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TRADE ISSUES AND DEVELOPMENT PROSPECTS OF
ISLAND DEVELOPING COUNTRIES OF THE PACIFIC

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Chapter I

TRADE PERFORMANCE OF THE PACIFIC ISLAND DEVELOPING COUNTRIES[1]

(a) Overview

1. The Pacific Island Developing Countries (PIDCs) are characterized economically by several key features:

- small populations;
- limited resource base, including natural, human and capital resources;
- open, trade-dependent economies - overall, exports are valued at 55 per cent of GDP while imports are valued at 67 per cent of GDP; and remoteness from the major world markets.

2. None of the PIDCs are industrialised nations and their level of economic development varies widely. Five of these countries are among the Least Developed Countries (Kiribati, Solomon Islands, Tuvalu, Vanuatu and Western Samoa).

(b) Growth in merchandise exports

3. The only PIDCs which have experienced growth in merchandise exports in the past five years are Papua New Guinea, Solomon Islands, Tonga and the Federated States of Micronesia, although in the case of the latter two countries, growth has been modest. Fiji experienced export growth in the late 1980s, but this has now levelled off. While exports grew in Nauru in the late 1980s, they are now declining rapidly, due to the depletion of the country's phosphate resources.

4. The low degree of merchandise export dependence in countries such as Western Samoa, Tonga and Vanuatu reflects the importance of other sources of foreign exchange earnings, including tourism and private remittances. In contrast, in Fiji, Papua New Guinea and the Solomon Islands, merchandise export orientation now constitute more than 30 per cent of GDP, reflecting the increasing export orientation of these economies.

5. The composition of PIDC exports has changed during the past decade. The increased contribution from manufactures and the decline in agriculture are particularly evident.

6. PIDC export development continues to be highly variable. An example can be seen in the growth and sudden decline of Fiji's garment exports to New Zealand. Exports grew rapidly from F$ 312,792 in 1987 to F$ 54.6 million in 1989, but by 1993, had declined to F$ 19 million.

(c) Growth in merchandise imports

7. In all the PIDCs, import dependence is high and equivalent to at least 40 per cent of GDP. Import dependence is greater in the smaller economies such as Kiribati, Western Samoa, Tuvalu and Vanuatu where the production base for many consumer and intermediate goods is comparatively under developed. Following the 1987 coups in Fiji, imports increased dramatically, but the trend has reversed slightly since 1991. Import growth is a predominant economic feature in most Pacific island economies. Exceptions are Vanuatu, which has experienced a decline in imports, and Tonga and Kiribati where import levels have remained stable.

8. Imports greatly exceed exports in most Pacific island economies. For example, since the mid 1980s, in Kiribati, Western Samoa and Tuvalu, imports have been over 10 times greater than exports. While import growth is stimulated by a number of factors, including high population growth rates.

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[1] Data used in the preparation of this report will be available in a separate annex document.

9. High population growth rates are a feature of many of the PIDCs and are seen as one of the key development issues to be addressed in the South Pacific in the next decade. Population growth continues to outpace economic growth in many PIDCs, averaging 2 per cent per year. These rates are unsustainable, particularly in the small island states, and have offset the growth in national income that has occurred in the last decade. Current rates of population growth are creating increasingly difficult economic, social and environmental problems for the PIDCs.

10. Population growth trends and PIDC import growth appear closely related. If population growth trends continue in the next decade as they have in the past, the import dependency of a number of the PIDCs is likely to continue, further undermining limited gains in exports, and increasing balance of trade deficits. Unless the PIDCs can improve their economic performance and lower high rates of population growth, they face a continuing decline in per capita incomes and standard of living[2].

11. The composition of PIDC imports has changed only slightly during the last decade. The increase in service imports is the only notable trend.

12. One of the key import issues to be addressed by the PIDCs is that of energy imports. PIDC petroleum imports account for between 6 per cent to 23 per cent of total import values, and from 10 per cent to over 400 per cent of total export revenue in some of the small island states. Improvements in the performance and efficiency of the energy sector would lead to significant savings in foreign exchange.

(d) Balance of trade in goods

13. Papua New Guinea and Nauru are the only Pacific island economies which have surplus balances of trade in goods. In PNG's, case this has only been achieved since 1991. Nauru's favourable position is deteriorating rapidly as exports of phosphate, its principal source of export earnings, are experiencing massive decline. The Solomon Islands' balance of trade in goods position has improved dramatically since 1992, largely due to log exports. However, log exports are widely viewed as unsustainable. Fiji's deficit balance of trade in goods has been steadily improving in the period since 1990. The remainder of the Pacific island economies have relatively large deficit balances of trade in goods, and in many countries, balance of trade figures are progressively worsening.

(e) Terms of trade

14. Pacific island economies are highly vulnerable to terms of trade shocks. The weakening of export prices relative to import prices was a major cause of the decline in Pacific island export earnings and balance of payments deterioration in the 1980s. It is difficult to analyze terms of trade in most Pacific island economies as statistics are not consistently available. However, it can be noted that the Pacific island economies are heavily dependent on primary commodity exports and there are often extreme year-to-year fluctuations in the commodity terms of trade. There has also been a long term adverse situation owing to weak prices for coconut products and other traditional primary product exports. As an example of the affects of commodity price fluctuations, changes in the price of sugar accounts for 80 per cent of the variation in Fiji’s export earnings.

15. A report by the World Bank[3] found that there was a strong link between exogenous shocks, terms of trade fluctuations and overall growth. In an analysis

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[2] Pacific Economic Cooperation Council (PECC). "Pacific Island Developing Economies: Priorities for the 1990s." The PECC Pacific Economic Development Report. 1995.

[3] World Bank. Pacific Island Economies: Building a Resilient Economic Base for the Twenty First Century World Bank. 1995.

of economic shocks to the economies of Fiji, Western Samoa and the Solomon Islands in the period 1983 - 1993, it was found that terms of trade shocks (positive and negative) can be very large, difficult to anticipate, and of long duration. Because of difficulties in responding through economic and trade policies, PIDCs have generally sought increased financing through aid and private remittances. However, in some PIDCs exchange rates depreciation has contributed to decreases in imports and higher export competitiveness.

(f) Growth in service exports

16. Exports of services contribute more than 50 per cent of total export earnings in the PIDCs, excluding Papua New Guinea. Trends in growth of service exports and imports are difficult to identify because of the paucity of data available. However, broad patterns have been determined by a range of studies during the past several years. Fiji and Papua New Guinea are the two largest exporters of services, although both export only a relatively small share of their total services output. During the period 1982 to 1993, the share of services as a percentage of PIDC total exports decreased by 1 per cent.

17. With the exception of Papua New Guinea and the Solomon Islands, Pacific island service exports are dominated by tourism. Tourist arrivals in the South Pacific increased by 5.9 per cent from 1992 to 1993. Annual growth is expected to continue at around this rate for the rest of the decade. However, the economic significance of tourism varies around the region. In several countries, tourism is the largest single earner of foreign exchange, generating considerably higher earnings than the value of merchandise exports. Other countries have yet to develop tourism to its full potential, in some cases due in part to access constraints such as inadequate air services

18. The only detailed time series data set available for services covers trade between Australia and Fiji and Papua New Guinea. In both cases, service exports have declined since 1990. It can be reasonably assumed that similar trends may exist for other PIDCs. In broad terms, most of the PIDCs record a small services trade surplus with Australia, primarily as a result of the region's importance as a major tourist destination.

(g) Growth in service imports

19. The Pacific island economies are significant importers of freight and insurance services as a result of their reliance on overseas shipping groups. They are also net importers of telecommunications and professional services. Papua New Guinea and the Solomon Islands are highly dependent on service imports, with service imports more than double the value of service exports. In 1982 the share of services as a percentage of PIDC total imports was 30 per cent, by 1993 this had increased to 37 per cent.

(h) Balance of trade in services

20. While the service sector varies widely among PIDCs, trade in services is dominated by tourism, associated transportation and the finance sector. Papua New Guinea, the Solomon Islands, Tonga and Western Samoa all have deficit balances of trade in services, although in the case of the latter two countries, this deficit is not substantial. In Fiji and Vanuatu, surpluses in the trade in services account are principally due to revenue from tourism.

(i) Public and private transfers (aid, remittances)

21. Most Pacific island economies are significantly linked with former colonial power economies or those of nearby countries, such as Australia and New Zealand. There are large inflows of aid from these sources. These relationships also provide opportunities for migration, with, for example, large numbers of Samoans and Tongans migrating to New Zealand, and increasing Fiji Indian migration to Australia. As a result, private remittances have become an important source of foreign exchange earnings, particularly in the smaller economies.

22. In Western Samoa, private remittances represent the largest source of foreign exchange earnings, and their share is growing, with a 16 per cent increase in the first six months of 1995. Tonga and Vanuatu are also highly dependent on private remittances for foreign exchange. In Kiribati, aid, interest and remittances represented more than 80 per cent of GDP in 1991. Large and increasing amounts of remittance transfers and aid in Tuvalu have boosted growth in real GDP to around 7 per cent per annum in the period 1986 to 1990.

23. Aid has been a dominant feature in South Pacific economies since their independence. Official development assistance averaged almost 27 per cent of GDP during the period 1980-1992. However, there is considerable variation ranging from 3.3 per cent of GDP for Fiji, to 56 per cent for Kiribati. The bulk of this aid (45 per cent) is in "services" i.e. technical assistance, or supplies "in kind" on grant terms, rather than loans - only in the Solomon Islands and Western Samoa does the ratio of loans in total aid exceed 15 per cent.

24. All PIDCs receive development assistance from bilateral and multilateral donors. Major donors to the region are Australia (49.7 per cent), New Zealand (4.5 per cent) and Japan (22.0 per cent).

25. Aid has clearly had a very positive impact on development in the South Pacific, according to the World Bank[4], but does not appear to have had substantial impact on growth.

26. This reflects both the target of aid (largely public services and facilities) and aid utilisation. The gross allocation of ODA is not the same as the transfer of financial resources that actually reaches a country - generally regarded as being below 60 per cent of total ODA. This largely results from supplies and consultant expenditure being made within the donor country rather than in the actual recipient country. The relationship between aid and growth issue is a controversial one. World Bank[5] analysts argue that large inflows of aid actually constrain economic development or compound economic constraints. One example is the overvaluation of real exchange rates by aid inflows raising wages and prices. This leads to losses in competitiveness, growth in imports, and deteriorating trade balances. The World Bank believes this problem may be occurring in the small island states of the Pacific particularly. Large aid inflows also tend to support growth in the public sector - often at the expense of the private sector.

27. Development assistance has been the main source of investment financing in the PIDCs for many years and is a large contributor to GDP in most of the PIDCs. As noted by PECC[6] nearly all economic infrastructure and social services have benefited from external aid support. PECC expresses the view that "although the effectiveness of foreign assistance has at times been questioned, there is little doubt that aid flows have made and will continue to make an important - and even crucial - contribution to economic and social progress in the PIDCs".

(j) Current account

28. When official transfers such as aid are excluded, current account deficits are a feature of the Pacific island economies. In Western Samoa, there has been a recent widening of the current account deficit, although the trend reversed somewhat in 1994. Fiji has moved from a current account surplus to a deficit. In the Marshall Islands and the Federated States of Micronesia, there has been no progress made in curbing the large current account deficits. While the Solomon Islands has managed to reduce its current account deficit, this has only

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[4] World Bank. Toward Higher Growth in Pacific Island Economies: Lessons from the 1980s World Bank, 1991.

[5] World Bank, 1995 - op cit.

[6] Pacific Economic Cooperation Council (PECC) - op cit., p. 39.

been as a result of increased log exports, which is not a sustainable industry.

29. Although Kiribati and Tuvalu maintain a current account surplus, when official transfers are excluded, there is a deficit situation. The large gap is attributable to the substantial funds Kiribati and Tuvalu derive from official aid flows and interest earnings.

30. The current account deficits (when official transfers are excluded) in the PIDCs are a reflection of fiscal policy, very low levels of savings and increased consumption. As a result, official international reserves have declined significantly in Fiji, Papua New Guinea, Solomon Islands and Western Samoa. With the exception of a depreciation by the Solomon Islands and the 1995 float of the Papua New Guinea kina however, exchange rates have remained relatively stable. External commercial borrowings have also largely been avoided except by the Marshall Islands. Containing budget deficits will be necessary if the Pacific island economies are to maintain or improve their external positions.

(k) Degree of concentration/diversification of trade in goods and trade in services

31. While Pacific island economies are highly dependent on commodity exports, several have undergone significant changes in their export base in recent years. With the exception of Western Samoa, the coconut industry has declined rapidly in most countries. However, natural resources including fisheries and forestry remain important sources of economic wealth.

32. World Bank analysis indicates very high export concentration ratios in many of the PIDCs, with average three product concentration ratios of 80 per cent. This compares to 64 per cent for Sub-Saharan Africa and 26 per cent for Australia. Fiji and Vanuatu are the only PIDCs to have reduced their export concentration in the past decade. These export concentration ratios highlight the continuing vulnerability of the PIDCs to changes in the global environment - particularly in commodity trade.

33. In the ten years to 1993, the share of agricultural commodities in total exports in Pacific island economies fell from 28 per cent to 16 per cent. In 1983, manufactured exports were insignificant, whereas by 1993, they accounted for 8 per cent of total exports. While most of this change is attributable to developments in Fiji, other economies are also diversifying their export mix.

34. The gradual change in export mix illustrates the ability of the Pacific island economies to respond to unfavourable primary commodity prices by diversifying into higher value-added products and manufactures and finding "niche markets", despite a formidable set of constraints typical of small island states. Even within traditional product categories, Pacific island economies have demonstrated an ability to seize opportunities for establishing successful new export industries, such as garments in Fiji, squash in Tonga, logs and timber in the Solomon Islands, veal in Vanuatu, seaweed in Kiribati, and fish for sashimi in the Federated States of Micronesia. Recent research conducted by the South Pacific Forum Secretariat found that good prospects also existed for a wide range of other products, including horticultural and floriculture products, bio-commodities, spices, furniture, handcrafts and garments.

35. Three groups of products dominate PIDC imports - foods, mineral fuels and manufactured goods (consumer products and machinery). Services constitute over 30 per cent of PIDC imports. The share of food in total imports is less than 20 per cent for the larger PIDCs and is above 30 per cent for smaller PIDCs. All PIDCs are dependent on imports of oil products. The relationship between population growth and imports of food and oil products is high, indicating that these imports are likely to continue increasing in total terms for most PIDCs.

(l) External dependence and vulnerability of the economies

36. The majority of PIDCs are highly import dependent, although the level of import dependence is not as great in Fiji, Papua New Guinea, Tonga and Vanuatu as it is in other countries. With the exception of Papua New Guinea and the

Solomon Islands, the level of export dependence in Pacific island economies is relatively low.

37. Countries such as the Marshall Islands, Micronesia, Cook Islands and the other small atoll states are highly dependent on imports for essential supplies. A 1995 foreign exchange crisis in the Cook Islands severely compromised the availability of essential food and medical supplies because of the high level of import dependence and the lack of foreign exchange to finance imports. The level of international reserves in Pacific island economies, and demonstrates the vulnerability of most of these economies (and in particular, Papua New Guinea and the Solomon Islands) as a result of their import dependence. There has been a recent trend towards decline of international reserves in Fiji, Papua New Guinea, the Solomon Islands and Western Samoa.

(m) Assessment of economic performance of Pacific island economies in relation to trade performance

38. Economic performance in PIDCs is characterized by low and volatile growth rates. This may be attributed to the PIDCs' vulnerability to exogenous shocks, and other factors such as domestic instability and heavy dependence on a narrow range of agricultural and primary products. The World Bank[7] found that while macroeconomic variables such as investment, consumption, inflation and aid flows were not highly volatile, large fluctuations existed in both export growth rates and economic growth rates. It concluded that there is a link, working through exports, between external shocks, terms of trade changes and economic growth in PIDCs.

39. PECC[8] has noted that the poor economic performance of the PIDCs is in sharp contrast not only to the region's intrinsic potential but also to the performance of other island nation groups. The Caribbean islands grew at an annual rate of 2.4 per cent, and the Indian Ocean islands at 3.7 per cent during the same period.

40. The traditional sources of economic growth in PIDCs are primary commodities and public investment. On the basis of economic performance over the past decade, there is little prospect that these factors will contribute significantly to future economic growth. New sources of growth will be found largely in the exploitation of niche markets by producers in the PIDCs. This will need to be accompanied by macroeconomic stability and a favourable investment climate for the private sector.

Chapter II

PRINCIPAL TRADE ISSUES AND PROSPECTS OF PACIFIC ISLAND DEVELOPING COUNTRIES IN THE CONTEXT OF TRADE Liberalization

(a) Overview

41. As the world economy continues to undergo rapid change, the PIDCs are faced with an increasingly competitive environment in which they must operate. The inevitable further integration of the world economy will present the PIDCs with a range of challenges which will not be easily overcome without significant structural change. There is a growing realisation in the PIDCs that: