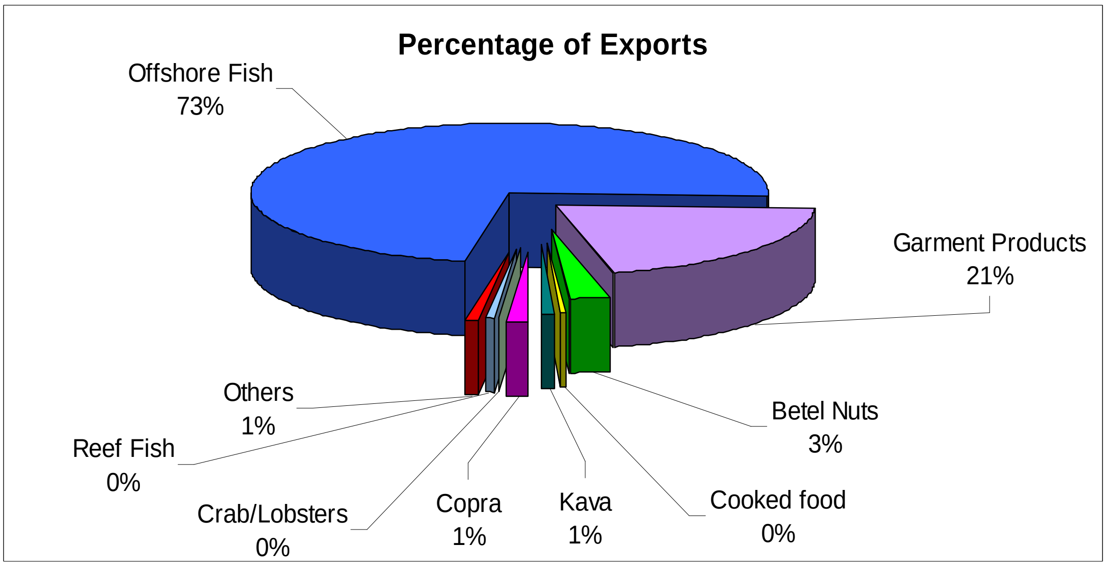
Figure 22 below shows export composition in 2004 where tuna accounted for 73%, followed by garment products, betel nuts, kava and copra.

Figure 22

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For FSM to boost its exports, it should move towards value-addition in agriculture and fisheries rather than relying on primary commodities. The Trade Policy must support industrialisation and promote value addition, especially in the fisheries sector where there are opportunities to establish canneries. The government should consider establishing an Export Processing Zone and provide the necessary infrastructure that is required including a liberal regulatory environment.

In order to boost export performance, the government must put in place measures to promote the participation of women in trade. Some of the problems affecting women in the handicraft sector include transport, marketing and handling constraints and FSM must take measures to address these constraints. It is encouraging to note that the Chuuk Women Council is providing training on making handicrafts, sewing, and food preparation amongst other things. The Council also established a handicraft store where all handicraft producers sell their items. FSM needs to work with the Forum Secretariat to assist the handicraft sector with a handicraft marketing plan. Efforts must also be made to assist handicraft producers to attend the handicraft school in the South Pacific. The export markets for the handicraft industry include Palau, Guam and Hawaii. There is also a potential market for ivory nuts in Japan. However, for this industry to develop, the intellectual property regime must be strengthened to avoid copying. There is also a need to come up with an association to protect the industry and control the quality of the products produced for export. The handicraft producers must fully utilize the marketing services that are provided by PITIC which has offices in New-Zealand, Tokyo, Sydney and China.

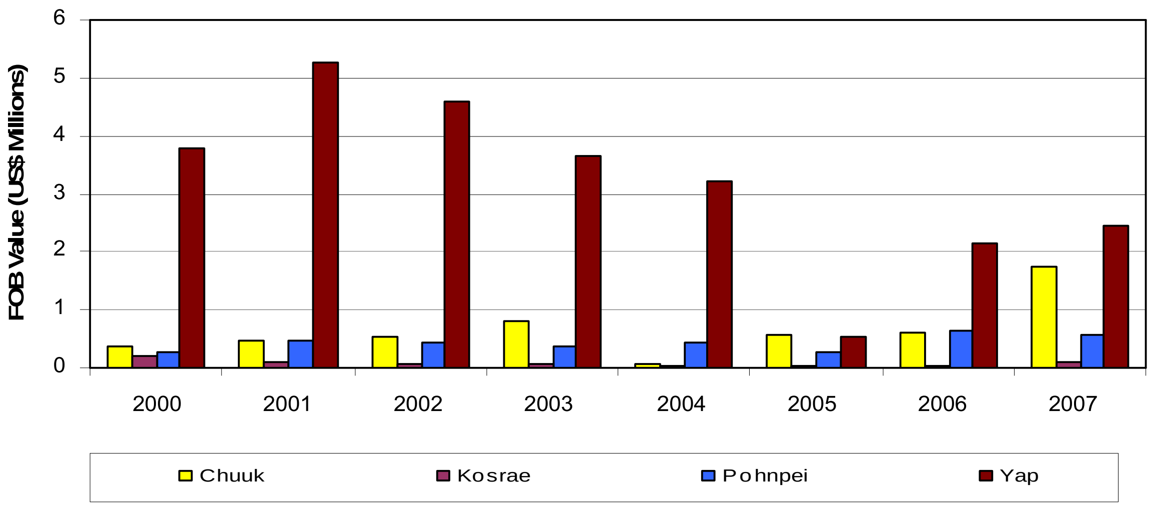
Another opportunity that can be explored is the production of bottled water for export to countries such as Kiribati, RMI, Nauru, US, Guam, China and Saipan. FSM should stop importing water in large quantities and tariff protection may be needed if a viable water industry is established. Plastic manufacturing is another potential business that can be established to support the water industry.

### 3.1.6 Exports by States

From 2000 to 2007, Yap State has the highest exports mainly because of betel nuts, handicrafts, piper leaves but total exports have been decreasing since 2001[19]. This is followed by Chuuk which exports mainly reef fish and cooked food exports to Guam. Ponhpei comes third and the main export products are kava and betel nuts. Exports from Kosrae are still very small and the main products are citrus, live clams and trochus.

Figure 23

**Exports by State**

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[19] This was mainly as a result of the closure of the garment factories and also because of the typhoon.

Table 26

| Export Products & Markets by State | | | | | | |
|---|---|---|---|---|---|---|
| **Agriculture** | **Chuuk** | **Kosrae** | **Pohnpei** | **Yap** | **Export Markets** | **2007** |
| Betel Nut | | | **Y** | **Y** | **CNMI,** Guam, Palau, RMI | + |
| Kava | | -Y | Y | | **Guam, Hawaii, US, CNMI** | + |
| Root crops (Taro) | | **-Y** | -Y | Y | **Guam, Hawaii,** US | + |
| Piper leaves | | | -Y | **Y** | **Guam,** RMI | + |
| Banana | **-Y** | **- -Y** | **-Y** | - -Y | **RMI**, Guam, Hawaii | **-** |
| Citrus | | **- -Y** | -Y | - -Y | RMI | **-** |
| Processed Noni | | Y | Y | | **Japan** | Potential |
| Copra | **-Y** | - -Y | **Y** | - -Y | **Bangladesh**, Japan, Korea | - |
| Coconut oil | | | **Y** | | | Potential |
| Pepper[20] | | | **Y** | | **Japan (3x)** | Potential |
| Powder lime | | | -Y | Y | | |
| Breadfruit | Y | | | | | |
| Vanilla | | Y | | | | Potential |
| **Marine** | | | | | | |
| Reef fish | **Y** | - -Y | **- -Y** | **- -Y** | **Guam,** CNMI**, US** | + |
| Lobsters/crabs | **Y** | **- -Y** | **Y** | **- -Y** | **Guam,** CNMI, RMI, Hawaii | + |
| Live clams | | Y | Y | | **US, EU** | + |
| **Other** | | | | | | |
| Handicrafts and Souvenirs | **-Y** | **-Y** | -Y | Y | Palau, Guam and Hawaii | + |
| Cooked food | **Y** | **- -Y** | **- -Y** | -Y | **Guam**, CNMI | + |
| Garments | | | | **Y** | US, EU | - |
| Offshore fish | | | | | **Japan, US,** Asia | - |

Notes: + exports increased from 00-06. - exports decreased. Bold indicates main market. Y= main export.

[20] Pohnpei produces only one tonne of processed pepper but the Japanese buyer needs more pepper (3 times higher).

### 3.1.7 Export Markets

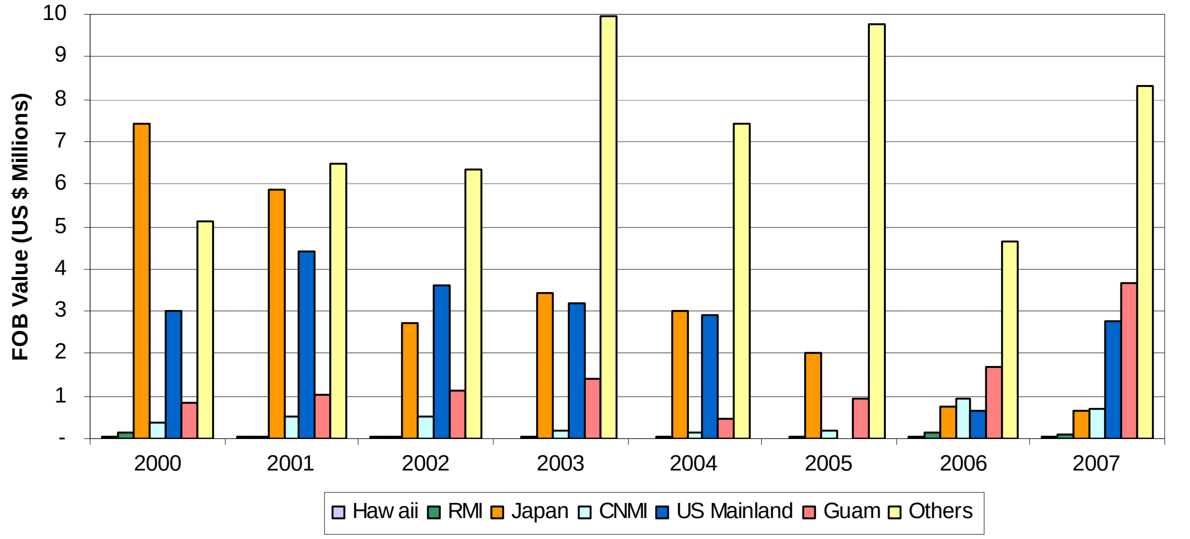
In 2000, Japan was the main export market for FSM followed by the US Mainland, Guam CNMI, RMI and Hawaii. Other countries accounted for a significant portion of FSM's exports. In 2007, exports to Japan have declined to the lowest level. Even exports to the US, CNMI, RMI and Hawaii have declined.

Table 27

| FSM's Major Export Markets | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Year** | **Japan - -** | **US -** | **Guam + +** | **CNMI -** | **RMI -** | **Hawaii -** | **Others +** | **Total +** |
| **2000** | **7,417,859** | **3,023,517** | **831,954** | **370,405** | **126,422** | **31,293** | **5,112,634** | **16,914,085** |
| **2001** | **5,871,743** | **4,411,112** | **1,043,469** | **498,041** | **42,241** | **43,387** | **6,474,935** | **18,384,928** |
| **2002** | **2,705,664** | **3,635,306** | **1,140,184** | **497,269** | **66,693** | **49,018** | **6,346,970** | **14,441,104** |
| **2003** | **3,433,887** | **3,179,932** | **1,422,113** | **170,479** | **43,970** | **10,395** | **9,931,988** | **18,192,764** |
| **2004** | **3,001,948** | **2,909,607** | **477,097** | **143,473** | **44,370** | **11,483** | **7,414,626** | **14,002,603** |
| **2005** | **2,010,000** | **15,000** | **942,000** | **174,000** | **48,000** | **15,000** | **9,781,000** | **12,984,000** |
| **2006** | **N/A** | **46,000** | **1,674,000** | **952,000** | **141,000** | **50,000** | **558** | **3,421,000** |
| **2007** | **659,901** | **2,791,061** | **3,640,026** | **693,378** | **75,451** | **37,903** | **8,291,921** | **16,189,640** |
| 2008, International Trade Publication: SBOC | | | | | | | | |
| Notes: + indicates that FSM exports to that market are increasing. - indicates that FSM exports to that market are decreasing. | | | | | | | | |

Figure 24

**FSM's Major Export Markets**

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In 2007 Guam was the major export market and had overtaken Japan which used to be the major export market for FSM. For example in 2004 Japan accounted for 21.4% of FSM's exports in 2004 compared to 4.1% in 2007. See figure 25 and 26 below.

**Figure 25**

**FSM's Major Export markets as a % in 2007**

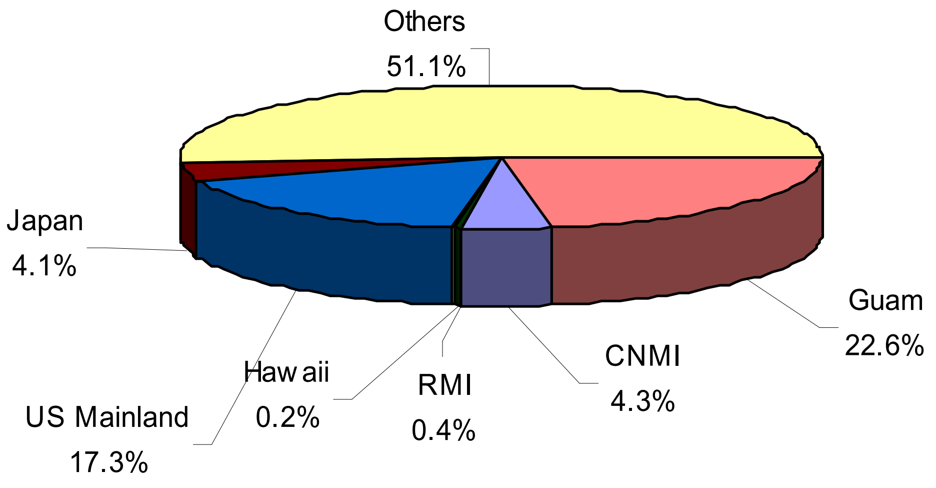


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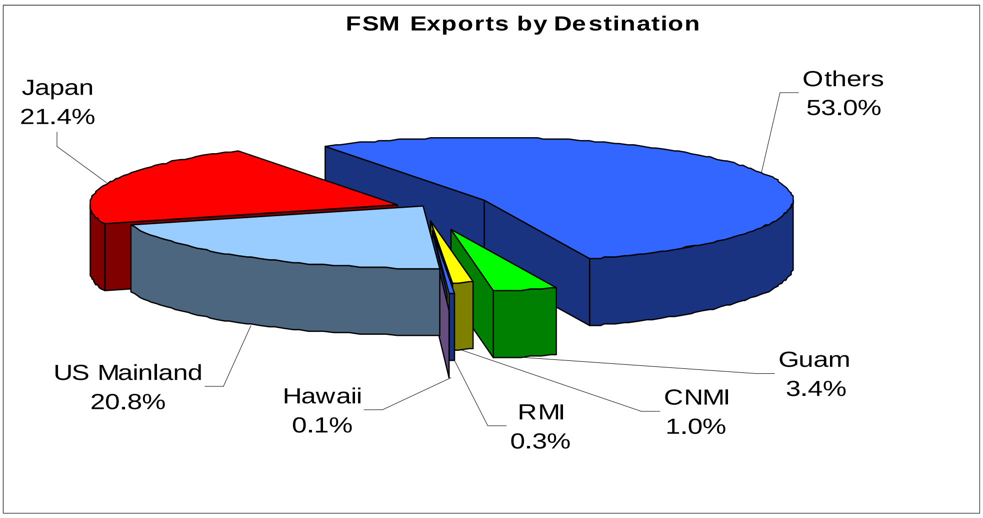
**Figure 26**

**FSM's Major Export markets as a % in 2004.**

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### 3.1.8 Measures to promote Exports

(a) Export Development Strategy

The main form of business in FSM is wholesale and retail and the market is already saturated for this business, hence the need to seriously explore viable export opportunities. FSM needs to put in place a number of measures to boost the export of various goods and services. It needs a comprehensive National Export Strategy which identifies the key products that can be targeted for export development and promotion. This list needs to be identified in consultation with the private sector and investors. The draft UNDP proposal can be used as a basis and customised to suit FSM's trade needs. The critical issue is to identify possible sources of funding for this project. The main objectives of the National Export Strategy should be to:

- establish an export processing zone;
- identify the products that can be produced for export;
- identify potential exporters who can be assisted to produce for the export market;
- have a shared vision on export-led growth;
- promote investment and development;
- promote value addition and enhance exports;
- consolidate existing markets and diversify into non-traditional markets;
- enhance the competitiveness of FSM products on the regional and international markets;

- develop an export culture and positive change of attitude among the business entrepreneurs ; and
- exploit comparative advantages and develop new industries.

(b) Trade promotion officers

FSM needs to have trade promotion officers in its major trading partners and strategic markets to promote its products and services. The FSM embassies must play a vital role in promoting trade, investment and tourism. The National Trade Facilitation Committee should assist with promoting exports and consolidating old and opening new markets. This body should be responsible for information gathering, dissemination, research and also assist exporters particularly SMEs in exporting to new markets.

(c) Participation in international fairs and expos

FSM should participate actively in international fairs and expos and the Government should assist by booking space in certain strategic international trade fairs, where specific products from small and medium scale companies will be exhibited. The space will be offered to these companies at concessionary rates in order to make them cost effective. Small and medium scale industries will have the opportunity to promote their products and be exposed to international trends in quality and technology. There should be conferences in countries such as US, EU, Japan and China, Australia and New Zealand and ambassadors and trade officials should actively market FSM products and services.

(d) Export incentives

The Government should place great emphasis on export enhancement and put various export incentives to assist exporters. The main objective of incentives should be to create an enabling operational business environment for exporters. Export incentives should be put in place after consultation with all stakeholders. Some of the incentives that may be considered include tax incentives, duty draw back schemes, subsidies, free zones, promotion and marketing assistance and freight subsidy schemes to diversify exports.

### 3.2 Trade in Services and Investment

The General Agreement on Trade in Services is the most comprehensive multilateral agreement regulating trade in services. It defines services by the mode in which they are delivered. Mode one is cross-border supply. In this case, just as in the case with goods, the service crosses the border. An example of this is where a user in FSM receives services from abroad (US) through its telecommunications (internet) or postal infrastructure. Such supplies may include consultancy or market research reports, tele-medical advice, distance training or architectural drawings.

Mode two is consumption abroad. In this case, the consumer goes abroad to consume the service. For example, if a US citizen travels to FSM to enjoy the diving tourism facilities, FSM is exporting its tourism services to the US. Conversely, FSM nationals can move abroad as students or patients to consume services in the US.

Mode three is commercial presence. The service is provided in FSM for example by a locally-established affiliate, subsidiary, or representative office of a foreign-owned and controlled company (e.g. bank, hotel group or construction company). An example of this is an American bank (Guam) which has branches in FSM.

Mode four refers to the temporary movement of natural persons abroad to supply a service. It is different from migration or employment. A foreign national (e.g. Micronesian) provides a service within country A (e.g. the US) as an independent supplier (e.g., consultant) or employee of a service supplier (e.g. consultancy firm, hospital, construction company).

### 3.2.1 General Laws Regulating Trade in Services and Investment

There is a close relationship between trade and investment. In FSM, international trade falls under the jurisdiction of the National Government while investment is regulated by the National Government and also by the four States. The general laws regulating services and investment in FSM include the National Foreign Investment Act of 1997 and the Regulations (1998), the Chuuk Investment Act (1998), the Kosrae Investment Act, the Pohnpei State Foreign Investment Act (2006), the Yap Investment Act, the Immigration Act [Title 50 Cap 1]; the Protection of Resident Workers Act [Title 51 Cap 1] and the Constitution of the Federated States of Micronesia. These laws are complemented by sector specific laws and other regulations that are enacted on a continual basis by the respective authorities.

All the five governments utilize the traffic light system (green, amber and red) to regulate investments. The sectors in the red category are prohibited and can be designated by the appropriate authorities, those in the amber sector are open but subject to a certain criteria specified in the regulations and those in the green box are open subject to all applicable laws and there is no specific criteria for obtaining or retaining a permit. FSM is also a party to the Multilateral Investment Guarantee Agency and the Convention on the settlement of investment disputes between States and nationals of other States.

### 3.2.2 Services Regulated by the National Government

The key infrastructural services such as telecommunications, commercial banking (insurance and non-commercial banking fall under the amber box), international maritime and inter-state air transport fall under the National Government and are in the green box category which means that there are no special criteria that investors are required to meet.

According to the National Postal Services Act, the National Postal Services of the Federated States of Micronesia and the Postmaster General are responsible for all postal services in the country. The Telecommunications Corporation Act (1981) establishes the fully-government owned Telecommunications Corporation of the Federated States of

Micronesia as the ‘*sole provider’* of all telecommunications services, except radio and television broadcasting, within the country ‘and between points in the Federated States of Micronesia and points outside thereof’. FSM Telecom (FSMTC) provides all telecommunications services in FSM, including internet and mobile telephony. The Department of Transportation, Communication and Infrastructure is the regulatory authority and FSM applies United States domestic postal rates to services within and from FSM.

A lack of competitive pressure in the telecommunications sector has resulted in the slower uptake of technological progress and limited efficiency gains. Trade in this sector is affected by the monopoly of FSM telecommunications and this scares away potential investors. The monopoly, also affects the tourism industry because most tourists would want quality telephone and internet services to communicate with their home countries. Liberalisation of internet and mobile phones should be considered but the basic telecommunication services may remain closed. Trade liberalization is important because it brings internal efficiency. However, other social goals such as providing services to the poor through a system of cross-subsidization - using revenues from segments like urban areas or international calls may be threatened by competition. But if liberalization is sequenced properly and the right regulatory framework, which amongst other things guarantees universal access, is put in place, liberalization will pay dividends and improve performance. This will help in facilitating the transfer of new technology and creates an environment which is conducive for investment and private sector development. This sector plays a vital role in business as indicated by the increasing trade through mode one and investment under mode three.

It should be noted that there is a legislation pending in Congress, which seeks to remove the monopoly status of the FSM Telecommunication Corporation. The four States are presently pushing for the liberalization of the telecommunications sector, with the objective of improving vital services and standards through sustainable competition.

The financial sector is another key sector that plays a vital role in trade and economic growth. At the moment there are only two commercial banks operating in the FSM, namely the Bank of the Federated States of Micronesia which is locally owned and the Bank of Guam (a U.S. bank). The Bank of the FSM is owned by the national and state governments (aggregate ownership of over 90%), however, with multi-government ownership and sound governance structures, it operates without significant interference and on commercial principles. The bank of Hawaii withdrew from the market in December 2002. The decision apparently was motivated in large part by broader corporate restructuring concerns as opposed to an isolated analysis of the FSM-based operations. In the depressed state of the FSM market, the Bank of Hawaii was unable to find an interested buyer, and was left with little alternative but to run down its operations. Its departure has reduced competition in the financial sector and entailed a loss of institutional knowledge that will take time to rebuild. A recent study for the banking sector found that there was space for another bank.

It is also argued that there is a large level of liquidity in the FSM banking system and capital is not a factor of production in short-supply. The problem is a lack of bankable projects and commercial banks have preferred to extend credit to consumers with secure public sector jobs and an identified repayment stream. However, others complain about the high interest rates, poor services and cumbersome loan application procedures.

In banking, deposit interest rates observed in the market are broadly similar to those throughout the United States, while lending rates are generally higher, reflecting the additional risk and costs of doing business in the FSM. The Federal Deposit Insurance Corporation (FDIC) has played a critical role in supervising the banking system and ensuring a sound and stable financial system. The banking system is also regulated by the FSM Banking Board, which is developing capacity for banking supervision. The role of the board includes licensing of domestic and foreign banks, on-site and off-site supervision of all banks, consumer protection and consultation with the FDIC.

Foreign banks wishing to establish in FSM must first obtain clearance from the Department of Resources and Development and a business licence from the Banking and Insurance Commission. A strong distinction is made in the Federated States of Micronesia Bank Act (1980) between foreign and domestic banking operations, significantly restricting market access and violating national treatment, given the lower capital requirements applied to the licensing of domestic banks.[21] An eligible foreign bank is defined as having a paid-in capital, surplus, and undivided profits of not less than $20,000,000 ($1,000,000 for any bank which is a member of FDIC or the US Federal Savings and Loan Insurance Corporation). Conversely a domestic bank is required to maintain a capital stock of only $500,000 and a minimum 50 % of which is to be paid in cash before the bank commence business, and at least two-thirds must be owned by FSM citizens, who have resided in the country for at least one year prior to the application. This restriction also limits FSM citizens living abroad from investing in this sector.

Prior to engaging in the business of selling of securities or insurance, a license to engage in or conduct such business must be obtained from the Secretary of the Department of R&D. The Foreign Investment Regulations (1998) requires foreign insurance providers to comply with regulatory conditions, including the filing of a $100,000 deposit with the Secretary of R&D, and the yearly filing of a verified statement summarizing all commercial activity transacted within the Federated States of Micronesia by the company during its previous financial year.

The major problems affecting export development in FSM relates to the transportation sector. With regards to international maritime transport, the Micronesian Shipping Commission (MSC) is responsible for giving license routes, managing competition and administering entry into the international shipping services of FSM, Palau and the Republic of the Marshall Islands. Licences of 5-year duration are issued, but subject to annual review. Route licensing and “competition management” may act as restrictions to market access, possibly national treatment depending on how the licensing system is applied. Cruise shipping services are open subject to safety requirements.

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[21] The lower capital requirements of US-registered foreign banks in FSM may also breach the WTO’s MFN principle.

With regards to air transportation, FSM maintains an open-sky policy. The United States, under the Compact of Free Association, guarantees air services to the Compact states. Priority in air transportation is required to be given to a US airline under the Compact, but no monopoly exists. New entrants are welcome subject to safety requirements.

### 3.2.3 Services regulated by the States

Almost all the sectors in Yap fall under the Amber list, meaning that they are open to foreign investment, subject to government regulation and certain requirements specified in the Yap State Foreign Investment laws and regulations. The operation of restaurants, bars and vehicle rental services, retail, wholesale, construction and consulting are some of the services that fall under the State's Amber List of regulated investment activities.

However, the government regulations are not detailed enough and this leaves a lot of discretion in the hands of the regulatory authority. If Yap wants to reserve some of the sectors for the local citizens, it must do so before making commitments to liberalize such sectors. In Yap State, foreign investors are required to obtain a business license under the Business Licences Act, and land may be leased for up to 99 years.

In Kosrae, the sectors that fall under the Amber list are open to foreign investment but subject to certain criteria that is specified in the foreign investment regulations and such criteria must be met before the permit is issued. The sectors in the Amber list include real property brokering, tourism other than eco-tourism, live reef fish trade or coral harvesting and those that the Director of Commerce and Industry may designate. There are no specific criteria for obtaining a permit for Amber list, except character criteria in Section 2.4 of the Act for retaining the permit. Sectors in the Green list are those that are open to foreign investment without criteria for the obtaining or retaining of a permit, except those character criteria in Section 2.4 of the Act. The Green list includes eco-tourism, professional services, exportation of local products, and other economic activities as the Director of Commerce and Industry may designate in the Regulations. The State of Kosrae has been involved in reforms relating to land administration, foreign investment and mortgages. The private sector development programme by ADB has also been implemented successfully. The Business Development Act was enacted to guide the creation and expansion of businesses. Foreign Investment requirements which relate to reporting requirements and land lease have been relaxed.

With regards to education, Kosrae encourages vocational training to cater for the increasing number of school dropouts and school-leavers. This will allow them to be absorbed in formal workforce or to gain better paying jobs in the USA. Special health clinics are also encouraged to complement the public health services provided by government. Kosrae supported the Pacific ACP Mode 4 proposal provided this was accompanied by development assistance to strengthen FSM's vocational training in sectors such as tourism, construction and health (nursing) to meet the high standards demanded by developed countries and to improve job opportunities in the USA for FSM nationals most of whom are working in the lower skilled jobs.

In Chuuk, the Amber list includes sectors that may be opened to Foreign Investment, subject to certain criteria specified in the Chuuk State Foreign Investment Regulations. These sectors include Casinos, Lotteries and other sectors as the Director of Commerce and Industry may designate. In Chuuk, hotel investment is restricted to FSM nationals, however foreign tour operations are permitted. A foreign investor who wants to do business in Chuuk must have a local partner to facilitate access to land and the land lease has been extended up to 99 years. Sectors which fall under the Chuuk State Green List of investment activities have no specific criteria to be met before a Foreign Investment Permit may be issued, other than minimum value standards which may be established under Section 6 (4) of the Chuuk State Foreign Investment Act. The Green List includes eco-tourism, professional services, intra-state airline services, exportation of local products and other sectors as the Director of Commerce and Industry may designate in the Regulations. Almost all sectors are in the green category and this implies that they are open to foreign investors. There may be wisdom in amending the investment regulations to specify the sectors which are open to foreign investors and those that are restricted.

The State of Pohnpei is the one with most restrictions on foreign investment. Section 6A (Local Ownership Requirement) of the Pohnpei State Foreign Investment Act requires certain business activities to be reserved exclusively for citizens and enterprises in which citizens have entire ownership interest[22]. The restricted sectors must not be undertaken by any business in which a non-citizen has an ownership interest. Under the investment Act, the Office of Economic Affairs is now charged with the promotion of investment while the Pohnpei Foreign Investment Board is charged with the regulatory functions. A foreign investor is required to have a minimum capital of US$50, 000 (US$500,000 in apartments) and must fulfil environmental and health conditions.

In all the States, an environmental impact assessment must be conducted especially in developments involving earth works and a permit must be obtained from the Environmental Protection Agency. On environmental services, major utilities in each of the States are corporatized state-owned enterprises. Most operate as the sole providers of utilities under their respective enabling Acts. It would have been better if all the utility companies in the four states are merged and turned into a single sustainable privatized utility specific company serving the whole of FSM.

[22] These sectors are wholesale or retail sale of goods, other than wholesale of petroleum, oil, lubrication and gasoline products, all land transportation including bus services, taxi services and car rentals, handicraft and gift shops (except those that are located on the premises of hotels or at the airport, or a duty-free gift shops at the airport), beauty shops and barber shops, (except within a hotel of 12 rooms or more), bakeries, bar services not associated and contained within a restaurant or a hotel having at least 12 rooms, tour guides, fishing guides, diving guides, and any other form of water transportation services, travel and tour agencies, hotels of less than 12 rooms, operations manufacturing goods produced by locally-owned enterprises, except where the Board finds the economic benefit of the applicant's business outweighs the need to protect the locally-owned enterprises, equipment rentals for both land and water within the State, including rentals related to tourism, commercial fishing for other than highly migratory species.

On tourism, there is a need to carve out some environmental, cultural or social exceptions. It was noted that there is frequent violation of the scope of the investment permit and the state of Pohnpei and the immigration authorities do not have enough staff and the capacity to monitor the provisions of the Act and the conditions in the permit to ensure that foreign investors do not abuse their permit status.

### 3.2.4 Analysis of the services sectors

The major problem in FSM is that there is no data on the source of investment, the sectors in which investment is going and the annual value of investment. There is no statistics on services imports and exports and how much trade in services contribute to GDP. This information is necessary in order to formulate a comprehensive investment policy and to decide which sectors to liberalize and which ones to reserve for the local citizens.

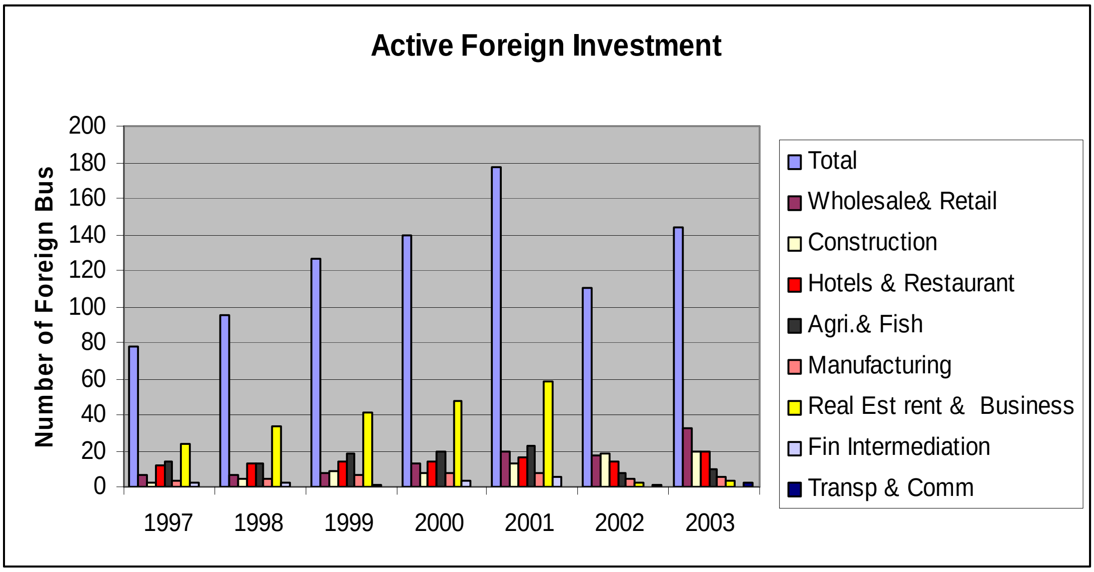
The chart below shows that the total number of active foreign investment businesses increased from 78 in 1997 to 177 in 2001 but declined to 144 in 2003. In general, foreign operators in wholesale and retail, construction, hotels and restaurant increased from 1997 to 2003. Real estate rent and businesses, agriculture and fisheries increased from 1997 to 2001 but declined sharply thereafter.  There is very little foreign activity in manufacturing, financial services, transport and telecommunication.

Table 28

**Active Foreign Investment in FSM 1997-2006**

| | Total | Wholesale & Retail | Construction | Hotel/Restaurant | Agriculture.& Fishing | Manufacturing | Real Estate rental & Bus | Financial Intermediation | Transport & Communication | Health & Social Work | Education | Public Admin | Other Services |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1997 | 78 | 7 | 2 | 12 | 14 | 3 | 24 | 2 | | | | | 14 |
| 1998 | 95 | 7 | 4 | 13 | 13 | 4 | 34 | 2 | | | | | 18 |
| 1999 | 126 | 8 | 9 | 14 | 18 | 7 | 41 | 1 | | | 1 | | 27 |
| 2000 | 140 | 13 | 8 | 14 | 19 | 8 | 48 | 3 | | | 2 | | 25 |
| 2001 | 177 | 20 | 13 | 16 | 23 | 8 | 58 | 5 | | | 3 | | 31 |
| 2002 | 110 | 17 | 18 | 14 | 8 | 4 | 2 | | 1 | 1 | 1 | 1 | 43 |
| 2003 | 144 | 32 | 20 | 19 | 10 | 5 | 3 | | 2 | 2 | 2 | 2 | 47 |
| 2004 | | | | | | | | | | | | | |
| 2005 | | | | | | | | | | | | | |
| 2006 | | | | | | | | | | | | | |

Figure 27




Trade in services in FSM is very complex due to the fact that some of the services sectors are regulated by the National Government while others are regulated by the States. Yap state has very liberal investment laws and most activities are owned by foreigners whilst Ponhpei has very restrictive laws. If an investor wants to determine whether to invest in FSM or not, he or she has to go through a maze of National and State regulations as outlined above to establish whether the sector he or she is interested in is open or not and whether there will be adequate protection of his investments. Unless the investment laws are simplified or standardised, they continue to pose serious obstacles to investment. Five different pieces of legislation governing investment in a small island nation like the FSM tend to partition the already small market and this makes it unattractive to investors. This is contrary to the recent global developments where countries are moving towards regional integration to create larger markets for the purposes of attracting investments.

The services sector represents about 56% share of GDP[23] (77% according to the US sources) and this shows that services play a vital role in the economy. However, the contribution of services exports to the economy is very small. Government assistance has been provided through restrictions to market access and granting of monopolistic status to state owned enterprises such as the electricity, telecommunications and coastal shipping. These restrictions have contributed to high utility costs, poor services delivery and high cost of doing business in FSM.

FSM should improve its Information and Communication Technology (ICT), adopt e-commerce and maintain a simple website with all the information needed by investors. There is a need to reduce red tape on investment and the bad attitude towards foreign investors must change. According to the World Bank's *Doing Business in 2007: How to Reform* report, Micronesia ranks 106$^{th}$ out of 175 countries and last among the Pacific

[23] World Bank Country data at a glance; Pacific Island Data and Statistics, other sources (partly estimates).

Island Countries (PICs) in the ease of doing business. The major weakness is in the area of registering property. The survey looked at the costs involved for a medium-sized business to register a fixed area of property (557.4 square meters) in a semi-urban location. FSM ranked 172 out of 175 because of its strict laws on land transactions but other PICs have improved. For example Palau was able to register such property in a relatively short period of time and at minimal cost, giving it a ranking of 13 out of 175.
The process of enforcing contracts is also less efficient compared to the other PICs. FSM ranked 139th and the time of enforcement is very high. It takes about 365 days for judgment to be handed down and 400 days for enforcements. It takes as long as 5¼ years, nearly twice the average for the region, to go through bankruptcy proceedings for a failed medium-sized business. At the end, the recovery rate is estimated to be only 3 cents on the dollar, compared to 21 cents for the region, giving Micronesia a ranking of 148th. Vanuatu ranks at 45th, which is the highest in the Pacific and closing a business takes half the time and the recovery rate is 13 times more than that of FSM.

Lack of credit information has hindered access to financing, particularly for unsecured loans, and reflects that the FSM financial system is still in its early development stages. In general, loans have declined between 1997 and 2006. The introduction of a new bankruptcy and secured transaction law is a positive step, which will promote effective restructuring and new lending. However, there should be effective implementation of these laws. It is too early to assess the impact of the new bankruptcy law on the efficiency of closing a business in FSM. In 2006, states eliminated the minimum capital requirement for starting a business and this improved its ranking. However, Pohnpei has re-introduced the minimum capital requirements.

The main challenges facing FSM are to reduce the time and cost in closing a business, improve access to credit, strengthen the enforcement of contracts and expand property registration. There is also a need to reduce the amount it takes to apply for a foreign investment permit. A lot must be done to improve labour skills and the attitude of workers. Work ethics and discipline need to be instilled at an early age.

FSM's investment ranking is very poor and the investment laws need to be reviewed continuously to create an environment which is conducive for business. Even though there are a number of issues that are considered by investors such as resources, market size, infrastructure amongst other things, the legal regime also play a vital role in influencing investor's decisions. For this reason, it is important to change those factors that it has control over including reforming its investment laws to ensure that they offer the maximum protection to investors and their investments. This should be accompanied by a strong judiciary and administration that can effectively uphold and enforce the rights of investors. However, FSM need to retain the necessary policy space to regulate such investment to protect the public interest and the environment. Certain sectors may need protection to ensure that the local citizens are given an opportunity to benefit. The investment laws must endeavour to strike a balance between the rights of investors and those of the host State.

Some of the restrictions that may hinder foreign investment included the monopoly in telecommunications, the national treatment distinctions made between local and foreign suppliers of banking, financial and insurance services, route licensing, through the Micronesian Shipping Commission's Entry Assurance System which has the effect of restricting market access to ensure routes are not saturated. Limiting competition across these key sectors has the effect of ensuring that prices are kept high and the quality of service to consumers remain low. Reduced competition in freight shipping may affect trade in goods in the three Freely Associated States.

Land ownership, as elsewhere in the Pacific, is prohibited, functioning as a disincentive to investment. The scale of this disincentive will be a product of the degree of facilitation and assistance provided by the National and State Governments in dealing with existing and customary landowners.

Restrictions on Mode 4 access are more solid, with strict requirements placed on employers under the Protection of Resident Workers Act, however provisions allowing for employment of an investor's senior management under EWAs, and the opportunity to extend this coverage to other qualified foreign personnel, allows for the key staffing of investment projects. The stipulation of equality of benefits for local and foreign workers in the construction sector, and a requirement for annual registration by non-citizens, are not seen to be major hindrance to access under Modes 3 or 4. Investors have also been complaining that it takes a longer period for the work permits to be issued (2-3 months).

According to a recent study by PDP Australia entitled Stocktaking of Limitations and Restrictions Applying to Trade in Services in the Pacific (2007), the regulatory environment is constraining foreign investment in the Pacific and in FSM in particular. There is lack of transparency and widespread use of administrative discretion in the awarding of various licenses. There is need to harmonise policies across the federal system on investment, immigration and professional standards. The monopoly in telecommunications especially in the growing internet and mobile sectors need to be removed. Limitations on the supply of shipping services should be rescinded and national treatment violations in banking and insurance services are also an obvious target for potential reform if FSM is to benefit from competition and international best practice in the financial services sector.

# 4 SECTION FOUR: FSM'S TRADE POLICY/BUSINESS ENVIRONMENT

FSM does not have a comprehensive trade policy and trade issues have been addressed on an ad hoc basis. No clear policies were set and coordination between responsible departments is very weak. This section reviews FSM's existing trade policy setting with a focus on the key domestic policies and instruments.

## 4.1 Domestic Trade Policies and Instruments

In order to boost production, FSM needs to put in place a number of measures to address the supply side constraints. The main focus should be on promoting production and value addition in agriculture, fisheries, manufacturing, food processing and putting in place quality infrastructure and services needed to promote trade and investment including promoting services trade, especially tourism. The trade policy should turn the goals in the SDP into reality and resources must be prioritized to boost domestic production in these sectors. There is a need to align the Compact funding to build infrastructure needed to support the private sector and also to fund trade-related projects.

FSM needs to build its capacity to produce and supply the export markets. Building capacity to trade should be a key national priority and assistance from donor agencies and its major trading partners is needed for this purpose. A comprehensive national export strategy is needed for this purpose. The strategy should identify products and sectors that should be targeted and prioritized for export development. It should also target the products that can be produced locally to substitute imports. A lot of emphasis should be put on value addition to local resources. The UNDP draft Export strategy can be used as a starting point and further developed.

A comprehensive Skills Development Initiative is needed in order to develop the necessary skills which are needed in the relevant sectors of the economy. There is a need to identify skills and the institutions which can be targeted for developing these skills. Vocational training schools in tourism, fisheries and agriculture, construction, nursing, science and technology amongst other things are vital in this initiative. A comprehensive research which will include competitiveness, protection policy, subsidies, incentives, market regulation of key export sectors needs to be conducted.

Trade taxes, import duties and export taxes are the key trade policy instruments but have not been used actively in FSM mainly because the FSM is an import based economy with little export activities. The tariffs are very low and FSM does not rely much on import duties for revenue[24]. At the present moment FSM does not have major industries that it needs to protect from import competition and rarely uses import duties for industry protection. However, the country needs to identify those industries that it has potential to develop in future and this should be reflected in the tariff structure. Some agricultural and fisheries and textiles products may also need protection. It is also important to note that due to global changes, it is difficult to identify industries that will need to be protected in

[24] However, one can also argue that the FSM economy is artificial as it relies much on US funding. The situation may change due to reductions in Compact funds.

future and the government does not have a good track record in picking winners, hence the need for private sector consultation.

FSM does not depend much on other levies and charges for revenue. States do charge excise taxes and other forms of taxes such as sales tax. In general, excise taxes are imposed on imported and domestic goods and services to raise revenue from alcohol, fuels, manufactured tobacco, luxury goods and vehicles. FSM also has a few non-tariff measures that are applied to imports and this include quarantine regulations on agricultural products and those that seek to protect health and safety of plants, animal and human beings.

FSM does not impose export taxes. It actually provides tax exemptions for exporters. The National Fisheries Corporation (NFC) used to provide transport subsidies but not anymore. Very little support is provided in terms of direct subsidies. Schemes to support smallholder farmers with inputs and transport are important to promote agriculture. This support is necessary to compensate for low commodity prices and improve product quality. Freight subsides are needed to compensate for high transportation costs. The government also needs to provide assistance for agricultural research and development. Funding can be given to institutions to support the development of three or four products with export potential. The FSM Development Bank used to give concessional loans and credit but this is no longer fully operational.

FSM should put in place contingency measures to protect its industries against unfair practices such as dumping, subsidised products and the sudden influx of imports. In order to use these measures in a least trade restrictive manner, there is a need to put in place legislation and mechanisms for imposing anti-dumping duties, subsidies and countervailing measures and safeguard measures. Some of the things that must be done at the domestic level to increase trade and domestic production includes improving the education system particularly training in maths, sciences and information and computer technology, using local content in food production and preparation and ensuring that the environmental dimension is taken into account.

### 4.1.1 Taxation

The National Government is empowered by the constitution to collect gross revenue tax (GRT), import and income taxes and all the remaining taxes are collected by the States. The National Government manages the tuna resources and keeps all revenues from the access fees. Revenue from penalties and fines is shared with specific States and local governments in certain instances. About ¾ of all domestic taxes are collected by the National Government and States collect the remaining ¼ through general sales taxes, excise taxes on alcohol, tobacco and other goods. In FY2005, total taxes amounted to $22.4 million and the States collected about $6.7 million. According to the Constitution, at least 50% of the nationally imposed taxes (and 80 percent of the fuel import tax) must be shared with the state in which the taxes are collected.

FSM derives about $21,176,207 (1999-2005 average) from customs duties and local revenue collection. In 2006, the total amount that was raised from customs duties and local revenue was $22,845,613. The State of Pohnpei raised about $10,226,398, Chuuk about $6,159,691, Yap about $4,492,418 and Kosrae about $1,967,105. The major contributions came from imports, GRT and wages. Imports including fuel and cigarette tax contributed to about $9,150,693 in 2006 which is about 40% of total tax revenue. Wages ($6,973,386) and GRT ($6,589,435) constituted about $13,562,822, which is approximately 60% of total tax revenue as indicated in the Table below.

Table 29

| **FSM Taxes** | | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
| Imports | 6,933,166.20 | 6,628,477.22 | 5,854,783.66 | 6,328,951.20 | 6,164,957.24 | 7,080,951.60 | 6,895,555.28 |
| Fuel | 961,931.12 | 894,345.30 | 857,010.22 | 697,794.54 | 634,437.36 | 579,519.76 | 718,375.39 |
| Cigarettes Tax | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 895,493.82 | 1,536,762.69 |
| GRT | 5,958,131.31 | 5,946,378.56 | 6,014,312.93 | 6,069,457.99 | 5,898,084.27 | 6,797,858.55 | 6,589,435.72 |
| Wages | 6,614,567.44 | 6,825,109.51 | 6,976,476.59 | 7,323,829.57 | 7,131,666.84 | 6,965,579.08 | 6,973,386.54 |
| License fee | 39,053.50 | 30,360.44 | 29,329.70 | 21,171.00 | 26,714.50 | 26,596.50 | 25,029.50 |
| Pen & Int | 349,313.01 | 221,739.59 | 1,196,107.34 | 122,635.30 | 213,122.32 | 136,692.04 | 116,978.89 |
| Bank charges | 7,894.37 | 228.69 | 110.00 | 145.00 | 100.00 | 36.00 | 123.00 |
| Other | 1,813.66 | 15,259.26 | 23,888.08 | 11,553.74 | 23,939.15 | 1,460.10 | 1,102.62 |
| Less bad checks | 4.76 | -7,037.30 | -129,616.26 | -6,107.28 | 0.00 | -1,940.77 | -11,136.49 |
| **Total** | **20,865,875.37** | **20,554,861.27** | **20,822,402.26** | **20,569,431.06** | **20,093,021.68** | **22,482,246.68** | **22,845,613.14** |

Source: Customs and Revenue.

In FY2005, tax revenues constituted about 12.2% of GDP as compared to roughly 10.8% the level that prevailed throughout most of the Compact 1 period from FY1987–2003. This reflects a policy change to the import tax that shifted the base from f.o.b. to c.i.f. and eliminated most personal (non-commercial) imports and increased taxes on beer and tobacco with effect from FY2005. Exports were exempted from gross revenue taxes consistent with adoption of an "outward"-looking development strategy. The contribution of grants to GDP decreased sharply from 53 % in FY1995 to 35% in FY05, however, the contribution of grants to total revenue only dropped by 3% over the same period from 66% to 63%. This shows that FSM still depends a lot on grants as a source of revenue than on its own local revenue. The contribution of tax revenue to GDP increased marginally by 2% from FY95 (10 %) to FY05 (12%). Due to the declining Compact funding, FSM needs to increase its local revenue efforts in order to avoid a financial crisis. The trade policy should fully support the ongoing tax reform.

Table 30

| Contribution of Grants and Tax to GDP and total revenue | |
|---|---|
| FY95 | FSM |
| Grants as a percentage of GDP | 53% |
| Grants as a percentage of Total Revenue | 66% |
| Tax Revenue as a percentage of GDP | 10% |
| FY00 | |
| Grants as a percentage of GDP | 45% |
| Grants as a percentage of Total Revenue | 65% |
| Tax Revenue as a percentage of GDP | 13% |
| FY05 | |
| Grants as a percentage of GDP | 35% |
| Grants as a percentage of Total Revenue | 63% |
| Tax Revenue as a percentage of GDP | 12% |

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In 2002, a nationwide tax and revenue symposium recommended the introduction of a comprehensive tax reform program including the introduction of a broad based consumption tax (value-added tax plus excises) and subsequently, a simple net profits tax. The consumption tax would be enacted at the state level, replacing the existing national gross revenue, import taxes and state sales taxes. It also called for the establishment of a unified tax administration to implement the new regime and collect taxes on behalf of both layers of government.

The Tax Reform Task Force (TRTF) was formally organized and created by the FSM President in January 2005. The TRTF is chaired by the Vice-President, with the FSM Customs and Tax Administration forming the secretariat. Membership on the task force included the Secretary of Finance, representatives from the private sector, one from each State and two members from the FSM Congress. The objectives of the TRTF were to:

- examine different options for reform of the FSM tax system in order to meet expected reductions in revenues and to support the long-term sustained economic development of the nation;
- prepare a tax reform proposal to present to the leadership of the FSM and the FSM Congress for consideration and enactment at the earliest possible time; and
- assist in education, holding of seminars and working groups to increase public awareness about the fiscal implications of the amended Compact, and the need to generate more local revenue, for tax reform, and to strengthen tax administration.

The TRTF's final recommendations were approved by the President in December in 2005. The key recommendations include:

- the introduction of a form of value-added tax (VAT) not by itself but only as part of a tax package, which must include the elimination of the current GRT and (state) sales tax and surtax;

- a form of net profit tax (or business income tax) to replace the GRT, allowing for deductions of business expenses from taxable revenues;
- the personal income tax (wages and salary) should be reduced, preferably by eliminating the tax at the lower income bracket;
- resources should be allocated immediately for upgrade of the capacity of the tax administration;
- one independent tax collection authority with operations nationwide must be established; and
- tax reform should aim at raising revenues by increasing compliance, and should not impose additional tax burden (beyond the existing tax burden) on the private sector.

According to a study by Nikunj Soni (2007) on Responding to the Revenue Consequences of Trade Reforms in the Forum Island Countries, it was clear that a resident team of tax experts will be required for several years for there to be successful implementation. It is estimated that tax reform and introduction of a VAT takes a minimum of two years and FSM may implement it in 2010. However, a detailed study by Baunsgaard and Keen (2005) suggests that in the most extreme circumstances, low-income countries may take up to 10 years to fully implement tax reforms such that the tax revenue-to-GDP ratio reach pre-liberalization rates.

The tax reform has also come at an opportune moment when FSM is contemplating entering into various trade agreements. It is important for the tax reform to be sequenced properly with trade liberalisation to avoid revenue losses. FSM should also consider the option of re-introducing import duties for tariff revenue or industry protection in future and these issues need to be taken into account in trade liberalisation.

In the case of FSM, which is dominated by the service industry, the most appropriate tax regime would be one based on a mix of consumption and income taxes rather than on trade taxes. An appropriate mix between import, consumption and income taxes will satisfy efficiency and equity concerns and provide adequate diversity of revenue for government. Minimal tax incentives and exemptions will avoid rent-seeking behaviour on the part of tax payers, increase government revenue collection activities, and facilitate a more simple, efficient and trustworthy collections agencies.

However, in FSM many workers are employed in the informal agriculture and fisheries sector and wages are not regular or even in cash and are almost impossible to tax. Furthermore, some of the workers may not spend their earnings in stores that keep accurate records of sales and inventories. In such an environment, it will be difficult to raise taxes such as income taxes and consumer taxes. This will be worsened by the fact that the customs staff is not well trained and equipped.

In terms of tax administration, Customs uses PC Trade (2002 version) and the HS 2003 codes.

The national government collects GRT and wages and salary taxes and it has been argued that the number of taxpayers in these categories is lower than it should be. Compliance has been hampered by the limited number of auditors as well as poor business and accounting skills on the part of local businesses. Providing tax incentives to promote investment is unlikely to be cost effective. The best strategy for sustained investment promotion is to provide a stable and transparent legal and regulatory framework and to put in place a tax system in line with international norms. Tax holidays and investment subsidies are among the least meritorious.

The study by the Nikunj Soni (2007) on Responding to the Revenue Consequences of Trade Reforms in the Forum Island Countries indicates that an effective customs administration should have a clear separation between the setting of tax policy and its administration, simple and transparent laws and regulations, protect confidentiality of taxpayer's information, a performance criteria, including revenue targets and service expectations, and the resources required to meet them, professional customs administrators who are well trained and well paid, a code of conduct for the staff that clearly spells out expectations and consequences of non performance, an effective internal audit function; and a clear and effective appeals procedure and, more generally, an atmosphere that encourages taxpayers to raise issues of interpretation of the tax laws and their administration (for example, through discussions with industry associations). FSM should work with PIFS to undertake further national consultations and in implementing trade and tax reforms.

### 4.1.2 Competition Policy

FSM needs to put in place a competition policy to promote competition in all sectors of the economy and address all the anti-competitive or trade restrictive practices which may disadvantage the local producers and consumers. A competition policy can be used to create an environment where the monopolistic tendencies of big companies in FSM can be addressed. Competition is good because it can promote efficiency and effective delivery of quality goods and services. The competition policy should be framed in such a way that it allows foreign competition but at the same time giving due regard to the local sensitivities. Some of the anti-competitive practices can best be addressed at a regional level and FSM must participate actively in any of these initiatives.

### 4.1.3 Government Procurement

Government procurement constitutes a major part in international trade and billions of dollars worth of goods and services are traded by governments worldwide. Even though it is normally exempted from major trade agreements, there is a need to ensure that the government procurement procedures meet international procurement standards. This is good from an accounting and reporting point of view especially from those countries that rely on donor funding. Furthermore, transparent and competitive procurement procedures ensure that the citizens have access to quality goods and services at reasonably cheap prices. Procurement procedures can also be designed in such a way that preferential treatment can be given to small and medium enterprises to ensure that they also benefit from the government tendering procedures. This can be done by giving preference to domestic companies below a certain threshold (e.g. $50.000).

There is a need to put in place a comprehensive procurement legislation which spells out the sanctions for flouting procurement rules, and the judiciary and other administrative institutions must be strengthened to ensure effective enforceability and implementation. Clearly laid down procurement rules and standards will go a long way in curbing corruption and conflict of interest and this enhances the value of the taxpayer's money and more importantly, it will raise FSM's image with the donors. Some States have rules on government procurement, but these laws need to be reviewed and updated to ensure that the procurement system is transparent. There is also a need to put in place deterrent penalties for those flouting the procurement rules. The private sector and the judicial system need to be vigilant in this respect to ensure that the rules are enforced.

The Forum Secretariat will be conducting a study on government procurement and examine the possibility of including government procurement under PICTA.

#### 4.1.4 Trade Facilitation

In order to facilitate trade, FSM needs to reform its customs procedures and adopt the state-of-the-art software for customs business being recommended by the World Customs Organisation and the WTO. There is a need to standardize and harmonize import and export procedures and documents to ensure swift movement of goods. Fees, formalities connected with importation and exportation must also be standardized and the trade regulations must be published regularly. All the red tape that is associated with clearing goods at customs must be reduced to a minimum and FSM should consider adopting a single window system for clearing imports rather that requiring the importers to go to various agencies. This wastes time and resources and these costs will be passed onto the consumers who in the final analysis will bear the brunt of the customs red tape. The amount of time that is taken to clear goods should be reduced to a minimum.

Streamlining and reforming customs can also minimize corruption at the borders and also ensure that there is efficient collection of revenue. A number of developing countries that have reformed their customs and utilized the latest technologies have actually witnessed an increase in the amount of customs revenue collected.

The customs officials also need to be strengthened and equipped to ensure that they monitor the goods that are coming into the country to ensure that they are safe and free from any disease that may pose a threat to animal, plant and human life and health. They need to be trained on other technical issues such as rules of origin, customs surveillance and how to combat customs fraud and irregularities. This is crucial for FSM to access the benefits under the Economic Partnership Agreement that is being negotiated with the European Community. A comprehensive review of the customs code is warranted in order to facilitate trade in the FSM. Some of the issues relating to trade facilitation can be addressed through regional cooperation and assistance from the donors in this area is much needed.

FSM also needs to establish a Competent Authority to deal with all issues related to export standards such as technical barriers to trade (TBT), sanitary and phytosanitary measures (SPS), certification, testing and conformance. The food safety laws need to be reviewed and FSM should cooperate with regional and international institutions to get assistance to build its capacity in this area. The Department of Health and R&D should cooperate with the exporters and address all the standards that are required for FSM products to qualify for the export markets. FSM should fully utilize the Regional Trade Facilitation Programme (RTFP) that is provided under PACER.

### 4.1.5 Corporate Governance

FSM also needs to adopt a comprehensive Corporate Governance Framework to ensure that the public companies, government enterprises and departments are run according to the best corporate practices. It has been proven that for companies or any government department to be effective, there should be an effective and independent board of governors and the relevant committees. The process for selecting office holders or board members should be transparent and only skilled and experienced people should be allowed to take such positions of responsibility. There should be a system in place to ensure financial accountability and responsibility, ethics, risk management, performance evaluation and succession planning. All these issues can be best addressed in a corporate governance framework. If a country does not adhere to sound corporate governance practices investment will flow elsewhere. It is also believed that poor corporate governance practices contributed significantly to the demise of public fishing companies in FSM and other projects.

### 4.1.6 Intellectual Property Rights (IPRs)

In order to promote investment and encourage innovation, FSM needs to adopt comprehensive pieces of legislation to protect copy rights, patents, trade marks, geographical indications and designs. Title 35 of the FSM Code provides for copyright, patents & trademarks but there are only a few sections dealing with copyright without addressing all the other forms of IPRs. There have been frequent adverts in the Kaselehlie Press giving trade mark cautionary notices, but this is an ineffective way of protecting trademarks. IPR legislation need to be supported by strong implementing institutions and regimes and the judiciary must play a vital role in upholding and enforcing IPRs. IPR is not only for big companies but even SMEs can develop their products, license them, improve the quality of their products and services, brand their products and market them effectively.

There is also a need to establish a sui generis system to protect traditional knowledge, bio-diversity and genetic resources. The Pacific Island Forum Secretariat is already running a pilot project that seeks to establish international rights to protect Traditional Knowledge and Cultural Expressions and this project should be extended to include FSM.

Yap State has adopted a resolution urging the FSM to put in place a patent legislation and there is a need for a follow up on this issue. Trade involving intellectual property is now of significant importance. FSM needs to protect its rare species of fauna and flora.

Protection of IPR is also important for health and safety reasons. In 2005, total world goods exports amounted to $10.3 trillion (IMF: 2005) and total counterfeit goods exports constituted about $0.2 trillion. By value, the OECD estimates the counterfeit goods trade at roughly $200 billion in 2005. About 70% of the counterfeits, based on the origin of seized pirate products, originated in East Asia, above all China. Some of the items that are pirated include knockoff rolexes, designer luggage, ray-bans, lower-priced medicines, food and household goods. Specific examples include foods like instant coffees, butter, and alcoholic drinks; personal products like tampons, toothpaste, razor blades and medicines from cough syrup to HIV treatments. FSM needs to include a provision in Customs Act for seizure of imported IPR infringed goods. The customs must also be strengthened to fulfil this task.

### 4.1.7 Trade and Environment

In an effort to develop and promote exports in agriculture, fisheries and tourism care must be taken to protect the environment to ensure that economic growth boosted by exports in these sectors is sustainable. Positive measures must be taken to ensure that there is balance between trade interests and environmental interests. If the environment is not protected, this may have enormous consequences in future not only on economic development but also on social lives of many people. At the global level, efforts are being made to take urgent and targeted measures to protect the environment and minimize the impact of climate change and FSM should participate fully in this process.

It is heartening to note that FSM has adopted the Micronesian Challenge, which is a commitment by RMI, CNMI, Guam, Palau and FSM to effectively conserve at least 30% of the near-shore marine resources and 20% of the terrestrial resources across Micronesia by 2020. This challenge exceeds the goals set by international treaties, which call for countries to conserve 10% of terrestrial and marine resources by 2010 and 2020 respectively. It calls for Micronesian leaders to work together at the regional level to confront environmental and sustainable development issues. There is also a need to conserve offshore fisheries to ensure sustainable trade and clean investments in the fisheries sector. This becomes crucial when FSM is considering investments in fish canning. A thorough environment impact assessment should be conducted and plans must be made on how to dispose the waste.

The relationship between trade and environment should be examined closely to ensure that the quest to promote trade does not lead to depletion of natural resources, pollution of the land, air and water. Agricultural production must not lead to deforestation, soil erosion and land degradation. The harvesting of marine resources must be monitored and managed properly to ensure that there is no over-exploitation. Even though there are costs involved FSM should endeavour to use clean technology in any form of business or manufacturing venture. Assistance must be sought from the developed countries to assist FSM to have access to clean development mechanisms.

# 5 SECTION FIVE: TRADE AGREEMENTS AND MARKET ACCESS

This section will look at the trade agreements that are already in place or those that FSM is negotiating. The purpose of these trade agreements is to provide market access and other developmental assistance to enable FSM to build its capacity to produce goods and services in an efficient manner and supply the global market. Some of the agreements that will be covered include the Pacific Island Countries Trade Agreement (PICTA), the Economic Partnership Agreement (EPA), the Pacific Agreement on Closer Economic Relations (PACER), the Compact Agreement with the US and the World Trade Organisation (WTO).

## 5.1 The Pacific Island Countries Trade Agreement (PICTA)

The main objective of PICTA is to promote regional integration among the Pacific Island Countries (PICs). It is supposed to serve as a stepping stone for PICs to participate in the increasingly liberalized global economy. PICTA also serves as a training ground before PICs negotiate free trade agreements with countries such as the EU, Australia and New-Zealand. The Pacific Island countries need to pursue regional integration in order to avoid being marginalized from the global system. Leaders also adopted the Pacific Plan which seeks to promote deeper and broader integration in the Pacific as a strategy for pursuing the main goals of economic growth, sustainable development, good governance and security. Regional integration becomes an imperative in light of the decline in aid and it also helps to sustain outward looking trade policies.

PICTA seeks to reduce tariffs to zero by the year 2015 for developing countries and 2017 for least developed countries (LDCs) and small island states (SIS). For those products that qualify for the negative list exemption, tariffs will be reduced to zero by 2020 for developing countries and 2021 for LDCs and SIS. However, non-tariff barriers such as quotas must be eliminated immediately. Alcohol and tobacco have been excluded from liberalisation but the Ministers are expected to make a decision on this issue in future. For products to qualify to trade under PICTA, they must meet the 40% local content criteria. At the moment, PICTA covers trade in goods only and about 3% of all PICs imports originate in other PICs. The table below shows the timetable for tariff cuts under PICTA.

Table 31

| **Non-(LDCs and SIS) – ad-valorem tariff** | | | | | |
|---|---|---|---|---|---|
| | **Maximum tariffs on goods from** | | | | |
| Base tariff on goods on entry into force | 1.1.2007 | 1.1.2009 | 1.1.2011 | 1.1.2013 | 1.1.2015 |
| > 20% | 20% | 15% | 10% | 5% | 0% |
| > 15% but not more than 20% | 15% | 10% | 5% | 0% | |
| > 10% but not more than 15% | 10% | 5% | 0% | | |
| not more than 10% | 0% | | | | |

Table 32

| Non-(LDCs and SIS): specific or fixed tariff | | | | | |
|---|---|---|---|---|---|
| **Maximum specific or fixed tariff on goods, as a percentage of base tariff (value) from** | | | | | |
| | 1.1.2007 | 1.1.2009 | 1.1.2011 | 1.1.2013 | 1.1.2015 |
| % of Base Tariff (value) | 80% | 60% | 40% | 20% | 0% |

For locally produced sensitive products to be included in the negative list and be entitled to a longer period of protection with higher tariffs, they must be locally produced, be produced by another PICTA member (risk of competition) and not currently being exported. This protection is not permanent and tariffs on such goods must be reduced to zero by 2020 for developing countries and 2021 for LDCs and SIS. States must come up with a negative list of products that they want to shield from liberalization for a limited period of time.

Table 33

| Non-(LDCs and SIS) – ad-valorem tariff (Excepted imports (Negative list) | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Maximum ad valorem tariffs on goods from: | | | | | | | | | |
| 2007 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
| Base Tariff | 40% | 35% | 30% | 25% | 20% | 15% | 10% | 5% | 0% |

Table 34

| Non-(LDCs and SIS): specific or fixed tariff (Excepted imports) | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Maximum ad-valorem tariffs on goods from** | | | | | | | | | | |
| 2007 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
| Base Tariff | 50% | 40% | 35% | 30% | 25% | 20% | 15% | 10% | 5% | 0% |
| | | | | | | | | | | |

PICTA allows members to protect their infant industries using protective tariffs for a maximum period of about 10 years for developing countries and 15 years for LDCs and SIS. The Agreement also allows countries to take some safeguard measures in the event that there is a sudden and unforeseen influx of imports as a result of eliminating the tariffs. Other flexibilities that are built into the agreement include the general exceptions, balance of payment exceptions, the provisions on amendment of the agreement and even withdrawal.

According to a 2007 study commissioned by the Forum entitled "The Potential impact of PICTA on smaller Forum Island Nations" the negative impact of PICTA on FSM is minimal.

Table 35

| The Potential Impact of Revenue Loss under PICTA | | |
|---|---|---|
| Country | Filmer's calculation of estimated cumulative loss of total tax revenues from the PICTA (1998 data) | FIC tariff revenue as percentage of government revenue (incl grants, 2005 data) |
| FSM | .. | 0.01% |
| Kiribati | 14% | 3.31% |
| Nauru | 2% | - |
| Niue | .. | 1.30% |
| Palau | .. | - |
| RMI | .. | - |
| Tonga | 3% | 7.13% |
| Tuvalu | 13% | 1.58% |

Only 0.01% of the total government revenue would have been lost in 2005. The average (03-05) imports from PACP is $1,857,922 and about $43,512 in import duties will be lost if all tariffs are eliminated.

Table 36

| The Percentage of FICs imports in total imports. | | | | | |
|---|---|---|---|---|---|
| **Year** | **2000** | **2001** | **2002** | **2003** | **2004** |
| Percentage of FICs imports in total imports | 0.24% | 0.46% | 0.57% | 0.64% | 0.44% |

The ratio of 'FIC' imports in this case is very low and somewhat volatile, but hovers around 0.5% for the years that data is available.

The FSM Statistic Unit publishes relatively detailed government revenue data, from which the following ratios of tariff revenue to total government revenue can be calculated.

Table 37

| Percentage of Government Revenue from Tariff Revenue | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Year** | **FY95** | **FY96** | **FY97** | **FY98** | **FY99** | **FY00** | **FY01** | **FY02** | **FY03 est.** | **FY04 est.** | **FY05 est.** |
| Percentage of government revenue from tariff revenue | 7.75% | 8.52% | 10.02% | 12.45% | 13.29% | 15.12% | 17.27% | 14.32% | 13.64% | 12.4% | 17.7% |

In this case, there is some upward movement in the proportion of government revenue sourced from import tariffs but, once again, there is significant volatility over the period. Despite this upward movement, because FIC import revenue makes up less than 0.5% of FSM imports, the impact of PICTA on government revenue will be insignificant.

Quantifiable economic benefits are not expected to be huge because intra-regional trade volume is currently very low. However, some of the benefits expected from PICTA include a big domestic market of about nine million people thereby increasing their export chance and this is also good for attracting investors; it can also lead to improved efficiency as industries exploit economies of scale due to expanded "local" market; more exports may lead to increase in output which in turn leads to employment and more income; lowering tariffs is expected to lead to lower prices and consumers will have a wider product choice; it promotes regional integration as an initial step towards more extensive liberalization and it provides experience in negotiating FTAs and creates the basis for negotiating FTAs with other regions.

Like any other trade agreements there may be costs associated with PICTA and measures need to be put in place to minimize the costs and maximize the benefits to ensure that in the final analysis, the agreement will result in a win - win situation. Some of the costs involved include adverse social impacts arising from “adjustment costs” associated with removal of tariff barriers; administrative operational costs; small revenue loss through tariff reductions (only serious in Tuvalu and Kiribati); introduction of consumption-based taxes (to replace lost tariff revenue) *could* be regressive.

The FSM has been granted a waiver on PICTA and this allows FSM to ratify PICTA without being obliged to offer the same trade preferences to U.S.

There are five FICs that are already trading under PICTA with effect from 01 January 2007, namely Cook Islands, Fiji and Samoa and August 2007 for Vanuatu and Niue. Kiribati, Nauru, PNG, Solomon Islands, Tonga and Tuvalu have completed notification, but yet to announce readiness to trade. FSM has only signed PICTA but not yet ratified it. RMI and Palau are yet to accede. States supported the need to ratify PICTA.

It is clear that FSM is already lagging behind. For the country to benefit from PICTA there is a need to boost production and export capacity and transportation links with the other island countries must also be improved.

FSM needs to expedite the ratification process and start trading under PICTA. After ratification, FSM should notify other PICTA members and inform them about the specific issues related to PICTA trading. Some of these issues involved and steps required include: providing information on the MFN tariff schedules; information on any conversions of specific rates; information on the existence of any trade distorting measures; any other information relating to PICTA trading, for example, status on the endorsement of changes to the Agreement; negative lists; PICTA tariff reduction dates; details of legislative changes to trade under PICTA; thoughts on potential for services sector, inclusion of alcohol and tobacco, and government procurement; requests for PICTA technical assistance, legislative and procedural changes; announcement of PICTA readiness and trading.

## 5.2 Extension of PICTA to Trade in Services

The Forum Trade Ministers have agreed that PICTA be extended to trade in services. According to the studies commissioned by PIFS, PICTA parties would be required initially to liberalize a minimum of four out of the seven sectors that have been identified for liberalization. The seven sectors are financial services, telecommunication, transport (air and maritime), tourism & travel, educational service, health services and professional services. Some of the sectors make sense to liberalize regionally, while others should be liberalized with a multilateral framework in mind – due to economic efficiency and scale. It is recommended that telecommunications and financial services be liberalized multilaterally, on MFN basis and air services be liberalized among the Forum Island members. Air Services are covered by the Pacific Islands Air Services Agreement (PIASA). Inter-FIC and Intra-FIC shipping services for all FIC shipping companies must also be liberalized regionally. Health and education services may also be included in FIC free trade in services arrangements (subject to limitations due to social and public-good nature of these services). Certain sub-sectors of the tourist industry may also be included in the free trade in services agreement.

However, trade Ministers urged FICs to ensure the liberalization commitments that they enter into with third countries do not supersede the commitments they give to PICTA parties.

## 5.3 The US Market

The US is a good market for services in particular mode four and tourism and a potential market for agricultural products. However, with regards to the fishing industry, it is important to note that the US fleet is declining and that since 1979, canneries based in the US have closed but the market for imported canned tuna has expanded rapidly since the 1970s. Tuna canneries in the US are loin-only plants and there is only one tuna cannery left on the US mainland – the Bumble Bee plant in Los Angeles and Puerto Rico, which solely uses tuna loins in the production process (does not process any whole round fish). Thus the US is a major market for tuna loins that are to be processed (i.e. into cans). Prices for canned tuna dropped since 1999-2004 and have been flat since then at $16/carton. The US market for imported fresh and frozen tuna is more stable but generally lower in value than the Japanese market. The US has a commercially significant (although niche) market for tuna fillets and steaks and the US market for fresh-chilled tuna is of considerable economic importance to FSM.

The US has 0% tariff for fresh or frozen tuna, fresh or frozen tuna fillets, 6-12% for canned tuna in water and 35% for canned tuna in oil.

FSM signed an amended Compact of Free Association Agreement with the US in 2004. Since the general objectives of the Compact Agreement have been dealt with above, this section will focus on trade provisions which allow FSM to export its products to the US market duty free with some few restrictions. FSM in turn is required to give Most Favored

Nation (MFN) treatment to the US with regards to any free trade agreements that it signs with third parties with the exception of PICTA parties.

This preferential trade arrangement is a good start. However, it is unfortunate that these preferences have not been fully utilized. This is mainly because the private sector in FSM does not have adequate capacity to produce and supply products to the US market. Aside from the natural disadvantages that affect the private sector in the FSM, the efforts by the private sector to export to the US are further hampered by:

- infrequent, inadequate and expensive transportation to the US market;
- the fuel prices that are on an upward spiral;
- Continental Airlines, which has imposed stringent restrictions on cargo;
- non-tariff barriers such as technical barriers to trade, sanitary and phy-tosanitary standards and;
- unfavourable rules of origin- 35% value addition (15% allowance).
- On tuna and skipjack that is 'prepared or preserved' in airtight containers and not in oil, exports cannot exceed 10% of US consumption of canned tuna during the immediately preceding calendar year' which was 45.8 million cases in 2005 (4.58 million cases).

It is also argued that US investors did not invest in FSM because of political barriers, labor issues and poor governance. The general view is that politics in FSM are very complex and can 'be daunting for any investors'. For example, one US official noted that FSM is 'crippled by the four state grouping'. According to several industry interviewees, consulted by the Forum Fisheries Agency (FFA), the major factors for the failure of offshore tuna investment in FSM, include governance issues, dependency on US grants and the preferences have not been utilized 'because we give them stuff, but we don't give them the path to independence'. The FFA study recommends that the FAS 'need to move away from mass consumer/ mass market and shift to boutique production'. They 'need to stay focused and be less greedy, and look at quality issues and niche markets'. It was suggested that tuna in pouches were a key potential, and despite competition from Ecuador. One US industry representative also suggested that 'the Compact states should go for duty free status to be competitive.

FSM should try to negotiate better trade terms similar to those that were given to American Samoa, which receives zero-duty on exports of canned tuna to the US market compared to 35% on tuna in oil plus section 936 of the Internal Revenue Act which provides tax credit. The US law states that production for US military and other government contracts must be undertaken on US soil and use fish from the US fleet. Canneries in Pago Pago also benefit from this captive market.

The preferences that were given to FSM by the US have been eroded because the US has extended even better tuna preferences to other countries under the Andean Trade Preference Act (ATPA 1991 reviewed in 2004) which covers Bolivia, Colombia, Ecuador and Peru. The Caribbean Basin Economic Recovery Act (CBERA) was renegotiated in the early 2000s and preferential treatment was extended to canned tuna. This scheme extends duty-free access for canned tuna to the US market to Haiti, Costa Rica, Netherlands

Antilles, Panama and Trinidad & Tobago (Trinidad & Tobago is a major supplier of albacore loins to Bumble Bee's cannery in Puerto Rico. CBERA has a potential duty preference higher than those in ATPA. There is also a threat from the Thai-US FTA. All these factors point to the fact that FSM is under pressure from the global tuna producers and any industries that are established in FSM will have to face this competition especially when the preferences are gone.

Some positive measures must be taken to assist the FSM private sector to fully utilize the trade preferences. Lack of utilization of preferences has been a major problem affecting many preferential schemes including those that are granted to the Africa, Caribbean and Pacific Sates by the European Union (EU). Poor countries are granted market access but no adequate technical and financial assistance is provided to assist the private sector to fully utilize these trade preferences. The EU has begun to address this imbalance by negotiating development oriented Economic Partnership Agreements with ACP countries. It has also agreed to provide ACP States with technical and financial assistance to address the supply side constraints and boost their production and export capacity. The same concept has been proposed at the World Trade Organization under the broad term Aid for Trade to assist poor countries to adjust to the increasingly liberalized global trading system and also to boost their capacity to trade. The US-FSM trade relations have been overtaken by these recent developments and need to be revamped and deepened to take into account these developments in order to assist the private sector to fully utilize the trade preferences. The trade chapter in the Compact Agreement is devoid of a development dimension and this should be integrated into the agreement to maximize the benefits to the private sector.

Furthermore, most trade agreements now cover services and a comprehensive trade in services agreement needs to be added to the US-FSM trade relations in order to assist FSM to participate actively in trade in services. For FSM to benefit fully from the labour agreement that it has with the US, there is a need for increased technical and financial assistance to develop technical and vocational training institutions in areas such as health, tourism and construction. This will facilitate the movement of people to the US and enable them to take skilled jobs and earn remittances. These remittances can be used to develop the FSM economy and this has the potential to fuel private sector growth and development. However, FSM needs to put in place measures to collect data on remittances and to encourage the use of remittances for productive purposes.

In order to promote private sector development and export capacity, some of the issues raised above need to be addressed urgently. There is a need for the US to provide technical and financial assistance in the form of Aid for Trade. Some of the technical assistance can be provided into FSM directly and other assistance can be provided by institutions that can be based in one of the Freely Associated States, hence the need to talk to Palau, the Republic of Marshall Islands (RMI) and other US territories to enhance cooperation on trade and private sector development.

The trade relations with the US should be strengthened to include the Aid for Trade component which will assist the FSM to develop its production and export capacity. The key issues that need to be addressed and funded under the Aid for Trade funding mechanism include:

- technical and financial assistance to implement the trade policy;
- assistance to develop trade in agriculture and fisheries with a focus on value addition;
- technical and financial assistance to upgrade the tourism infrastructure and market tourism in the US;
    - assisting local operators to meet demands and needs of US tourists, including product development and training to required standards of service provision;
    - training in management of environmental impact of new tourism products developed for the US market;
- technical and financial assistance to upgrade vocational education training institutions targeting those sectors with a potential for exports such as health, construction and tourism;
- assisting FSM to negotiate better transportation arrangements with Continental or other US Airlines to ease transportation problems;
- entering into arrangements with the US including its territories to assist exporters to meet technical standards and requirements such as SPS and TBTs;
- assisting the private sector to address supply side constraints and to build their capacity to trade;
- providing loans to SMEs at reasonably affordable rates;
- establishing export promotion agencies that are responsible for assisting exporters to meet standards and other technical requirements in export markets;
- assisting FSM to carry out regulatory reforms that are required as preconditions for opening up the services sectors and also to enhance competition and effective delivery of quality services;
- strengthening competition and intellectual property regimes;
- assistance to supply institutional markets in the US (e.g. the military where FSM citizens are serving);
- deepening the US-FSM trade relations by removing restriction on canned tuna in oil and textiles through:
    - relaxing rules of origin-CTH approach;
    - giving adjustment assistance to Yap State which was affected by loss of preferences in the textiles industry;
    - expanding the agreement to cover trade in services.

All the activities listed above require an injection of financial and technical assistance in order to promote private sector development.

Another equally important issue is the need for FSM to discuss the Most Favored Nation (MFN) treatment provision in the Compact Agreement and assess its impact on FSM if it decides to sign a goods agreement with the EU. FSM should negotiate with the US on *whether* or *how* the MFN provision shall be applied. If the US applies the MFN provisions in their strict form, FSM will loose a lot of revenue from US imports and this will severely derail economic growth and private sector development. Since FSM does not have major trade with the EU (average imports from the EU constitute about $279,740 whilst those from US constitute more than 50% of total imports), the US should consider granting FSM an MFN exemption to allow it to conclude a trade in goods agreement with the EU. The trade in goods agreement with the EU will not affect the US exports since the EU is a distant supplier.

Another important issue that needs to be addressed is the trade and tax incentives that were abolished by the US. In 1986, the U.S. Congress passed enabling legislation to put into effect the Compact of Free Association between the U.S. and FSM. The first Compact Agreement had incorporated a number of provisions that would have given FSM special tax and trade concessions that were meant to serve as the engine for economic growth and stimulate private sector development. Unfortunately, the U.S. Congress, in the process of authorizing programs and funding levels that were part of the agreed Compact, deleted or modified a number of those provisions. In this process, Section 254 of the original Compact agreement which would have provided American taxpayers an exemption of all U.S. income taxes if they resided in the FSM for 183 days per year and paid FSM taxes was modified. This provision would have provided a powerful instrument for economic growth as some US citizens would have moved to the FSM to enjoy its climate while benefiting from a tax "holiday" in the U.S.

Equally important is the deletion of section 936 of the US Internal Revenue Services Act, which provides for tax credit to US companies. This is the main provision that has enabled the canneries in American Samoa to survive. By changing the FSM from the status of a US possession to a freely associated state, FSM also lost some of the trade benefits which are enjoyed by US possessions such as American Samoa and was never fully compensated for this loss.

It is patently clear that FSM has suffered major losses as a result of the deletion or modification of trade and tax provisions. According to a study that was conducted by Donald E. Dembowski from Development Associates, it is estimated that the loss that FSM suffered as a result of this is about $95 million and the US has provided only $20 million to the Investment Development Fund (IDF) to compensate for the loss. This amount has already been exhausted; however, the US indicated that upon a showing of additional adverse financial and economic impact, an additional $40 million could be provided. The $40 million under the IDF has been authorized and should be used to support trade capacity building with a particular focus on the private sector.

Since the money is aimed at compensating the losses that FSM suffered as a result of the deletion of the trade and tax benefits, the IDF money should be used for trade-related activities which are meant to support private sector development and building their capacity to trade and attract foreign investment. These activities include:

- securing the investments needed to expand the country's capacities to produce competitively traded goods and services and to market them internationally as provided in the FSM trade policy as briefly articulated above;
    - this could be accomplished through the promotion of small and medium scale joint venture undertakings between private FSM and U.S. business

firms and through the establishment of trade-related, financial, technical training institutions in the tourism, fisheries, and agricultural sectors.

The assistance that is sought under the IDF should be over and above the assistance that is provided under the Aid for Trade facility. The trade assistance under IDF can be converted into to Aid for Trade. The Aid for Trade should be over and above the Compact funding and grants that the US provides to FSM.

If the above actions are taken, they can go a long way in promoting private sector development and the capacity of FSM producers to produce goods and services that can compete effectively in the global market. This will assist FSM to meet its ultimate objective of sustainable economic growth, development and self reliance. The US and FSM must consider negotiating something akin to the Economic Partnership Agreement but with a major development component since the US is a closer partner than the EU. This will compliment the SDP goals and the overall US objectives of ensuring that FSM achieves sustainable economic growth, development and become less dependent on aid.

### 5.4 The Pacific Agreement on Closer Economic Relations (PACER)

PACER is an arrangement between the Forum Island Countries (FICs) on one hand and Australia and New Zealand on the other. It is not a free trade agreement, but provides financial and technical assistance for FICs to implement PICTA. The assistance provided focuses mainly on trade facilitation and promotion, capacity building and structural adjustment. FSM has not yet signed PACER.

PACER also contains provisions for future trade negotiations between FICs and Australia and New Zealand (ANZ) including economic and technical assistance to help FICs implement trade liberalisation measures and facilitate "adjustment". The overall goal of PACER plus is to facilitate sustainable development in FICs. The parties seek to gradually and progressively establish a single regional market, which includes Australia and New Zealand. This will assist the FICs to integrate into the global economy. PACER envisages the negotiation of Forum-wide trade arrangements 8 years after PICTA enters into force (2011). However, if FICs enter into free trade negotiations with developed countries (e.g. EPA) they are required to enter into consultations or free trade negotiations with ANZ. It should be noted that Fiji and PNG have already signed an Interim EPA Agreement and this has triggered PACER consultations.
FSM has fairly significant trade with ANZ. Total imports from Australia (average 03-05) amount to $6,428,865 and the total duty collected is about $284,022. If FSM liberalizes about 80% of tariff lines (12% of the value of its trade) with Australia, it will loose about $25,024 in tariff revenue. Imports from New-Zealand amount to $1,113,588 and the duty collected amounts to $38,353. If FSM liberalizes about 80% of its tariff lines and (30% by value of its trade) with New-Zealand, it will loose about $6,729. Total revenue loss from PACER will be estimated to be $31,753. Alternatively, if FSM liberalise 80% of its tariff lines (19% of the value of trade) it will loose about $40,686. If 85% of tariff lines and (35% by value) is liberalized with new-Zealand about $7,123 will be lost. Total revenue loss from PACER will be estimated to be $47,809.

Since the revenue loss from ANZ is not huge, it is recommended that if PACER consultations begin, FSM should participate as an observer and if the outcome of the negotiations is favourable to its needs, it can sign the agreement.

However, it should be noted that fish exports to ANZ have been negligible mainly because of strict SPARTECA rules of origin, the fact that the MFN rates on fish products are already low (5%) , and ANZ have entered into a free trade agreement with Thailand a major exporter of fish.

## 5.5 Japanese Market

The Japanese market is a good market for agricultural products, tourism and fisheries. However, with regards to fisheries, it is important to note that the Japanese tuna fleet has been declining but it remains the most important in the Western and Central Pacific Ocean (WCPO) and it catches more tuna in the WCPO than any other country. The best market is the sashimi market and the average price for fresh big eye and yellow fin since 2003 have been good. However, it should be noted that Japan has introduced its own strict version of Hazard Analysis and Critical Control Point (HACCP) and this may impact exports particularly from small island countries like FSM.

The katsuobushi market (premium) for boiled, dried, smoked, and fermented skipjack (or bonito) is another big market which uses about 67% of the Japanese purse seine catch but there is limited opportunity for expanding katsuobushi exports from PICs beyond Soltai's existing market.

It should also be noted that 65% of domestic canned tuna demand is met by production in Japan (100,000mt of final product per year) and 35% of canned tuna is imported mainly from Thailand and the market share of domestic canneries has declined by 14% since 1998 because of cheaper product from Thailand. Japan's market for canned tuna has remained stagnant at around 100,000mt per year for 20 years and only 10% of the volume of tuna consumption in Japan consists of canned tuna. The Japanese canning tuna industry was initially established with government encouragement as an export-orientated industry to supply the US market, but Japanese canneries no do not export any canned tuna because they are no longer cost-competitive on international markets. In an attempt to overcome high operating costs, the canning industry is increasingly utilising imported frozen loins, which is the same approach of tuna canneries in France, Italy, the US and (increasingly) Spain.

Japan's tariffs are very low. It imposes a 3.5% import tariff, which applies to all imports of fresh and frozen tuna, and a 9.6% tariff on most types of canned tuna. Worse still, internal taxes and charges total 14-15% of the fish price. Japan has never applied its GSP to non-processed tuna and its GSP for canned tuna offers very limited commercial utility to PICs - only 2.4% lower than the MFN. The logical conclusion is that there is less room for a cannery based in FSM to supply the Japanese canned tuna market or to improve the preferences.

## 5.6 Economic Partnership Agreement (EPA)

The Cotonou Partnership Agreement which was signed in 2000 is an international agreement between 27 members of the European Union (EU) and the 79 members of the African, Caribbean and Pacific (ACP) group. The agreement covers development assistance, trade and political relations between the EU and ACP countries. The relationship between the EU and ACP countries dates back to 1963, however, the ACP group was formalised in 1975 and this relationship was governed by a series of Lome Conventions. The Lome Conventions provided non-reciprocal trade preferences to ACP countries and were found to be inconsistent with WTO rules because they discriminated against other developing countries. The EC and ACP countries applied for a WTO waiver to maintain the preferences until December 2007. This is the main reason why the Cotonou Agreement was negotiated. It seeks to usher in a new trade relationship based on reciprocity and which is also WTO compatible while giving the desired flexibilities to ACP countries. This will take the form of an Economic Partnership Agreement. Negotiations on EPAs started in September 2002 and the Agreement is supposed to enter into force in 2008.

The first objective of EPAs is to foster smooth and gradual integration of ACP states into the world economy, taking into account their development priorities. The ultimate goal is to promote sustainable development and eradicate poverty. The second one is to enable ACP states to play a full part in international trade, especially in multilateral negotiations and to help them manage the challenges of globalization thereby facilitating their transition to the liberalized global economy. The third one is to enhance the production, supply and trading capacity of ACP sates and their capacity to attract investment thereby creating new trading dynamics; strengthening trade and investment policies and the capacity of these countries to deal with trade-related issues. The fourth one is to ensure that the economic and trade cooperation is implemented in full conformity with WTO rules, including special and differential treatment taking into account the different levels of economic development. The Cotonou Agreement also makes it clear that EPAs must promote regional integration.

The EPA is envisaged to cover key issues such as trade in goods, services, investment, fisheries and development. The EU is also pushing for the inclusion of other trade-related issues such as competition policy, intellectual property rights, government procurement and trade facilitation. FSM should not accept binding rules on these trade-related issues as they may pose enormous costs. FSM already has recommendations on how to address these issues unilaterally. There are also very few benefits of signing a trade in services agreement if the EU does not agree to the regional needs on temporary movement of people and the related technical and financial needs needed to upgrade vocational schools.

### (a) Trade in Goods

A trade in goods agreement will cover agricultural, forestry, fisheries and manufactured products. FSM does not export major products to the EU and its imports are also very minimal. If FSM wants to benefit from the liberal rules of origin (global sourcing) including those in fisheries, it will be required to sign a trade in goods agreement. The advantage of signing a goods agreement is that FSM will have an opportunity to venture into value addition in agricultural products and process tuna, which can be exported to the EU market under favourable rules of origin.

The fact that FSM does not have major trade with the EU means that the impact of competition from the EU and loss of tariff revenue will be minimal. The total value of imports from the EU is about $279,740 (03-05 average) and the average duty collected is about $11,759. If FSM liberalizes 80% of the value (and tariff lines) of its trade with the EU, the indicative duty lost from the EU will be $8,440 whilst the duty lost from the US because of FSM's Compact obligations will be $165,756. This will be the likely outcome if FSM considers revenue consequences only. Most of the revenue will be lost after 10 years from signing EPA (see Scenario A).

Table 38

| Scenario A (Revenue Consequences) | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | **Value of imports** | **Duty collected** | **Share of avg total imports excluded from liberalization** | **% of national tariff lines excluded from liberalization** | **Total Duty Kept (value)** | **Total Duty Lost (value)** | **Total Duty Lost (%)** | **Duty Lost - Yr 0 [Cat A]** | **Duty Lost - Yr 6 [Cat B]** | **Duty Lost - Yr 6-10 [Cat C]** | **Duty Lost - Yr 6-15 [Cat D]** |
| EU | 279,740 | 11,759 | 20% | 20% | 3,318 | 8,440 | 72% | 7 | - | 5,702 | 2,738 |
| Aus | 6,428,865 | 284,022 | 88% | 20% | 258,998 | 25,024 | 9% | 60 | - | 11,668 | 13,356 |
| NZ | 1,113,588 | 38,353 | 70% | 20% | 31,624 | 6,729 | 18% | 12 | - | 5,208 | 1,521 |
| USA | 39,686,914 | 3,319,640 | 89% | 20% | 3,153,885 | 165,756 | 5% | 2,441 | - | 57,212 | 108,208 |
| PACP | 1,857,922 | 43,512 | 88% | 20% | 41,796 | 1,717 | 4% | 18 | - | 253 | 1,455 |
| ANZ | 7,542,453 | 322,375 | 85% | 20% | 290,622 | 31,753 | 10% | 72 | - | 16,876 | 14,877 |

However, if FSM excludes products such as fish, textiles and footwear, agricultural products, wooden products and other products that FSM may be able to produce in future, the revenue loss from the EU is likely to be $8,298 and $ 256,022 from the US. It is recommended that this scenario be adopted because it gives FSM wider policy space in terms of future trade policy and the tariff incentives and protection that FSM may want to give to investors and local producers. The revenue loss may be recovered by a comprehensive tax reform.

FSM is recommended to adopt scenario B. In order to avoid the loss of revenue from US imports, FSM may consider requesting the US to exempt it from the MFN Compact obligation. However, the more realistic approach for FSM is to reform its tax structure to minimise revenue loss. The Constitutional issues surrounding the tax reform will need to be sorted out sooner rather than later. States will benefit from new market access potential in the EU which has the possibility of attracting foreign investors in the tuna processing sector and a successful tax reform will bring in more revenue.

Table 39

**Scenario B (Revenue Consequences and Industry Protection)**

| | **Value of imports** | **Duty collected** | **Share of avg total imports excluded from liberalization** | **% of national tariff lines excluded from liberalization** | **Total Duty Kept (value)** | **Total Duty Lost (value)** | **Total Duty Lost (%)** | **Duty Lost - Yr 0 [Cat A]** | **Duty Lost - Yr 6 [Cat B]** | **Duty Lost - Yr 6-10 [Cat C]** | **Duty Lost - Yr 6-15 [Cat D]** |
|---|---|---|---|---|---|---|---|---|---|---|---|
| EU | 279,740 | 11,759 | 20% | 20% | 3,460 | 8,298 | 71% | 83 | 4 | 5,169 | 3,153 |
| Aus | 6,428,865 | 284,022 | 81% | 20% | 243,336 | 40,686 | 14% | 2,775 | 233 | 21,952 | 15,990 |
| NZ | 1,113,588 | 38,353 | 65% | 20% | 31,230 | 7,123 | 19% | 298 | 27 | 1,271 | 5,542 |
| USA | 39,686,914 | 3,319,640 | 83% | 20% | 3,063,618 | 256,022 | 8% | 8,617 | 2,536 | 110,855 | 131,321 |
| PACP | 1,857,922 | 43,512 | 83% | 20% | 38,961 | 4,551 | 10% | 213 | 184 | 1,555 | 2,384 |
| ANZ | 7,542,453 | 322,375 | 79% | 20% | 274,566 | 47,809 | 15% | 3,073 | 260 | 23,223 | 21,532 |

**(b) Services**

Services negotiations are based on the General Agreement on Trade in Services. There will be a general agreement with basic disciplines and obligations that apply to the parties and a schedule of specific commitments where countries use a positive list approach to identify the services sectors that they want to liberalize and the restrictions that they want to impose on market access or national treatment. The agreement also allows parties to regulate services. However, it is important for FSM to identify all the restrictions that it wants to put in place and the conditions that can be imposed. The agreement is required to be compatible with the WTO, meaning that there should be substantial sectoral coverage without excluding *a priori* any sector or mode of supply. There are also flexibilities that are allowed for developing countries.

The services sector is another area where FSM stands to benefit from EPAs. Most of the services sectors have been discussed above under the services section and FSM has submitted its draft demand and offer to the EU. FSM has offered to open the tourism sector (hotels and restaurants), air transportation, financial services (banking and insurance) and selected business services. Other sectors that FSM has in the fallback are maritime transportation, construction and communication services. Opening up sectors such as, maritime transport, telecommunications (initially internet and mobile phones), the financial sector, some high value and capital intensive tourism activities have potential benefits to the economy. On the demand side, FSM has requested the EC to provide technical and financial assistance to strengthen key infrastructural services sectors, to upgrade its technical and vocational education training schools and put in place the right regulatory framework which takes into account social equity, environment, cultural sensitivities and sustainable development. FSM needs technical and financial assistance from the EC to ensure that the right regulatory regime is put in place before liberalization and also to ensure that FSM develops the capacity to export services such as tourism, mode four and other services where FSM can develop capacity export to the EU.

**(c) Fisheries**

FSM has already signed a bilateral Fisheries Partnership Agreement with the EU. Under EPA, the Pacific ACP initially proposed a Multilateral Fisheries Partnership Agreement (MFPA) with the EU but the EU made it clear that it was not interested in the MFPA. The current version is now a watered down fisheries chapter which has very little value but may be of symbolic importance.

FSM has requested development assistance to develop the fisheries industry to enable FSM to benefit from its tuna resources. Rather than relying on access fees, FSM should move towards processing the fish and export them to the EU market. There is also a need for assistance to enable FSM producers to meet EU standards. A competent authority responsible for testing and certifying products needs to be established urgently.

The EU is one of the biggest single markets for tuna. It is important to note that the US market is stagnant and the Japanese market is in decline. Around 90% of total tuna catch by the EU is by Spanish and French vessels and only few Spanish purse seine fleets are active in the WCPO. The most important tuna canning countries in the EU are Spain, Italy and France and production in France and Italy has been relatively stable since the mid-1970s, whereas canneries in Spain have experienced considerable growth and it supplies most of the tuna but imports a marginal amount of canned tuna. These canneries survive mainly because of tariff protection. The tariff for fresh/chilled fish fillets (0304) is 15% (GSP 14.5%) and frozen fish fillets is 18 % (GSP 14.5). For prepared and preserved tuna in oil (1604), not in oil, in pouches, tuna loins for use under 1604, the MFN tariff is 24% whilst the GSP rate is 20.5%. These tariffs offer huge preferential margins for ACP countries but the WTO mediation culminated in the allocation of a quota of 25,000mt of canned tuna at 12% to Thailand, Philippines and Indonesia in early 2003 and the current negotiations at the WTO threaten to erode such preferences.

The EU production is declining but there is a booming market in the EU for tuna loins classified under the HS code as ‘for further processing under 1604’ (i.e. to be canned- 0%

universally), which are categorized under a different tariff chapter heading than tuna fillets for direct human consumption. In general terms, exporting tuna to the EU remains a viable economic endeavour because the market volume is very large and it is continually increasing. In fact, canned tuna consumption in the EU is the driver for the global purse seine and tuna canning industries as consumption is stagnant in Japan and has declined in the US. Compared to the US, canned tuna is a relatively high value product in the EU and has consistently fetched a higher aggregated retail price than in the US. There is also a growing (albeit niche) market in the EU for tuna fillets and steaks for direct human consumption, partial reprocessing or even simple repackaging under tariff headings other than Chapter 1604 (i.e. tuna imported as frozen or fresh fillets under tariff heading 0304).

Despite declining demand by EU-based canneries, the average price for imported frozen tuna in the EU has risen significantly since 2 000. The export of whole round fresh chilled tuna from PICs to markets in the EU is unlikely to ever prove a fruitful avenue because of high airfreight costs and poor connections.

From the discussion above, it is patently clear that the canning industry in Japan is no longer exporting, there is only one canning plant left in the US and the EU canneries are facing high operational costs and are shifting towards importation of loins rather than whole tuna. The tariffs which protect these industries are being threatened by the WTO negotiations and the preferences that are given to ACP countries are also facing inevitable erosion. This raises an important question for FSM; in light of the fact that canneries in major developed countries are loosing competitiveness to Thailand and other low cost producers in South America; will FSM be able to develop long-term competitiveness and survive after the preferences are gone? This is a question that FSM should bear in mind when assessing potential investors to ensure that genuine investors are allowed to operate and develop long-term competitiveness to avoid what happened in the garment industry in Yap and globally when textiles preferences expired.

### (d) Investment

FSM needs a lot of assistance to improve the investment climate in all the four states. FSM's ranking is poor and some regulatory reforms are necessary. The investment regime must focus on protecting the rights of investors and their investments and these needs to be balanced with the right of the governments to regulate investment to meet public policy objectives. The need to reform EU investment institutions to make them more friendly and accessible to SMEs is also a key issue for the FSM. The European Investment Bank (EIB) and the EU Centre for Development of Enterprises (CDE) are essential for supporting SME development. However, the EU is not interested in negotiating a separate investment agreement and wants investment to be included under trade in services.

### (e) Adjustment assistance / Aid for Trade

Adjustment assistance will be required to assist FSM to adjust to the liberalisation shocks and also to implement the various agreements and make the necessary regulatory reforms. Aid for trade is also needed to assist FSM to address its production and supply side constraints. Without a comprehensive package on adjustment assistance and aid for trade, EPA would be a meaningless agreement. All the stakeholders must identify their needs and priorities to ensure that their requests for technical and financial assistance are included in the EPA negotiations. FSM should also ensure that the commitments on aid for trade or adjustment assistance are couched in legally binding language and implementation of the agreements should be contingent on provision of such assistance. If technical and financial assistance is not forthcoming, FSM should not be required to implement the agreements.

A Commonwealth Secretariat study by Milner (2005) estimated that the ACP wide adjustment costs would be 9 billion euros and the PACPs costs were estimated to be 642 million euros. For FSM, the costs were estimated to be 51 million euros. Another United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) study by Smith estimated the adjustment costs over a five year period to be about 170 million euros for the Pacific and 8 million euros for FSM. Another study that was conducted by Robert Scollay in 2007 estimated the PACP costs to be about €159,621,250 and €22,035,000 for FSM. This funding will be required for trade policy, developing the fisheries sector, regulatory regimes and national competition authorities, human resources development and mode four assistance, investment promotion and protection, and the facility to reduce the cost of capital for SMEs, laboratory and meeting EU standards.

The funding will come from the Pacific Regional Indicative Programme (PRIP)-EDF 10. The two focal sectors that have been identified for funding under EDF 10[25] are Human Resources Development (€40 million) and Sustainable Management of Natural Resources (30 million). In addition to this, there is also a non-focal sector (€6.2 million) and an incentive tranche (€19 million). This will bring the total amount of funding available under the EDF to €95 million. The EC member states have also agreed to provide additional resources under the Aid for trade Strategy and PACP requested that they be given at least their historic share of aid which translates to about €25 million per year. However, given the amount of resources needed to implement EPA and to enable FSM to benefit from the agreement more resources will be needed. The EU has also indicated that all the funding will come through under the EDF and no additional funding will be provided.

### 5.7 The World Trade Organization (WTO)

FSM is not a WTO member but other Island countries such as Fiji, Papua New Guinea, Solomon Islands and Tonga are WTO members. Other countries that are acceding to the WTO are Vanuatu (since 1995) and Samoa (since 1998). Since accession is a long term process, FSM should consider conducting a diagnostic study on the costs and benefits of accession.

The advantages of joining the WTO include:

- benefiting from the technical and financial assistance programmes for small and vulnerable economies;

[25] Other sectors such as fisheries, tourism, ICT, environment, human resource development etc… were considered to be cross-cutting issues and would form part of the two focal areas.

- participating in multilateral negotiations and shaping global trade rules to suite the needs of small Islands,
- trade policy review mechanism, which reviews its trade policy environment and recommends best practices for reform;
- locking in commitments, which gives certainty and predictability to traders; and
- market access to WTO members.

In general, the costs of adjustment will be minimal since FSM's tariffs are already low. If FSM signs EPA it would have adopted most of the WTO obligations but without the corollary rights. FSM's trading partners are already WTO members and have already adopted trade policies that in one way or the other influence FSM even though FSM is not a WTO member. Some of the costs of negotiating and participating can be met by the WTO technical assistance programmes and donor agencies. FSM will also get an opportunity to participate in the WTO trade policy training programmes, which will assist the country in shaping its trade policies and building its capacity to trade.

# 6 SECTION SIX: RECOMMENDATIONS AND IMPLEMENTATION

Implementation of the Trade Policy must be based on a realistic and doable strategy to minimize difficulties in the implementation phase. It could be based on three pillars. The first pillar would be a fast track based on full utilization of the current market access arrangements. The second phase would be a short term component integrated into the SDP for developing export-oriented industries to fully exploit not only the current markets but also new niche markets. The third one would be a medium to long term export based industrialisation strategy. The three strategies can be launched in tandem. The main issues in each phase would be to build the supply side production and export capacity to produce competitive goods and services, and full exploitation of the markets access that FSM has for goods and services. The first objective focuses on domestic trade policy in a narrow sense and the latter on international trade negotiations under PICTA, EPA, PACER, US and WTO. The third pillar focuses on an independent dimension of trade policy; which is institution building throughout all the phases of intervention and this will enable integrated design, implementation, coordination and monitoring of FSM's trade policy. The following matrix can be used to illustrate the implementation of this trade policy framework.

Table 40

| | Supply side Policies | Market access and Entry policies | Trade policy Institution Building |
|---|---|---|---|
| **Fast track recommendations** | Establish Adjustment Facility (EPA facility) | Exploit existing market access opportunities (utilise preferences) | Trade policy institution Building |
| **Short term (5years ) recommendations** | Support export oriented and import-substitution industries | Improve market access and entry for key potential products and services through regional and multilateral negotiations | Capacity Building programme for trade policy formulation, negotiations and implementation |
| **Medium to long-term recommendations** | Institute enabling policy environment for manufacturing and services | Increase market access and entry through positive measures. | Sustainable capacity in trade policy formulation, negotiations and implementation. |

The first pillar focuses on supply side polices under fast track and seeks to strengthen the production and trade performance by finding new or expanding existing markets of key export products in agriculture, fisheries and tourism. The idea is to concentrate on quality and reasonable volume to fill the containers. Tourism potential can be expanded. The structural adjustment facility can be created to fund selected export oriented industries to improve production efficiency and outputs, to conduct negotiations and marketing to find new markets. The SAF can be used for fast track recommendations. It can initially be funded by donors and eventually by exporters. FSM should work with the PITIC trade missions in the US, China and one should be established in the EU.

The second pillar is embedded in the SDP which seeks to promote the agriculture, fisheries and tourism sectors. Agriculture is both for food security and exports. The main service sector is tourism and export of skilled and lower skilled labour. Policies must be put in place to support production in huge quantity and good quality to ensure that the products become competitive in the international markets. FSM needs to boost its negotiating capacity to derive meaningful benefits from trade negotiations. There is a need to put in place mechanism for national consultations and follow up of trade issues and training of skilled trade negotiators. Support is also needed for import substitution industries. The continued existence of these industries is important because they provide employment and pay tax.

The third pillar can be implemented simultaneously with the first two. This focuses on creating an enabling policy environment for manufacturing and semi-manufacturing industries including SMEs, prioritizing value addition of many FSM products. Incentives must be made available to those industries using a substantial portion of local inputs. The main focus is on identifying and developing manufacturing base in FSM for the domestic and export markets. The development of the services sector is also important especially infrastructural services and tourism.

The trade policy must be implemented within a wider development policy which is the SDP and all the other social issues need to be taken into account because these may derail even the limited development that may have taken place. It is important for the trade policy to be integrated into a wider development strategy. Issues such as population growth, environment and health need to be addressed. Trade facilitation, especially supporting transportation networks, financing facilities for SMEs, small cottage industries and agricultural extension to improve production and output should be encouraged.

FSM needs to take stock of the skills that it needs and address the labor supply issues affecting production. The trade policy must also be linked to the Millennium Development Goals (MDGs). The public sector reform must continue to ensure that FSM develops trade policy formulation capacity. Other issues such as unemployment problems affecting mainly the youths and women should also be prioritized.

A monitoring mechanism should be established at the official's level and at the highest policy level. There is a need to assess progress on an annual basis and propose remedial action. FSM should mobilise international support for the endogenous capacity building project on trade. The capacity of the Trade and Investment Division to function effectively must be strengthened. Support may be sought from donors to develop institutional and human resources development in order to enhance institutional capacity in trade analysis, trade policy formulation, trade negotiations and supply capacities. Government personnel handling trade should be trained in trade negotiations and such training must also be conducted in selected tertiary institutions. Full recommendations are contained in Annex 2.