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Regional Trade Agreements and Developing Countries: the Case of the Independent Pacific Island States

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Programme

Introduction: Jean-Michel Debrat (AFD) and Pierre Brunhes (Ministry of Overseas Territories)

Morning: Macroeconomic dynamics and their social outcomes

Session 1: The catching up process of the French Overseas territories
Chairman: Alain Vienney (President of the IEDOM-IEOM)

"Overseas Territories: outcomes and challenges", Jean-David Naudet (AFD)
"Job creations, unemployment and skills shortage in the French Overseas Territories" Vincent Hecquet (INSEE DIRAG) and Claude Parain (INSEE Réunion)
"A comparative macroeconomic analysis of the Outermost Regions", Olivier Sudrie (University of Versailles Saint-Quentin en Yvelines)
Debate

Session 2: Challenging a sustainable growth for the Island economies
Chairman: Jean Gaillard (INSEE Réunion)

"Macroeconomic disequilibria and public transfers", Philippe Jean-Pierre (University of La Réunion, CERESUR)
"Innovation and openness: the case of La Réunion", Guy Dupont (Development Agency of La Réunion)
Debate

Afternoon: Small islands integration in their regional market

Session 3: What role for regional organisations in the opening process?
Chairman: Jacques Wunenburger (DG Trade, European Commission)

"The regional integration: opportunities and challenges for the French Overseas Territories", Jean-Michel Salmon (University of Antilles-Guyane)
"Regional trade agreements: the case of the Pacific Islands, Robert Scollay (Associate Professor & Director of APEC Study Centre, the University of Auckland Business School)
"Competitiveness and insularity", Bernard Poirine (Papeete University)
Debate

Session 4: What are the comparative advantages of the Overseas Territories?
Chairman: Fred Célimène (Pr. Université Antilles-Guyane)

"The challenge of transport and tourism: the Polynesian example", Christian Vernaudon (CEO of Air Tahïti)
"Nickel and environment in New Caledonia", Pierre Alla, (CEO of the SLN)
"Biodiversity and French Overseas Territories", Jean-Philippe Palasi (UICN)
Debate

Closing session: Pierre Jacquet, AFD Chief Economist

What is “CEROM”?

Due to their historic, geographic and political specificity, the macroeconomic dynamics of French Overseas Territories are largely driven by the distant mother country. As a consequence, specific methodologies, data and surveys are required for their analysis. In 2003, seven institutions - the Agence Française de Développement (AFD), central banks of French Overseas Territories (IEDOM, IEOM) and local statistics offices (INSEE, ISPF, ISEE, SPPE) - have decided to take up this challenge by developing the CEROM partnership in order to provide economic data (among which economic accounts) and macroeconomic surveys on French Overseas Territories.

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Foreword

The present paper corresponds to Robert Scollay's contribution at the conference organized by Agence Française de Développement with its CEROM partners on 26 June 2007 in Paris (Maison de la Chimie) on the topic: "Opening the French Overseas Territories for a sustainable growth?"

Agence Française de Développement would once again like to extend its gratitude to the author and to all the speakers and participants who contributed to the success of this conference.

Analyses and opinions in this article reflect the point of view of its author and do not necessarily reflect the official position of Agence Française de Développement.

AFD has also produced other publications based on this event:

- "Opening the French Overseas Territories for a sustainable growth?", summary of debates at the 26 June 2007 conference.
- "French Overseas Territories: macroeconomic disequilibria and transfers", Philippe Jean-Pierre, Working Paper n° 51;
- "Remoteness, insularity and competitiveness", Bernard Poirine, Working Paper n° 52;
- "Why open up? Constraints and prospects for French Overseas Territories", Jean-Pierre Salmon, Working Paper n° 53.

These publications are available on AFD's website: http://www.afd.fr

Introduction

There are 14 Forum island countries (FICs): the Melanesian states of Papua New Guinea, Solomon Islands and Vanuatu; the Micronesian states of Federated States of Micronesia, Kiribati, Marshall Islands, Nauru and Palau; the Polynesian states of Cook Islands, Niue, Samoa, Tonga and Tuvalu; and the hybrid Polynesian/Melanesian state of Fiji, which also has a large Indian population. All 14 of these states are members of the Pacific Islands Forum, which also includes as members Australia and New Zealand. The latter have strong traditional ties with the Melanesian and Polynesian FICs (including Fiji) in particular.

The Pacific Islands Forum (formerly the South Pacific Forum) provides a vehicle for cooperation among the FICs themselves, and between the FICs and Australia and New Zealand, the two developed countries of the South Pacific. There is a somewhat uneasy balance, or tension, between these two roles. The Forum Secretariat provides the FICs with technical and administrative support. For the FICs the Forum is both an expression of the social and cultural linkages extending far back into their history, and a means of renewing, strengthening and deepening those linkages, as well as building a foundation for closer economic relationships with each other and with other partners.

1. Economic and Trade Characteristics of the Pacific Island States

1.1. Selected Economic Indicators

These 14 independent Pacific Island nations occupy islands scattered across an area of ocean that measures 7,000 kilometres from east to west and 4,000 kilometres from north to south. Table 1 lists these fourteen countries, ranked first by population and then by GDP, the latter statistic indicating the economic size of the market represented by each FIC.

Salient points to note from Table 1 are:

- Papua New Guinea, with a population of 5.7 million, accounts for just under three-quarters (73%) of the total FIC population of almost 8 million.
- The four Melanesian FICs – Papua New Guinea, Fiji, Solomon Islands and Vanuatu – are the most heavily populated of the FICs, together accounting for 92% of the FIC population.
- Samoa and Tonga together account for just 3.6% of the total FIC population.
- Five FICs (Cook Islands, Nauru, Niue, Palau and Tuvalu) have populations of less than 25,000, with the smallest of these, Niue, having a population of less than 2,000.
- A further three FICs (Tonga, Kiribati and Republic of the Marshall Islands) have populations between 25,000 and 100,000.
- Papua New Guinea and Fiji are by far the largest FIC economies, accounting respectively for 49% and 28% of total FIC GDP. The four Melanesian FICs together account for 84% of total FIC GDP.
- Total FIC GDP is just over 10% of New Zealand's 2004 GDP.

Table 1: Population and GDP of Forum Island Countries (c. 2004)

	Population ('000)		GDP (US$ million)	% of total FIC GDP
Papua New Guinea	5,695	Papua New Guinea	4,246	49.3%
Fiji	836	Fiji	2,433	28.3%
Solomon Islands	460	Samoa	392	4.6%
Vanuatu	216	Vanuatu	317	3.7%
Samoa	183	Solomon Islands	258	3.0%
Fed. States of Micronesia	113	Fed. States of Micronesia	226	2.6%
Tonga	98	Tonga	182	2.1%
Kiribati	93	Cook Islands	172	2.0%
Marshall Islands	55	Palau	129	1.5%
Palau	21	Marshall Islands	122	1.4%
Cook Islands	14	Kiribati	77	0.9%
Nauru	10	Nauru	35	0.4%
Tuvalu	10	Tuvalu	20	0.2%
Niue	2	Niue	2	0.0%
Total	7,805	Total	8,610	

Source: UNESCAP

- Three Polynesian FICs (Samoa, Tonga, and the Cook Islands) account for 8.6% of FIC GDP, a significantly larger share than their share of population.
- The three former US trust territories in Micronesia (Federated States of Micronesia, Marshall Islands, and Palau) together account for 2.4% of total FIC population and 5.5% of total FIC GDP.

Papua New Guinea is also by far the largest FIC by area, occupying 463,000 square kilometres, or 1.7 times the land area of New Zealand. The remaining thirteen FICs occupy hundreds of islands with a total land area of 65,000 square kilometres, or 14% of the land area of Papua New Guinea.

Table 2 provides estimates of FIC GDP per capita, calculated from the data in Table 1. Three of the smallest FICs (Cook Islands, Palau and Nauru) have the highest GDP per capita. The Cook Islands has easily the highest GDP per capita among the FICs. In all of the other 11 FICs, GDP per capita is below US$3,000, and in three of them it is below US$1,000. Fiji has the highest GDP per capita among the larger FICs, at US$2,910. Papua New Guinea, the largest FIC, has a lower GDP per capita than any other FIC except the Solomon Islands.

Five of the FICs (Samoa, Vanuatu, Solomon Islands, Kiribati and Tuvalu) are classified as least developed countries (LDCs) under the United Nations definition. Samoa is generally believed to be ready for graduation from LDC status. At the other end of the scale, Papua New Guinea would probably meet the United Nations criteria for LDC status, but political considerations dictate that it is unlikely to seek reclassification.

Table 3 shows that the FICs are heavily import-dependent, with import-to-GDP ratios of over 40% for all except the Marshall Islands. Their export orientation, in contrast, is much

Table 2: GDP per Capita of Forum Island Countries (US$, c. 2004)

Cook Islands	12,257
Palau	6,246
Nauru	3,485
Fiji	2,910
Marshall Islands	2,205
Samoa	2,145
Tuvalu	2,042
Fed. States of Micronesia	2,009
Tonga	1,852
Vanuatu	1,467
Niue	1,000
Kiribati	823
Papua New Guinea	746
Solomon Islands	561

Source: calculated from Table 1

Table 3: Trade Ratios and Visitor Numbers

	Ratio of trade to GDP (1996)		Visitor numbers (1995)
	Import	Export	
Cook Islands	42%	3%	47,899
Fed. States of Micronesia	60%	5%	
Fiji	48%	37%	318,495
Kiribati	67%	14%	2,653
Nauru	74%	17%	
Niue	50%		2,161
Palau	88%	10%	53,229
Papua New Guinea	57%	10%	
Rep. Marshall Islands	27%	39%	
Samoa	57%	6%	
Solomon Islands	54%	59%	2,072
Tonga	52%	8%	24,219
Tuvalu	82%	9%	922
Vanuatu	41%	13%	43,721

Source: Pacific Islands Forum Secretariat, Regional Support Strategy Document, 2002 more variable. Exports are a significant factor in the economies of Fiji, Solomon Islands and the Marshall Islands, but much less significant in many other FICs. Tourism development is largely confined to FICs with direct air links to major tourism markets, especially Fiji and, to a lesser extent, Cook Islands, Palau, Vanuatu, Tonga and Samoa.

1.2. Potential for Intra-FIC Trade

The wide variation in income per capita among the FICs could be taken as evidence of significant differences in the relative costs of labour and capital and in labour force skill levels, and might normally be taken as an indication of potential for mutually beneficial trade.

The summary data in Table 4 on the structure of production in a number of FICs, while admittedly somewhat dated, suggest however that this conclusion should not be too readily accepted. Production in these economies is dominated by the agriculture, forestry and fishing sector and services. Agriculture, forestry and fishing accounts for an especially large share of GDP in the Solomon Islands (41%), Samoa (40%) and Tonga (37%). In most other FICs, the share ranges from 15% to 27%. In Papua New Guinea, mining accounts for 27% of GDP and agriculture, forestry and fishing for 26%. The GDP share of agriculture, forestry and fishing is unusually low in the Marshall Islands (13%) and Palau (7%).

The services sector accounts for the largest share of GDP in most FICs. Services, excluding construction and electricity, gas and water, account for over 70% of GDP in Palau (81%), Kiribati (79%), Marshall Islands (75%) and Cook Islands (73%), and for between 50% and 70% of GDP in Tuvalu (67%), Vanuatu (64%), Fiji (54%) and Tonga (50%). The services sector share of GDP is relatively low in Papua New Guinea (33%) and Samoa (34%).

Manufacturing, in contrast, is not highly developed in most FICs. The GDP share of manufacturing is highest in Samoa (18%) and Fiji (15%), but the figure for Samoa is heavily skewed by a single large enterprise that exists solely to supply the Australian and New Zealand automotive industries, taking advantage of preferential access available under the South Pacific Regional Trade and Economic Cooperation Agreement. Papua New Guinea's manufacturing sector is small relative to the size of its economy (8% of GDP), but large relative to the size of the manufacturing sectors in FICs other than Fiji. In all other FICs for which data are available, manufacturing accounts for 5% of GDP or less. These data suggest that the range of manufactured goods likely to be traded between the FICs in a regional trade agreement is probably very narrow, with most of the supply potential residing in Fiji and, to a lesser extent, Papua New Guinea. The potential for trade in the agricultural, forestry and fisheries products that dominate FIC production structures tends to be inhibited by transport and quarantine problems, as well as by the fact that the FICs tend to produce similar products in these sectors.

The narrow production base in most FICs, taken together with the actual trade data in the following section, clearly indicates that intra-FIC trade is unlikely in the foreseeable future to account for more than a small share of total FIC trade, even if it were to increase substantially as the result of a free trade arrangement among the FICs. In addition to trade barriers, the low level of intra-FIC trade reflects the existence of other significant obstacles to this trade, particularly the high costs of transportation among the FICs, related both to their small size and to the large distances separating them from each other. Fiji is the main potential source of manufactured exports to other FICs, with Papua New Guinea being the only other FIC with potential for any significant manufactured exports to other FICs in the short term.

Table 4: Sectoral Composition of GDP (%)

	Cook Is	Fiji	Kiribati	Marshall Is	Palau	PNG	Samoa	Solomon Is	Tonga	Tuvalu	Vanuatu
Agriculture, forestry, fishing	21.0	19.4	17.4	13.3	6.8	26.5	39.9	41.3	36.8	23.9	22.7
Mining, quarrying	0.0	3.3	0.0	0.3	1.2	27.2	0.0	0.1	0.7	0.9	0.0
Manufacturing	2.6	14.8	0.9	2.2	0.8	8.2	17.9	4.0	3.9	4.0	5.2
Electricity, gas, water	2.9	4.1	1.2	2.5	1.4	1.3	6.4	1.8	2.5	3.6	1.7
Construction	1.2	4.5	1.8	6.5	9.0	3.9	1.9	6.9	6.0	5.6	6.5
Wholesale/retail, restaurants, hotels	20.1	16.5	11.2	17.4	35.0	8.6	10.4	10.1	13.3	19.0	32.9
Transport, storage, communications	10.4	12.6	11.3	6.8	14.9	5.2	2.7	6.5	8.6	6.2	7.5
Finance, insurance, real estate, business services	10.9	14.1	5.7	14.6	8.4	0.9	-	4.7	10.2	11.8	13.9
Community/social/personal services	27.9	17.4	36.9	34.4	21.6	13.1	20.8	23.9	22.6	30.2	11.6
Adjustments	3.0	-6.7	13.6	2.0	0.9	5.1	0.0	0.7	-4.6	-5.1	-2.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: National Statistics c. 2000

1.3. Pacific Island Trade Flows

This section focuses on the trade flows of the Pacific islands with the outside world and with one another. Data are included for the French Pacific overseas communities and territories (OCTs) as well as the FICs.

1.3.1. FIC and the French Pacific Territories as Import Markets

Table 5 focuses on the Pacific islands as import markets. The table shows exporting countries' shares of total 2004 exports to each FIC and French Pacific OCT and to both the FICs and the Pacific islands (FICs and French Pacific OCTs) as a whole. The table shows that the distribution of market share between the exporting countries is by no means consistent across the FICs and French Pacific OCTs.

Australia tends to dominate exports to the Melanesian countries and to Kiribati and Nauru, while New Zealand dominates exports to the Polynesian countries. Exports to Fiji are much more evenly contested, with Australia accounting for 28% of exports to Fiji and New Zealand 21%. These shares are respectively below and above the shares of Australia and New Zealand in exports to the FICs as a group, which are 35% for Australia and 15% for New Zealand. The United States is unsurprisingly the dominant exporter to Federated States of Micronesia and Palau, its former trust territories, with 38% and 48% of exports respectively, but has a share of exports below 5% to all other FICs except Samoa, Tonga and Vanuatu. The European Union (EU) accounts for just under 4% of exports to the FICs as a group, but its share of exports to individual FICs ranges from 15.7% for the Cook Islands to under 1% for Palau. Its shares of exports to some of the smaller FICs are well above its share of exports to the FICs as a group. The ASEAN countries are major exporters to Papua New Guinea, Fiji and the Solomon Islands and have significant exports also to Vanuatu and Samoa. Japan is the dominant exporter to Tuvalu, and also has significant exports to Palau, Federated States of Micronesia, Vanuatu, Kiribati and Samoa. China, Korea and Hong Kong each have significant shares in exports to some individual FICs, but not to the FICs as a whole.

Thus the share of exporting countries in exports to the FICs as a group is not at all a reliable predictor of shares in exports to individual FICs. Traditional linkages are clearly important, presumably explaining the position of dominant exporters enjoyed by Australia in Melanesia, New Zealand in Polynesia and the United States in the "Compact" countries. Shipping links, geographic proximity and commercial links of individual firms are also likely to be significant factors. In a given year, the shares of some exporting countries in exports to smaller individual FICs may be unusually high, owing partly or wholly

Table 5: Shares of Exporting Countries in Total World Exports (Exports of "All Reporters" to FICs and French Pacific OCTs, 2004)

(a) US$

	PNG	Fiji	Samoa	Tonga	Cook Islands	Niue	Vanuatu	Solomon Is	Kiribati	Tuvalu	Nauru	FSM	Palau	FIC Total	New Caledonia	French Polynesia	Wallis and Futuna	Pacific Islands Total
New Zealand	61,164,068	226,049,296	64,918,463	39,125,415	48,725,975	8,845,410	15,106,439	11,364,244	3,808,038	1,531,401	314,566	1,464,200	999,767	483,417,282	79,934,459	110,806,226	4,531,007	678,688,974
Australia	684,230,505	295,320,718	21,404,757	10,634,682	5,676,304	242,970	36,821,742	36,260,671	20,472,300	2,767,944	12,229,028	7,823,453	993,104	1,134,878,178	150,788,241	119,577,785	4,677,064	1,409,921,268
EU-25	33,247,647	44,139,029	4,514,399	4,660,037	11,864,793	1,858,068	9,169,452	4,022,050	4,150,114	886,577	2,257,344	491,350	669,224	121,930,084	877,635,952	748,452,077	13,138,743	1,761,156,856
Fiji	1,907,907		11,407,225	7,437,779	904,472	17,121	4,947,163	2,303,930	6,723,615	2,247,866	146,515	203,616	61,790	38,308,999	1,993,723	5,174,659	1,752,451	47,229,832
Papua New Guinea		807,672		223,519	1,406		1,458,900	8,820,860	217,782			157,540		11,687,679				11,687,679
Samoa	27,053	947,645		341,152	241,772			8,782						1,566,404	997,781			2,564,185
Cook Islands		139,136	15,461	15,208		1,499								171,304				171,304
French Polynesia		241,984	22,464	12,538	136,351	35,942						731		450,010	3,532,695		485,326	4,468,031
New Caledonia	1,246	345,662	1,434,742	10,287			7,547,668	105	69,874		2,614			9,412,198		1,794,973	7,984,789	19,191,960
Japan	63,419,403	43,534,136	19,567,550	2,500,060	2,022,440	23,575	23,713,851	5,476,392	5,730,161	4,976,323	82,002	11,159,175	8,397,599	190,602,667	33,301,692	34,510,398		258,414,757
China	52,502,245	32,507,172	5,875,666	6,265,518	820,867		7,215,524	3,300,826	865,321	2,243,137	99,024	7,438,478	425,491	119,559,269	8,247,928	11,727,933		139,535,130
Rep. of Korea	13,977,142	23,118,670	5,875,666	357,724	267,343	5,199	1,915,673	1,174,992	469,982	88,013	82,774	7,350,788	6,206,680	60,890,646	21,546,225	9,237,778	23,484	91,698,133
China, Hong Kong SA	6,517,551	18,844,737	329,889	355,248		4,536,675	1,501,088	2,021,823	247,162	21,840	386,657			34,762,670	23,395,241			58,157,911
ASEAN	377,539,850	308,061,829	25,021,840	1,173,960	667,737	6,212	19,902,210	37,507,645	1,280,144	208,835	136,184	2,369,907	494,163	774,370,516	209,001,474	132,943,528	553,078	1,116,868,596
USA	42,604,388	25,393,492	12,183,286	7,098,986	934,727	613,279	9,467,188	2,753,557	1,321,392	322,371	726,885	24,447,954	17,005,800	144,873,305	45,081,620	93,009,134	168,564	283,132,623
Others	39,805,860	65,962,544	8,292,511	2,543,180	3,153,564	113,737	2,410,930	829,546	801,592	866,611	233,265	1,076,960	225,217	126,315,517	16,999,069	18,305,837	282,896	161,903,319
All Reporters	1,376,944,865	1,064,953,641	180,863,919	82,755,293	75,414,939	16,299,687	141,177,828	115,845,423	46,157,477	16,160,918	16,696,858	63,984,152	35,478,835	3,232,733,835	1,472,456,100	1,285,540,328	33,597,402	6,024,327,665

(b) Percentages

	PNG	Fiji	Samoa	Tonga	Cook Islands	Niue	Vanuatu	Solomon Is	Kiribati	Tuvalu	Nauru	FSM	Palau	FIC Total	New Caledonia	French Polynesia	Wallis and Futuna	Pacific Islands Total
New Zealand	4.4%	21.2%	35.9%	47.3%	64.6%	54.3%	10.7%	9.8%	8.3%	9.5%	1.9%	2.3%	2.8%	15.0%	5.4%	8.6%	13.5%	11.3%
Australia	49.7%	27.7%	11.8%	12.9%	7.5%	1.5%	26.1%	31.3%	44.4%	17.1%	73.2%	12.2%	2.8%	35.1%	10.2%	9.3%	13.9%	23.4%
EU-25	2.4%	4.1%	2.5%	5.6%	15.7%	11.4%	6.5%	3.5%	9.0%	5.5%	13.5%	0.8%	1.9%	3.8%	59.6%	58.2%	39.1%	29.2%
Fiji	0.1%		6.3%	9.0%	1.2%	0.1%	3.5%	2.0%	14.6%	13.9%	0.9%	0.3%	0.2%	1.2%	0.1%	0.4%	5.2%	0.8%
Papua New Guinea		0.1%		0.3%	0.0%		1.0%	7.6%	0.5%					0.4%				0.2%
Samoa	0.0%	0.1%		0.4%	0.3%			0.0%						0.0%	0.1%			0.0%
Cook Islands		0.0%	0.0%	0.0%		0.0%								0.0%				0.0%
French Polynesia		0.0%	0.0%	0.0%	0.2%	0.2%						0.0%		0.0%	0.2%		1.4%	0.1%
New Caledonia	0.0%	0.0%	0.8%	0.0%			5.3%	0.0%	0.2%		0.0%			0.3%		0.1%	23.8%	0.3%
Japan	4.6%	4.1%	10.8%	3.0%	2.7%	0.1%	16.8%	4.7%	12.4%	30.8%	0.5%	17.4%	23.7%	5.9%	2.3%	2.7%		4.3%
China	3.8%	3.1%	3.2%	7.6%	1.1%		5.1%	2.8%	1.9%	13.9%	0.6%	11.6%	1.2%	3.7%	0.6%	0.9%		2.3%
Rep. of Korea	1.0%	2.2%	3.2%	0.4%	0.4%	0.0%	1.4%	1.0%	1.0%	0.5%	0.5%	11.5%	17.5%	1.9%	1.5%	0.7%	0.1%	1.5%
China, Hong Kong SA	0.5%	1.8%	0.2%	0.4%		27.8%	1.1%	1.7%	0.5%	0.1%	2.3%			1.1%	1.6%			1.0%
ASEAN	27.4%	28.9%	13.8%	1.4%	0.9%	0.0%	14.1%	32.4%	2.8%	1.3%	0.8%	3.7%	1.4%	24.0%	14.2%	10.3%	1.6%	18.5%
USA	3.1%	2.4%	6.7%	8.6%	1.2%	3.8%	6.7%	2.4%	2.9%	2.0%	4.4%	38.2%	47.9%	4.5%	3.1%	7.2%	0.5%	4.7%
Others	2.9%	6.2%	4.6%	3.1%	4.2%	0.7%	1.7%	0.7%	1.7%	5.4%	1.4%	1.7%	0.6%	3.9%	1.2%	1.4%	0.8%	2.7%
All Reporters	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Comtrade

to large one-off transactions. The EU does not account for a large share of exports to any of the larger FICs, though the data indicate that it can be a significant presence, at least in some years, in exports to individual smaller FICs.

It can also be seen from Table 5 that the EU has, unsurprisingly, a much higher share of exports to the French Pacific OCTs, with just under 60% of exports to New Caledonia and French Polynesia, and just under 40% of exports to Wallis and Futuna. The shares of Australia and New Zealand in exports to the OCTs are correspondingly lower. When exports to the FICs and to the OCTs are aggregated, the EU turns out to be the largest exporter to the combined Pacific islands grouping, due entirely to its very high share of exports to New Caledonia and French Polynesia. Australia has the next largest share, with New Zealand's share at 11% a distant fourth after ASEAN. No other exporting country has a share exceeding 5%.

Table 5 also provides information on exports of the FICs and French Pacific OCTs within the FIC and French Pacific OCT grouping. Fiji has just over a 1% share of exports to the FICs as a whole (and just under 1% of exports to the combined FIC/OCT group), but the shares of other FICs and OCTs are much lower. Fiji has a significant share in exports to Kiribati and Tuvalu, where it is respectively the second and third largest source of imports, and also has a share of just under 10% in exports to Tonga, just over 6% in exports to Samoa, and just over 5% in exports to Wallis and Futuna. Among the Melanesian FICs, Fiji's shares in exports to Vanuatu and the Solomon Islands are 3.5% and 2% respectively, but its share in exports to Papua New Guinea is minuscule, as are its shares in exports to other FICs. Thus, Fiji has much smaller shares in exports to the Melanesian FICs than to Tonga and Samoa, the Polynesian neighbours to its east. Fiji's largest export shares are found in the two FICs (Kiribati and Tuvalu) where its shipping connections are more regular than those with other exporting countries, and where it has longstanding bilateral trade ties.

Papua New Guinea has a substantial share (7.6%) of exports to the Solomon Islands, but its shares in exports to Fiji and Vanuatu, the other two Melanesian FICs, are only 0.1% and 1% respectively, and its shares in exports to other FIC and OCT markets are negligible or non-existent. Other FICs have only tiny shares in exports to markets within the FIC and OCT groups. The OCTs have low shares in exports not only to the FICs but also to each other: their shares are all below 1% except for New Caledonia's 24% share in exports to Wallis and Futuna and 5% share in exports to Vanuatu, and French Polynesia's 1.4% share in exports to Wallis and Futuna.

1.3.2. FIC Exports to External Markets

Table 6 provides some data on FIC export markets. As the data presented in the previous section have already made it clear that the FICs' exports to one another are only a minor factor in their overall exports, it is not surprising that all the main markets lie outside the FIC group. It is also notable that Australia and New Zealand have a much less dominant role in the export trade of the FICs than in their import trade. Table 6 shows that in fact Australia and New Zealand are very minor export markets for FICs other than Fiji (with its significant garment exports to Australia in particular), Papua New Guinea and Samoa (with its special arrangement for assembly and export to Australia of wiring harnesses). There is in fact considerable diversity in the FICs' major export markets. Japan is a key market for Tonga, and Japan together with other Asia-Pacific developing economies account for a substantial share of the exports of the Solomon Islands, Papua New Guinea and Kiribati in particular. The United States is an important export market for Vanuatu. Of the FICs mentioned in this paragraph, the exports-to-GDP ratio is above 30% for Fiji and the Solomon Islands, but is 10% or less for Papua New Guinea, Tonga and Samoa.

FIC exports are generally dominated by primary products, with Fiji's garment exports and Samoa's wiring harness exports being the most significant exceptions, although both Fiji and Papua New Guinea export small amounts of a wider range of manufactured goods. In some cases, exports are heavily dependent on trade preferences, notably the sugar exports of Fiji and canned tuna exports of Papua New Guinea and the Solomon Islands to the EU, and Fiji's garment exports and Samoa's wiring harness exports to Australia. Papua New Guinea has the most diversified export base. In addition to its preferential canned tuna exports to the EU, Papua New Guinea's major exports include palm oil, coffee, cocoa and

Table 6: Main Markets for Pacific Island Countries' Exports, 1999

	Australia and New Zealand	Japan	USA	Other Asia-Pacific developing countries	Other
Fiji	37.5%	4.5%	14.8%	10.9%	32.3%
Kiribati	2.3%	40.0%	15.0%	13.4%	29.3%
Papua New Guinea	26.5%	11.7%	4.6%	15.0%	42.2%
Samoa	69.4%	0.9%	12.0%	2.2%	15.5%
Solomon Islands	2.0%	35.4%	0.8%	43.4%	18.4%
Tonga	11.5%	59.0%	19.0%	2.0%	8.5%
Tuvalu	2.0%	n.a.	n.a.	5.9%	92.1%
Vanuatu	1.6%	11.2%	25.3%	5.5%	56.8%

Source: Pacific Islands Forum Secretariat, Regional Support Strategy Document, 2002

tea among agricultural products; tropical hardwood logs; and gold, mineral ores, natural gas and oil among mineral products. Some of these products also figure in the exports of the Solomon Islands, notably palm oil, hardwood logs and, to a lesser extent, mineral products.

Some FICs that have substantial fisheries resources but lack the financial resources needed to establish canneries have been developing exports of tuna loins as an alternative processed fish product. Nevertheless, most of the fish caught in FIC waters continues to be processed outside the region.

Several FICs have been successfully developing niche exports, such as squash from Tonga, black pearls from the Cook Islands, desiccated coconut from Tonga and noni juice from several FICs. French Polynesia is a major competitor in export markets for the latter two products. Kava was showing growing potential as an export for several FICs until a ban on kava imports was apparently imposed in Europe. Some success has been achieved with exports by airfreight of fresh fish to Japan and the United States, and of fresh fruit and vegetables to New Zealand, mainly by FICs with direct air links to those markets.

1.4. Tariffs

Tariff levels are highly variable across the FICs. Tariffs have traditionally been high in the Polynesian and Melanesian FICs, in large part reflecting the importance of tariffs as a source of government revenue but also serving some protective purpose in Fiji and Papua New Guinea in particular. A number of larger FICs have undertaken substantial tariff reforms, notably Fiji, Papua New Guinea and Samoa. Characteristically, these reforms have reduced tariffs on a wide range of goods to either zero or low levels (3% in Fiji, 8% in Samoa), but have left high tariffs on a number of products where imports compete with local production: the maximum tariff in Fiji is 27% and in Papua New Guinea 45%[1].

Among the smaller FICs, tariffs are relatively low in Federated States of Micronesia and Palau, and the Cook Islands recently removed tariffs on most imports. Niue levies a flat 10% tariff on most imports. Vanuatu, the Solomon Islands, Kiribati and Tonga have stood out as FICs maintaining high tariffs across a wide range of imports. The Solomon Islands apparently decided recently to reduce all tariffs to 10%, and Tonga has undertaken to bind most tariffs at either 15% or 20% under the terms of its accession to the World Trade Organisation (WTO). Tariffs remain very high in Kiribati and Vanuatu.

In FICs that have undertaken tariff reforms, the impact on government revenue has been offset by the introduction of value added taxes. This has been the case in Papua New Guinea, Fiji, the Cook Islands and Tonga. Vanuatu has also introduced a value added tax, but despite this it still relies heavily on tariffs as a source of revenue – more so than

1 Excluding certain special cases such as the tariff on sugar in Papua New Guinea.

most other FICs – because of the lack of an import tax and political constraints on introducing such a tax. Kiribati also remains heavily dependent on tariffs as a source of government revenue.

The wide range of tariff structures among the FICs makes it very difficult to envisage the establishment of a FIC customs union in the foreseeable future.

2. FIC Participation in Trade Agreements with External Partners

2.1. WTO Membership

Three FICs (Fiji, Papua New Guinea and the Solomon Islands) are members of the WTO, and a further three (Samoa, Tonga and Vanuatu) are at various stages in the accession process. Tonga has completed its accession negotiations and is believed to be on the point of ratifying its WTO accession agreement. Vanuatu was on the point of agreeing terms of accession for the WTO's 2003 Cancún ministerial meeting but pulled back at the last minute. It is understood to be ready to recommence negotiations shortly. Samoa's accession negotiations are in progress.

Any regional trade agreement (RTA) involving FIC WTO members will have to comply with relevant WTO obligations. In the case of an RTA involving only FICs, it may be sufficient to meet only the relatively undemanding requirements of the "Enabling Clause", which essentially provides a dispensation from normal WTO rules for various trade arrangements involving developing countries, including RTAs. An RTA including developed country members, on the other hand, must satisfy the requirements of Article XXIV of the GATT, now part of the WTO Agreement, along with the "understanding" on its interpretation incorporated into the Final Act of the Uruguay Round. If the RTA covers services trade, it must also comply with Article V of the GATS. There are no "enabling clause" provisions for preferential agreements on trade in services. Forum economic ministers have made a clear commitment to implement policies consistent with WTO principles wherever possible.

FIC WTO members have been actively supporting the Small Economies Work Programme (SEWP) in the WTO, seeking recognition of the special problems of small economies and pressing for these to be reflected in appropriate dispensations from some WTO rules, including the rules governing their preferential trading arrangements with developed countries. These efforts have yet to bear fruit.

2.2. Preferential Agreements with External Partners

The FICs have historically enjoyed non-reciprocal trade preferences from their major trading partners under a wide range of agreements, the most important of which have been:

- The Generalised System of Preferences (GSP) is made available unilaterally by developed countries to all developing countries, although the product coverage varies between developed country markets. GSP is the most favourable preferential arrangement available to FIC exports to Japan, Canada and, for most FICs, the United States.
- The Lomé Convention and its successor agreement the Cotonou Agreement have provided preferential access to the EU, along with a range of other benefits for all FICs that are members of the African, Caribbean and Pacific (ACP) group of states. Until the signing in 2000 of the Cotonou Agreement this group excluded the Federated States of Micronesia, Marshall Islands, Palau, Nauru, Niue and Cook Islands, but since 2000 these six FICs

have also become members of the ACP group. The Lomé and Cotonou arrangements have required WTO waivers, since they do not comply with WTO rules on preferential trading arrangements.

- The duty-free quota-free access for essentially all products provided by the EU's Everything But Arms (EBA) agreement[2] is available to the five FIC LDCs (Kiribati, Samoa, Solomon Islands, Tuvalu and Vanuatu), which will also progressively benefit from similar schemes for duty-free quota-free access made available to LDCs by other developed countries.
- Compacts of Free Association (CFAs) with the United States provide trade access privileges, as well as various important entitlements to financial assistance, for Federated States of Micronesia, Marshall Islands and Palau.
- The South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA) provides duty-free access to the Australian and New Zealand markets, provided rules of origin requirements are met.
- Papua New Guinea Australia Trade and Commercial Relation Agreement (PATCRA): applicable only to Papua New Guinea.

It is noteworthy that among the preferential regional trade agreements in which FICs participate, only SPARTECA and the Cotonou Agreement have a membership comprising all fourteen FICs.

While Australia and New Zealand might seem to be the natural developed country markets for at least the Melanesian and Polynesian FICs, the export performance of the FICs in these markets has been notably weak, even though SPARTECA has been in existence since the early 1980s. The development of Fiji garment exports and Samoan wiring harness exports were two cases of substantial export development under SPARTECA. Access under SPARTECA, along with the availability of quota access to the United States market, was a major factor in the emergence of the Fiji garment industry from the late 1980s. Export development on this scale under SPARTECA has not however been replicated elsewhere.

One factor is likely to have been the SPARTECA rules of origin, based on the 50% area content rule in the Australia-New Zealand Closer Economic Relations (CER) agreement with some provision for relatively minor derogation. Arguably this rule took little account of the realities of manufacturing in small island economies, where the lack of a significant manufacturing base made it inevitable that manufacturers would be more than usually dependent on imported inputs[3]. Quarantine regulations and their implementation in Australia and New Zealand have also been perceived by FIC exporters as a very significant non-tariff barrier to their exports, both in effect and in intent.

During the negotiation of the Cotonou Agreement, the EU served notice that it would not be willing to seek any further waivers for non-reciprocal trade agreements with the ACP states, beyond the initial waiver sought for the trade provisions of the Cotonou Agreement, which was subsequently granted by the WTO members and which expires at the end of 2007. The Cotonou Agreement accordingly provided for the negotiation of new reciprocal free trade agreements, called Economic Partnership Agreements (EPAs) with ACP states, to take effect from the beginning of 2008. Separate agreements are to be negotiated with regional ACP groupings, instead of a single agreement with all ACP states as was the case with the Lomé and Cotonou arrangements. Provision was made for "alternative trade arrangements" for those ACP states unable to enter into a reciprocal EPA, but the exact format of these alternative arrangements has yet to be clarified. The EPA negotiations commenced in 2002 and are scheduled to conclude in December 2007, although it appears likely that they will extend into 2008.

2 Under EBA, special arrangements apply during a transitional period for rice, bananas and sugar, but these products are not of export interest to the FIC LDCs.

3 See Scollay (2003b) for an extended discussion of SPARTECA rules of origin.

3. New Preferential Trade Initiatives by the FICs[4]

3.1. Challenges for the FICs in a Changing Trade Policy Environment

The FICs' traditional approach to trade policy was based on import tariffs and non-reciprocal preferential access for their exports to the markets of developed country partners. Tariffs were and in a number of cases still are an important source of revenue, and have also served a significant protective function in some FICs, notably Fiji and Papua New Guinea, where light manufacturing has developed behind the protective barriers. Non-reciprocal preferential market access was in practice important for a limited range of specific exports of certain FICs.

As in the case of SPARTECA, the effect of the preferential arrangements with the EU in encouraging FIC exports has been limited to a very small number of products, mainly sugar from Fiji (via the Sugar Protocol) and canned tuna exports from Fiji, Papua New Guinea and the Solomon Islands. Similarly, the CFA preferences have led to very little increase in exports to the United States by its former trust territories. Quota-based access under the Multi-fibre Agreement did however facilitate the development of significant garment exports to the United States from Fiji, and intermittently from the former trust territories as well. In some cases a side effect of preferential access has been a lack of pressure to achieve and maintain international competitiveness; in the Fiji sugar industry, for example, competitiveness has deteriorated alarmingly. At the same time, high tariffs imposed for revenue-generating purposes in some FICs have raised cost structures and undermined international competitiveness.

This model of trade policy had been under steadily increasing threat since the late 1980s. Recognition of the threat led to a decision by the FICs in the late 1990s to begin changing their approach to trade policy, as described in greater detail below. Since that time, the challenges have continued to mount, providing the context for the further evolution of FIC trade policy initiatives.

Preferences began to be eroded with the implementation of unilateral tariff reduction programmes by Australia and New Zealand and the implementation of Uruguay Round commitments by WTO members. Both the garment exports of Fiji and the wiring harness exports of Samoa to Australia are potentially vulnerable to further unilateral tariff reduction by Australia. At the WTO's Doha Ministerial meeting in 2001, further erosion occurred when the EU had to accept a demand from Thailand and the Philippines for a tariff reduction on canned tuna as the price for securing a further waiver for the non-reciprocal preferences granted to the ACP states under the Cotonou Agreement. Subsequently, the EU's Everything But Arms initiative and similar initiatives by other developed countries have provided non-ACP least developed countries with market access equal to or in some cases better than that enjoyed by non-least developed ACP countries, while the United States' African Growth and Opportunity Act (AGOA) has motivated some international clothing firms to relocate from Fiji to Africa. The WTO panel and appellate body decisions on EU sugar subsidies are inevitably forcing a major revision of the EU's sugar regime, leading at the very least to a substantial fall in the EU sugar price and a corresponding fall in the value of the preferential access of ACP sugar exporters such as Fiji. Fiji's garment

4 This section draws heavily on earlier material in Scollay (2001) and Scollay (2006).

exports to the United States have received a possibly fatal blow from the ending of textile quotas under the terms of the WTO Agreement on Textiles and Clothing and from China's entry into the WTO. A successful outcome to the Doha Development Agenda will inevitably entail further erosion of preferences.

Ironically, the effect of these challenges to preferential access is now being compounded by the accelerating worldwide trend to proliferation of preferential trading arrangements (PTAs). When PTAs are formed between trading partners with whom the FICs have no such preferential arrangements (or preferences of a relatively limited nature such as GSP), the FICs find themselves in the position of being victims of trade discrimination, due to their exclusion from these arrangements. The threat of this discrimination is particularly acute in East Asia, and, for FICs other than the "freely associated states", in the United States. Both the East Asian countries and the United States are beginning to develop considerable networks of preferential trading arrangements, and so far the FICs have not been invited to participate in these networks.

One other very disturbing historical trend has been the decline in the FICs' apparent ability to attract foreign direct investment (FDI). A recent study by Forsyth (2003) concluded that FDI inflows are now failing to keep pace with the depreciation of the existing capital stock. Two sets of factors can be cited to explain this trend, which poses a major threat to future economic growth in the Pacific ACP states:

- intensifying competition among developing countries to attract FDI and to be included in international production networks, and the inherent handicaps faced by the FICs (along with many other developing countries) in competing with more attractive investment destinations;
- lack of certainty offered to foreign investors, due to lack of an enabling policy environment, perceptions of policy instability and political threats to economic policy, and land tenure issues.

A further obstacle to the FICs' trade and economic development is the severe political impediments to liberalisation of the key "infrastructure" sectors of telecommunications, transport (sea and air) and financial services, and the inefficiencies that result from insulating these sectors from competition. Of these key sectors, some progress towards liberalisation has been made in the case of air services, with the conclusion of the Pacific Islands Air Services Agreement (PIASA). The value of the PIASA has been compromised, however, by the reluctance of Fiji to join the agreement. Some individual FICs have relatively open financial services sectors. Tonga and Samoa have implemented major reforms in their telecommunications sectors, and Fiji is now moving in the same direction.

3.2. FIC Response: A Cautious Shift in the Trade Policy Approach

As the challenges began to mount, and in response also to the broader challenge of globalisation, the FICs had decided by the late 1990s that their traditional trade policy model was unsustainable, and the decision was made in principle to move to a more outward-looking trade policy. At the same time, they were very nervous at the prospect of any immediate removal of barriers, due to concern in some cases over the impact on local industries and in other cases over the impact on government finances of the resulting loss of tariff revenue. Accordingly, it was decided to investigate a Forum free trade area as an initial step.

3.3. New Preferential Initiatives: The 1998 Studies on Forum Free Trade Options

The format of a Forum free trade area (FTA) proved controversial. Australia and New Zealand initially insisted that they should be included as full members of any Forum FTA, both by virtue of their status as Forum members and because it was argued that a FIC-only FTA would deliver little or no benefit to the FICs and might even turn out to be welfare-reducing. The basis for the latter contention was that the potential for increasing trade between the FICs was very limited, and that such new trade as did develop under a FIC-only FTA might well be in the nature of welfare-reducing trade diversion rather than welfare-increasing trade creation. Seen in this light, the debate could be seen as a special case of the debate over the merits for developing countries of preferential trade strategies focusing on FTAs with other developing countries, as against pursuing FTAs with developed country partners. The issues arose in extreme form in this special case owing to the tiny size of the FICs and the relatively small size of Australia and New Zealand compared to other potential developed country partners.

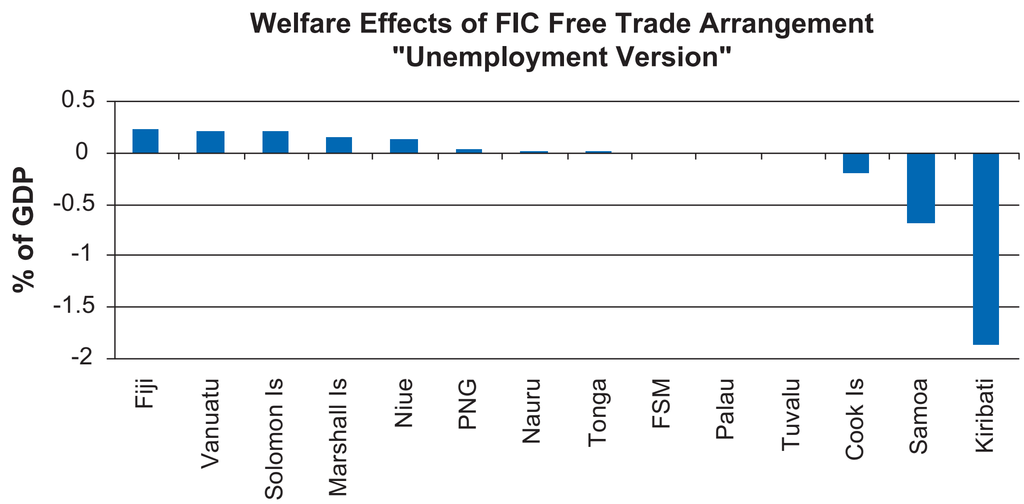
The upshot of the controversy was that three studies were commissioned in 1998 on possible free trade options for the FICs. Scollay (1998) reports the results of some rudimentary computable general equilibrium simulations carried out to explore the possible effects of a FIC-only FTA. A summary of these results is given in Table 2. Similar simulations, using essentially the same dataset, were performed by Stoeckel *et al*. (1998) for an FTA including Australia and New Zealand as well as the FICs. Lastly, Scollay and Gilbert (1998) report on the extension of the simulation exercise to consider full most-favoured-nation (MFN) liberalisation by the FICs. In each case, simulations were performed for two scenarios: an “unemployment scenario”, assuming the existence of substantial unemployed resources in the FICs prior to liberalisation, and a “full employment” scenario, assuming full employment of resources in the FICs prior to liberalisation.

The studies by Stoeckel *et al*. (1998) and Scollay and Gilbert (1998) were designed to test two expectations: first, that an FTA including Australia and New Zealand as members would deliver greater welfare gains to the FICs than a FIC-only FTA, and second, that full MFN liberalisation by the FICs would deliver greater welfare gains than a Forum FTA that included Australia and New Zealand. From the perspective of Australia and New Zealand, the purpose of the additional studies was to provide decisive evidence that an FTA including themselves as members would serve the interests of the FICs better than a FIC-only FTA. From the FIC perspective, however, a result showing welfare gains increasing with the scope of the liberalisation undertaken would demonstrate not that the FICs should proceed immediately to the most complete liberalisation possible but that the decisive factor should be the size of the initial liberalising step that the FICs felt themselves able to take. From this perspective, provided that the welfare effects for the FICs from all three alternatives were shown to be positive, a decision to opt for a FIC-only FTA would be perfectly reasonable if the FICs considered that an immediate move to more ambitious liberalisation would require adjustments so great as to be politically and socially unsustainable. From their perspective, it was important that the welfare effects of a FIC-only FTA should be shown to be positive, but the size of those welfare gains relative to the gains from the other alternatives was of much less importance.

Although construction of the models used in these simulations was very time-consuming, owing to widespread and serious data deficiencies, the models are nevertheless very crude. The crudeness of the models and the deficiencies in the data on which they are based preclude giving any serious weight to the particular numbers generated in the simulations. At best, the results provide some potentially useful information on the direction and order of magnitude of economic effects.

In the simulations of a FIC-only FTA reported in Scollay (1998), a scenario assuming the existence of substantial unemployed resources was taken as the base case. The welfare effects indicated in this base case are shown in Figure 1.

Figure 1.

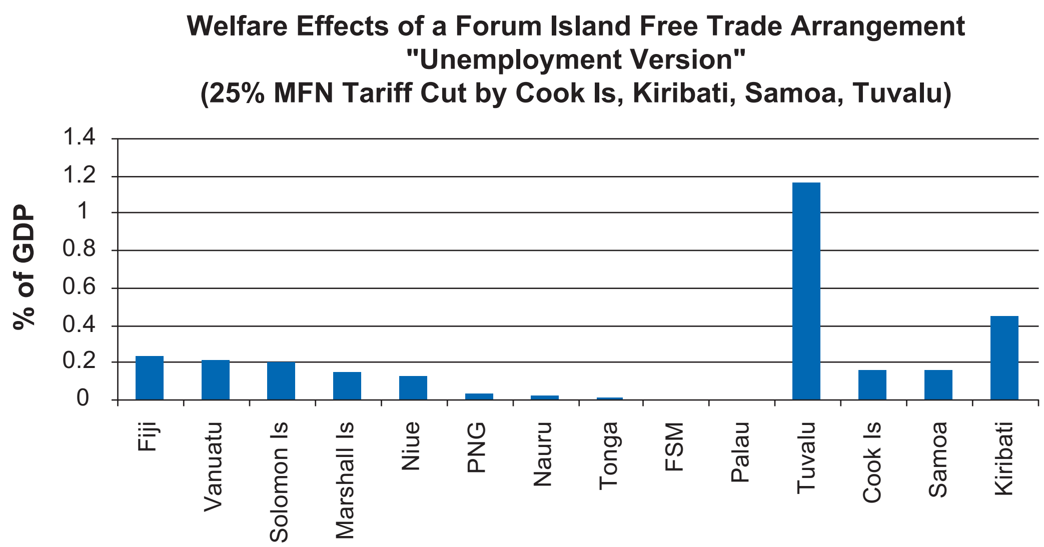


A more detailed summary of the simulation results for the base case is as follows:

- All FICs increase imports from other FICs, which may be some indication of trade creation (note that the high percentage increases in some cases can give a misleading impression, since these increases are generally from a very low base).
- Imports from the rest of the world increase for half the FICs. Both increases and decreases are very small in percentage terms, suggesting that trade diversion may not be as great a problem as feared.
- Exports rise in all cases but one (where they remain constant).
- Employment rises in all cases.
- As expected, there are tariff revenue losses in all cases, and in five cases the loss is moderately severe.
- All but four FICs experience increases in welfare, but the changes in welfare are generally small (in all but two cases amounting to 0.2% of GDP or less).

Scollay (1998) provides some comment on whether the projected increases in trade between FICs are realistic.

Figure 2.



Although it is impossible to validate the simulation results in full, a number of examples of potential increased trade are identified.

In the cases of the four FICs experiencing welfare losses under the initial simulations, as an experiment a further simulation was run in which external (MFN) tariffs were reduced by 25% simultaneously with the formation of the FTA. The results of these simulations are shown in Figure 2. In each case, this 25% MFN tariff reduction was sufficient to convert the welfare losses into welfare gains, and furthermore, in each case reductions in imports from the rest of the world are converted into increases. This provided striking confirmation of the importance of ongoing MFN liberalisation in parallel with any move to form a FIC-only FTA, in order to ensure that the outcome would be welfare-increasing.

A comparison is provided in Table 7 of the welfare effects indicated in the three studies, under both alternative scenarios in each case. The comparison shows that the studies essentially confirmed expectations that welfare outcomes would improve with the scope of the liberalisation undertaken. While the "full employment" scenarios consistently produce less favourable results (as might be expected), a clear hierarchy emerges under both scenarios. For almost every FIC the welfare gains increase (substantially in most cases) as the coverage of the tariff removal widens from a FIC-only FTA to an FTA including Australia and New Zealand, and finally to full MFN liberalisation. From the FIC perspective, however, a crucial finding from the studies was that a FIC-only FTA could deliver welfare gains, albeit relatively small gains, to all FICs, conditional in some cases on a degree of parallel MFN liberalisation.

Table 7: Summary of Results for FIC Free Trade Scenarios

	FIC free trade area		FIC free trade area with Australia and New Zealand		MFN liberalisation	
	Unemployment	Full employment	Unemployment	Full employment	Unemployment	Full employment
Cook Islands	- 0.19	- 0.30	2.61	- 0.22	3.44	0.14
Federated States of Micronesia	0.00	0.00	0.03	0.00	0.41	0.00
Fiji	0.23	0.12	3.27	0.08	3.30	0.09
Kiribati	- 1.87	- 2.29	2 .83	- 1.75	7.15	1.80
Marshall Islands	0.15	- 0.07	1.05	- 0.07	6.65	0.36
Nauru	0.02	0.00	0.06	0.00	0.06	0.00
Niue	0.13	- 0.40	2.18	- 0.39	4.59	0.21
Palau	0.00	0.00	0.21	0.01	1.14	0.03
Papua New Guinea	0.03	0.00	1.32	0.06	2.61	0.16
Samoa	- 0.68	- 0.84	1.06	- 0 .55	3.32	0.96
Solomon Islands	0.20	- 0.03	3.29	0.03	5.25	0.24
Tonga	0.01	- 0.25	1.73	- 0.15	3.24	0.39
Tuvalu	- 0.02	- 0.54	-	-	5.09	0.19
Vanuatu	0.21	- 0.42	0.90	- 0.31	4.22	1.07

3.4. The PICTA and PACER agreements

The results of the three studies did not foreclose an interesting subsequent debate on whether the proposed FTA should be a FIC-only arrangement or whether it should include Australia and New Zealand. Whereas Australia and New Zealand continued to insist that their status as Forum members entitled them to foundation membership of any such FTA, the FICs were fearful of the consequences of opening up their economies to free trade with Australia and New Zealand on a reciprocal basis. Although the studies showed that a FIC-only FTA offered them only very small potential benefits, the

FICs considered that the correspondingly smaller adjustment that would be required of them made such an arrangement a more suitable first step into the world of reciprocal free trade – a first step that could be followed later by negotiation of a free trade agreement with Australia and New Zealand. They therefore resisted Australian and New Zealand pressure for inclusion in the proposed FTA and in the process gained some very valuable experience in the practice of trade negotiations.

The atmospherics changed when it became evident that under the terms of the Cotonou Agreement the FICs would shortly be called upon to enter negotiations for a "WTO-compatible" (and therefore non-reciprocal) FTA with the EU as the replacement for their existing non-reciprocal trade arrangement. Instead of insisting on entitlement as Forum members to immediate participation in a Forum FTA, Australia and New Zealand began to insist on the principle that they could not accept being placed in a disadvantaged position relative to the EU in FIC markets, and this principle was also readily accepted by the FICs.

The result was the conclusion in 2001 of two agreements, the Pacific Island Countries Trade Agreement (PICTA) providing for free trade among the FICs, and the Pacific Agreement on Closer Economic Relations (PACER), providing a framework for future trade relations between the FICs and Australia and New Zealand, including a future free trade agreement.

The PICTA is a conventional free trade agreement providing for elimination of trade barriers over a lengthy transitional period, with the exception of products placed by each FIC on a "negative list". FIC LDCs and other FICs classified as "Small Island States" were allowed still lengthier transition periods than those applied to other FICs. Many FICs discovered when they came to formulate their negative lists that the number of sensitive industries requiring permanent protection from other FIC exporters is relatively small. Fiji, which has a larger range of protected industries, decided that only a tiny fraction of these needed to be excluded from a FIC-only FTA. Bucking this particular trend was Papua New Guinea, which insisted on an unnecessarily lengthy negative list, including even products not made in Papua New Guinea and not likely to be made there in future.

Ratification and implementation of PICTA have been much slower than initially envisaged. The three Compact countries were given extra time to decide whether to participate in PICTA, in recognition of their sensitivity over possible implications for their relations with the United States. In the event the United States agreed to waive the Compact obligations of Federated States of Micronesia and the Marshall Islands in relation to PICTA. Nevertheless, those two FICs along with Palau and Tuvalu have yet to ratify PICTA. Although the remaining ten FICs have ratified PICTA, only three have begun to implement the tariff reductions required under the terms of PICTA. The remaining seven FICs are expected to implement these reductions progressively over time.

Two significant extensions of the PICTA have been envisaged, and some preliminary work has been done on both proposed developments. The first is the extension of PICTA to cover trade in services.

Trade in services may offer a promising avenue for development of inter-FIC trade, and Forum leaders expressed interest at an early stage in extending PICTA to cover services. Service sectors such as tourism may well benefit from closer integration among the FICs, and commitments on services trade could also accelerate review and eventual reform of service sector regulation in FIC economies. At the same time, sensitivities relating to land ownership and ethnic differences mean that issues such as right of establishment and mobility of business persons will have to be handled with great care.

The second extension is the expansion of PICTA to include some or all of the French and US Pacific territories[5]. This would provide FICs with preferential access to markets that are very affluent by FIC standards and that, at least in the case of the French territories, are highly protected against imports from other non-European sources. Cautious steps are being taken at present towards the opening of negotiations between the FICs and New Caledonia.

The PACER responds to Australian and New Zealand concerns by providing that any FIC or group of FICs that

5 See Scollay (2003a) for an analysis of this issue.

enters into negotiations with a developed country partner on a free trade agreement[6] must undertake consultations with Australia and New Zealand as soon as practicable thereafter, "with a view to the commencement of negotiations for free trade arrangements"[7]. The PACER further provides that eight years after the PACER entered into force, unless this provision is triggered in the meantime, the FICs will enter into negotiations with Australia and New Zealand for a reciprocal free trade agreement[8]. The "price" received by the FICs for agreeing to this was the commitment by Australia and New Zealand to provide financial assistance for mutually agreed trade facilitation programmes. After some initial skirmishing this has resulted in the establishment of a substantial Regional Trade Facilitation Programme, funded by Australia and New Zealand.

3.5. The Melanesian Spearhead Group Trade Agreement

A second regional economic integration initiative within the FIC group proceeding in parallel with PICTA has involved only the Melanesian FICs. These countries had earlier formed themselves into the Melanesian Spearhead Group (MSG), which was conceived initially as a political grouping of Melanesian countries (Grynberg and Kabutaulaka, 1995). The founding members were Papua New Guinea, the Solomon Islands, Vanuatu and the Kanak party from New Caledonia (FLNKS). Fiji joined at a later date.

Subsequently, the MSG members agreed to form the Melanesian Spearhead Group Trade Agreement. The parties to this agreement were Papua New Guinea, the Solomon Islands, Vanuatu and Fiji; New Caledonia was also invited to join, and the FLNKS was granted observer status in the meantime. Initially, the MSG Trade Agreement was a positive list agreement, involving partial liberalisation of trade in a very small range of products; this range was subsequently expanded somewhat.

In 2004, the decision was taken to convert the MSG Trade Agreement to a negative list agreement, and a new text was drafted for this purpose. It would appear that this decision was motivated by a determination on the part of the members that the MSG Trade Agreement rather than PICTA should be the principal instrument of trade liberalisation among MSG members, and a recognition that in order for this ambition to be achieved the MSG Agreement could not be seen to lag behind PICTA in terms of its overall scope.

In the new MSG Trade Agreement, each member was entitled to submit its own negative list of products excluded from the agreement, and mineral fuels, tobacco products and most beverage products were also specifically excluded. Many of the provisions of the new MSG Trade Agreement were drafted quite loosely, for example on the timing of tariff reductions, quantitative restrictions, safeguards and temporary suspension of obligations (often referred to as the "hardship" provision). The degree of looseness in the drafting may have been intentional, designed to allow a degree of flexibility in interpretation and thereby to encourage the members, especially the smaller members, to feel that they could be more comfortable with the MSG Trade Agreement than with PICTA.

Perhaps predictably, however, numerous disputes broke out as soon as the agreement began to be implemented, which has limited its effectiveness to some degree. Exporters in Papua and New Guinea in particular appear to have been eager to take advantage of the agreement, and there was initially rapid growth of exports of some products such as biscuits and certain hardware items. The Solomon Islands and Vanuatu, however, have tended to react to increased penetration of their markets by imposing special duties or import bans under the safeguard or hardship provisions of the agreement. Vanuatu was reported to have imposed a special duty on some Papua New Guinea exports that exceeded its MFN duty rate. Fiji imposed bans on some Papua New Guinea exports, notably corned beef, on grounds stemming from the Technical Barriers to Trade and/or Sanitary and

6 Defined as an agreement within the meaning of GATT Article XXIV:8.
7 Article 6 of the PACER.
8 Article 5 of the PACER.

Phyto-Sanitary agreements. Papua New Guinea responded in kind, and this threatened to lead to escalating retaliation and counter-retaliation that could eventually halt all trade between the two countries. Considerable effort has had to be expended on attempting to resolve these disputes, so far with only partial success.

Reportedly, modifications to the MSG Agreement have recently been agreed that seek to address some of the difficulties encountered to date. These include the setting of clear timetables for the phasing out of tariffs and the introduction of clearly defined procedures for the use of the safeguard and hardship provisions. Assuming these modifications are ratified, it remains to be seen how they will be implemented in practice.

There is nevertheless considerable momentum behind the MSG process. The more avid promoters of the MSG Trade Agreement, especially within Papua New Guinea, are clearly seeking to position that agreement as an alternative to and possibly a substitute for PICTA. The reported recent decision to open membership in the MSG Trade Agreement to all FICs that wish to join, regardless of whether they are MSG members, is evidence of at least partial acceptance of this approach within the MSG. The MSG Trade Agreement is seen as a vehicle for promoting Melanesian leadership, or more specifically Papua New Guinean leadership, among the Pacific island states, whereas in the PICTA process the management role of the Pacific Islands Forum Secretariat is seen in negative terms by at least the more strident advocates of the MSG Trade Agreement, in part because they view the Forum Secretariat as excessively influenced by Polynesian interests (and, more recently, by Australian and New Zealand interests). Some of these strident advocates of the MSG Trade Agreement also appear to have been spreading the almost certainly misleading notion that prioritising the MSG Agreement over the PICTA might enable countries to avoid PACER obligations. The decision to establish an MSG Secretariat in Vanuatu indicates a desire to establish support structures that are independent of the Pacific Islands Forum Secretariat, although the capacities of the MSG Secretariat are currently very limited.

No formal proposal has apparently been made to extend the coverage of the MSG Agreement to include services. There are unconfirmed reports that the MSG members have decided formally to approach the government of New Caledonia (as distinct from the FLNKS), inviting New Caledonia to join the agreement. These reports suggest that as an inducement to join New Caledonia will be offered “soft” terms of accession, requiring initially only minimal opening of its market to MSG exporters.

4. Preferential Trade Arrangements with Developed Country Partners: Current Status

As noted earlier, negotiations between the FICs[9] and the EU for an Economic Partnership Agreement (EPA) to replace the trade provisions of the Cotonou Agreement commenced formally in 2002. These negotiations began to intensify through 2006 as the pressure of the scheduled conclusion date of 31 December 2007 began to be felt, but many important issues remain unresolved.

The extent of unresolved issues reflects some basic differences between the FICs (and indeed other ACP regional groups) and the EU on what an EPA should be expected to accomplish, with each side taking its stand on its own interpretation of the framework established in the Cotonou Agreement. In conceptual terms, the Cotonou Agreement has provided an interesting example of an attempt to establish comprehensive linkages between trade arrangements, development assistance and development policies, all with the purpose of promoting sustainable development, and combined with an acceptance that the arrangements eventually agreed must address the specificities of the situation of the developing country parties to the agreement. This in turn has provided the FICs (again, along with other ACP regional groups) with the motivation and justification to develop and propose their own ideas on the kind of agreement best suited to achieving the avowed objectives of the Cotonou Agreement, given their particular circumstances. On a number of important points these ideas remain in conflict with the views of the EU on the content of the EPA[10].

It remains to be seen how many FICs will choose to join the agreement that is eventually negotiated. From the perspective of the potential triggering of the PACER provisions, the crucial issue is whether the negotiations are aimed at establishing a free trade agreement within the meaning of GATT Article XXIV:8, as specified in the PACER. While the terms of the Cotonou Agreement might suggest that this is self-evidently the case, a number of the FICs are known to have reserved their positions on this issue, so that even the extent to which the PACER might be triggered remains unclear at this late stage in the EPA negotiations.

While the EPA negotiations are very demanding for the FICs, tying up a large proportion of the trade policy expertise that they have available, the impact on the FICs of granting reciprocal preferential access to the EU is not expected to be dramatic. A much more significant impact will result from any consequential agreement to concede reciprocal market access to Australia and New Zealand. In this sense the EPA negotiations can be usefully viewed as a “trial run” for the eventual negotiations with Australia and New Zealand. The FICs have also begun to respond to the changing trade architecture in East Asia by investigating options for their future trade relationships with major East Asian economies such as Japan, China and Korea.

Hitherto the FICs’ stance toward Australia and New Zealand on the issue of a free trade agreement has been entirely defensive, aimed at giving themselves breathing space to prepare for the very substantial adjustments likely to be imposed by reciprocal free trade with Australia and New Zealand. Some FICs need this breathing space to plan and begin to implement the restructuring of their fiscal systems that will be needed to cope with the loss of significant amounts of tariff revenue. Others need to build the capacity to engage

9 In the context of the EPA negotiations the FICs are more correctly referred to as Pacific ACP states (PACPs). For the sake of consistency the acronym FIC will continue to be used here.

10 The European Commission, negotiating the EPAs on behalf of the EU, claims of course that it is bound by the terms not only of the Cotonou Agreement but also of the mandates it has received from the member states.

more effectively in two-way trade and to prepare for the structural changes in their economies that will follow from free trade with Australia and New Zealand. The Compact countries continue to be concerned about implications for their relationship with the United States.

The provisions of the PACER make it inevitable that negotiations will have to begin with Australia and New Zealand at some point, with the only questions being the timing, and, in the event that the negotiations are triggered by Article 6 of the PACER (rather than Article 5), how many FICs will be obliged to participate, or will choose to participate, in those negotiations. The PACER does not require that the negotiations reach a successful conclusion, so the FICs can still reject proposals from Australia and New Zealand that they deem to be unacceptable. The FICs thus still have a number of cards that they can play if they continue to be defensively-minded in their stance towards Australia and New Zealand.

At the same time, one result of the experience of EPA negotiations with the EU has been to firm up FIC views on the “positive agenda” that they should be putting forward in negotiating trade and economic partnership agreements with developed country partners. Just as the extent of eventual FIC participation in an EPA will depend on the extent to which the EU accepts that positive agenda, so the stance adopted by the FICs in eventual negotiations with Australia and New Zealand is also likely to be conditioned by the attitude of these two countries towards key elements of the FICs’ positive agenda.

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