UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

REGIONAL TRADE AGREEMENTS AND DEVELOPING COUNTRIES: THE CASE OF THE PACIFIC ISLANDS' PROPOSED FREE TRADE AGREEMENT

by

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UNITED NATIONS

New York and Geneva, 2001

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ABSTRACT

Fourteen of the world's smallest and most vulnerable economies – the Forum Island Countries (FICs) of the Pacific island region – are in the process of forming themselves into a free trade area (FTA). This paper begins by reviewing the characteristics of the FICs and their external trade. It is shown that despite their small size this is in many ways a very diverse group of economies. Standard analysis of FTAs suggests that trade creation effects from a FIC FTA are likely to be small and that there may be a substantial risk of trade diversion. Loss of tariff revenue is a major concern, which needs to be addressed by restructuring of tax and tariff systems in some cases. Quantitative studies have confirmed the small size of the trade creation effects and indicated the size of likely tariff losses, but were somewhat reassuring on the issue of trade diversion. Studies have also highlighted the importance of continuing attention to most-favoured-nation tariff reductions in parallel with the formation of the FTAs in order to ensure that welfare effects are positive. A brief outline of the proposed FTA is provided. The proposed FTA should not be evaluated as a "stand-alone" exercise but as part of a wider process of gradually integrating the FICs into the global economy. It must also be seen in the context of the FICs' existing non-reciprocal free trade arrangements with Australia and New Zealand and the European Union, and the prospective future development of those relationships on a reciprocal basis.

ACKNOWLEDGEMENTS

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INTRODUCTION*

The proliferation of regional trading arrangements (RTAs) was a prominent feature of the international trading system in the last decade of the twentieth century. The World Bank (2000) notes that of the 194 agreements notified to the General Agreement on Tariffs and Trade (GATT) or the World Trade Organization (WTO) since the GATT's inception, 87 were notified in the years from 1990. Laird (1999) notes that 45 agreements were notified in the years from 1995 to 1998, with an estimated 62 further agreements which had not yet been notified to the WTO by mid-1998. A new survey by WTO (2000) counted a total of 172 RTAs currently in force with a further 68 under negotiation, some of which are designed to replace existing RTAs.

Not surprisingly, these developments have been accompanied by a lively debate on the effects and implications of RTAs. There are several strands to this debate. One strand concerns the benefits and costs of RTAs for their members, in comparison with other alternatives open to them. A related issue is the effect of RTAs on non-members. A further area of debate related to both these issues is the set of questions regarding how RTAs can be designed to maximize benefits and minimize costs. There is also a long-running debate over whether the spread of RTAs threatens to undermine the multilateral trading system based around the WTO, and a closely related debate on whether the WTO's disciplines and procedures relating to RTAs are adequate to the situation. The implications, negative or otherwise, of the tendency for RTA developments to centre around major trading nations has been a particular focus of debate.

Developing countries have not stood aside from the trend towards RTAs. Developing countries in all major regions of the globe have been and continue to be participants or potential participants in RTAs, and many participate simultaneously in several such agreements. The issues raised in wider debates have naturally also been applied to the questions relating to the place of RTAs in the trade strategies of developing countries, and the contribution which participation in RTAs may make to the development process.

Debate on this last point has a long history and not surprisingly the focus of the debate has tended to shift in line with changing ideas on the relationship between trade and development. In earlier years, when the import substitution paradigm heavily influenced thinking on development issues, proposals for RTAs among developing countries often reflected an interest in exploring a regional as distinct from a national approach to import substitution, through the creation of larger protected markets for the import-substituting industries to exploit. More recently, as outward-looking trade strategies have increasingly become the norm, RTAs have tended more often to be

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* On 28 June 2001, the trade ministers of the Pacific Islands Forum member countries announced that they had endorsed a proposal for the establishment of a free trade area between the island country members of the Forum (the Forum Island Countries, or FICs), to be known as the Pacific Island Countries Free Trade Agreement (PICTA). At the same time they endorsed a proposal for a framework agreement, providing for the future strengthening at an appropriate pace of trade and economic cooperation between all Forum members (including Australia and New Zealand), to be known as the Pacific Agreement on Closer Economic Relations (PACER). These agreements will be recommended for approval and signature to the Forum leaders, who will be meeting in Nauru in August 2001.

evaluated for their contribution to the more effective integration of their members into the international economy. Debate also continues, however, on the relation between trade and economic integration and the development of the domestic economy, for example through improved infrastructure facilities.

This paper aims to make a modest contribution to debates surrounding participation by RTAs in developing countries by considering the arguments commonly aired in these debates in the context of a specific proposal to form a free trade area (FTA) among the island nations of the South Pacific, the so-called Forum Island Countries (FICs), which made the political decision in late 1999 to proceed with the negotiation of an agreement on a FTA, referred to in this paper as the FIC FTA. In the process it will be seen that the advantages and disadvantages of a given RTA proposal need to be assessed in the light of the economic characteristics of the participating countries and their trade. It will also become clear that grasping the full implications of a proposal such as FIC FTA requires an understanding of how the proposed arrangement may interact with the members' trade relations with their major de-

veloped country economic partners.

The first section of this paper highlights key economic characteristics of the FICs and their major trading and economic relationships. This is followed by a discussion of the factors which are likely to be important in assessing the benefits and costs of the proposed FIC FTA, leading to some preliminary conclusions about its likely economic effects. These conclusions are then tested against some rudimentary quantitative analysis of the implications of the FIC FTA, leading to some further conclusions about FIC FTA's likely economic effects and about the way the agreement should be designed in order to maximize benefits and minimize costs. The main features of the proposed FIC FTA are then outlined and briefly discussed in the light of the conclusions from the preceding analysis. A further section deals with the linkages between the FIC FTA proposals and the existing trade agreements between the FICs and their major developed country trading partners, together with the complications which may arise for the ongoing management of these existing arrangements in the context of the FIC FTA proposal. This section is followed by a brief concluding section.

I. ECONOMIC CHARACTERISTICS OF THE FICs AND THEIR TRADE

A central theme of this paper is that the economic characteristics of the members of an RTA and the characteristics of their existing international trading relations have an important bearing on which issues are likely to be important in assessing the role of the RTA in their trade strategy, the likely benefits and costs of the RTA, and possibly also on the likely balance between those benefits and costs. The paper begins therefore with a brief review of the economic characteristics of the FICs and their existing trading relations. The data presented in this section of the paper were collected mainly from national statistics agencies during visits to the FICs in the early part of 1998, and in each case are the latest data available at that time. In some cases the data are not available in published form.

There are fourteen FICs in all: the Melanesian States of Papua New Guinea, the Solomon Islands and Vanuatu; the Micronesian States of the Federated States of Micronesia, Kiribati, the Marshall Islands, Nauru and Palau; the Polynesian States of the Cook Islands, Niue, Samoa, Tonga and Tuvalu, and the hybrid Polynesian/Melanesian State of Fiji, which also has a large Indian population. All fourteen of these States are members of the Pacific Islands Forum, which also includes as members Australia and New Zealand, which 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 as 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.

A. Economic size and income levels

The fourteen FICs are all extremely small economies by international standards, but at the same time there are also enormous variations among them in relative size. Figures 1 to 3 illustrate these points, and the data on which these figures are based are shown as appendix 1.

The total population of the fourteen FICs is just over 6 million, of which 4.14 million and 0.75 million respectively are accounted for by Papua New Guinea and Fiji. The population of individual FICs ranges from Papua New Guinea's 4.14 million to an estimated 2,300 in Niue. Three FICs (Niue, Nauru and Tuvalu) have a population of less than 10,000, and a further two (the Cook Islands and Palau) have populations of between 10,000 and 20,000. While the land area of most FICs is very small, large expanses of ocean separate the FICs from each other, and in many cases also separate the constituent islands of the individual FICs. One consequence of this oceanic separation is that most FICs have very large Exclusive Economic Zones, and the marine resources within these zones are among their most valuable resources. On the other hand, isolation, small size and susceptibility to natural disasters, as well as severe fluctuations in

Figure 1. Population of Forum Island Countries, 1993 or later
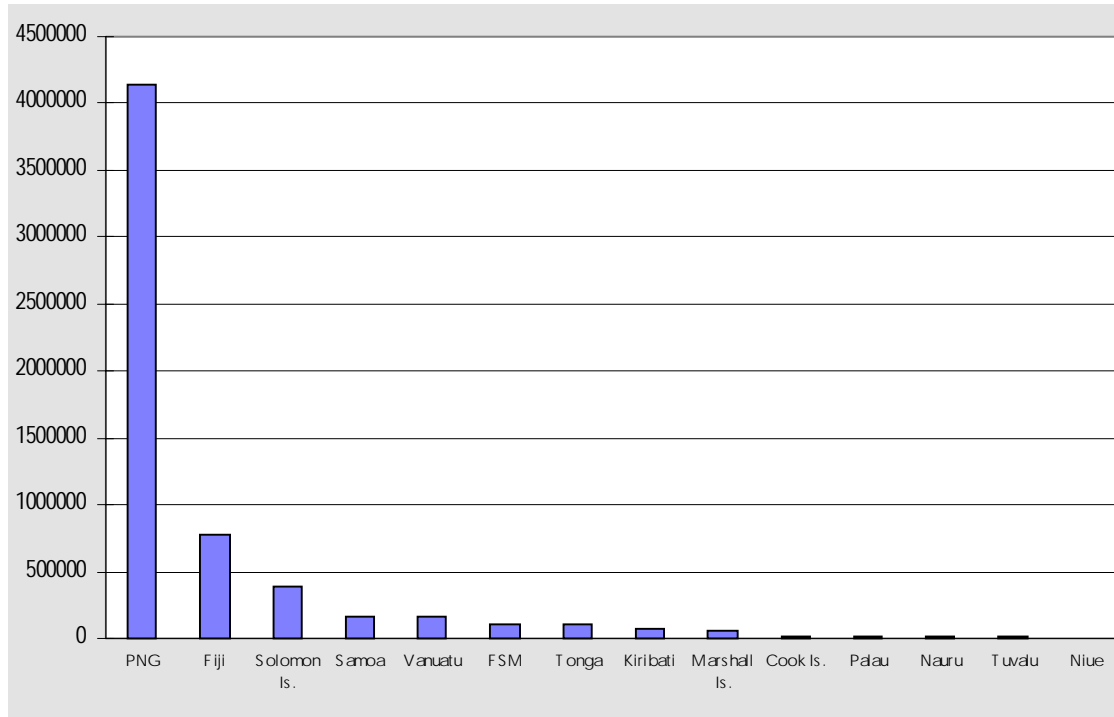
the world prices of their main exports, are all elements of the vulnerability of the FICs as small island States.

In terms of economic size, available statistics indicate a total combined gross domestic product (GDP) of the fourteen FICs in the mid-1990s of US$ 8,452 million. To put this in perspective, this is approximately 13.5 per cent of the GDP of New Zealand, the smaller of the two developed country Forum members and one of the smallest members of the Organization for Economic Co-operation and Development (OECD). Of this total FIC GDP, US$ 7,112 million, or just over 83 per cent, was accounted for by Papua New Guinea and Fiji alone. Figure 2 shows clearly the disparity in economic size between these two economies and the remaining 12 FICs. Figure 3, which excludes Papua New Guinea and Fiji, allows a more meaningful comparison of the economic size of the remaining 12 economies.

The very small size of the combined FIC market suggests that the potential for economic

gains based on economies of scale through forming an RTA is clearly limited. Furthermore, small economic size is likely to be associated with severe limitations on availability of administrative resources. A regional trade arrangement which requires complex negotiations and administrative arrangements would absorb a disproportionate share of those resources. It is unlikely that such an arrangement would be sustainable for the smaller FIC economies.

There is also considerable variation in income levels among the 14 FICs, as figure 4 indicates. The range in GDP per capita is from US$ 8,204 in Palau to US$ 651 in Kiribati. This represents a ratio of 13:1 between the highest and lowest average income levels within the FICs, comparable in fact to the corresponding ratios within the European Union or the North American Free Trade Area (NAFTA). It is noteworthy that the two largest economies, Papua New Guinea and Fiji, with per capita GDP of US$ 1,111 and US$ 2,250 respectively, are not close to either end of the range. Such

variation in income per capita may point to a significant difference in relative costs of labour and capital and in skill levels in the labour force, and might normally be taken as an indication of the potential for mutually beneficial trade to take place.

B. Production structures

The summary data in table 1 on the structure of production in a number of FICs suggest, however, that this conclusion should not be accepted too readily. Production in these economies is dominated by agriculture, forestry and fishing. Agriculture, forestry and fishing accounts for an especially large share of GDP in the Solomon Islands (41 per cent), Samoa (40 per cent) and Tonga (37 per cent). In most other FICs the share is between 15 per cent and 27 per cent. In Papua New Guinea mining accounts for 27 per cent of GDP, in addition to the 26 per cent accounted for by agriculture, forestry and fishing. The share in GDP of agriculture, forestry and fishing is unusually low in the Marshall Islands (13 per cent) and Palau

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

Manufacturing, on the other hand, has not developed much in most FICs. The share of manufacturing in GDP is highest in Samoa (18 per cent) and Fiji (15 per cent), but the figure for Samoa is heavily skewed by a single large enterprise which 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 (SPARTECA). In all other FICs for which data are available, manufacturing accounts for 5 per

Figure 2. Nominal gross domestic product (1)
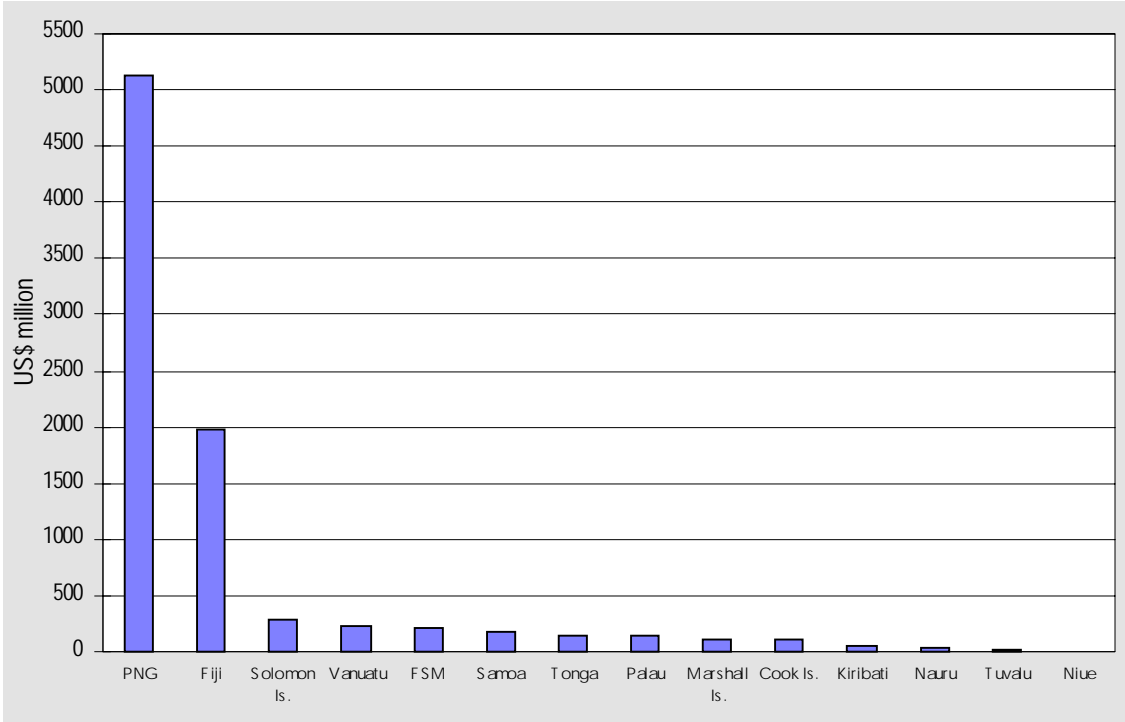
Figure 3. Nominal gross domestic product (2)
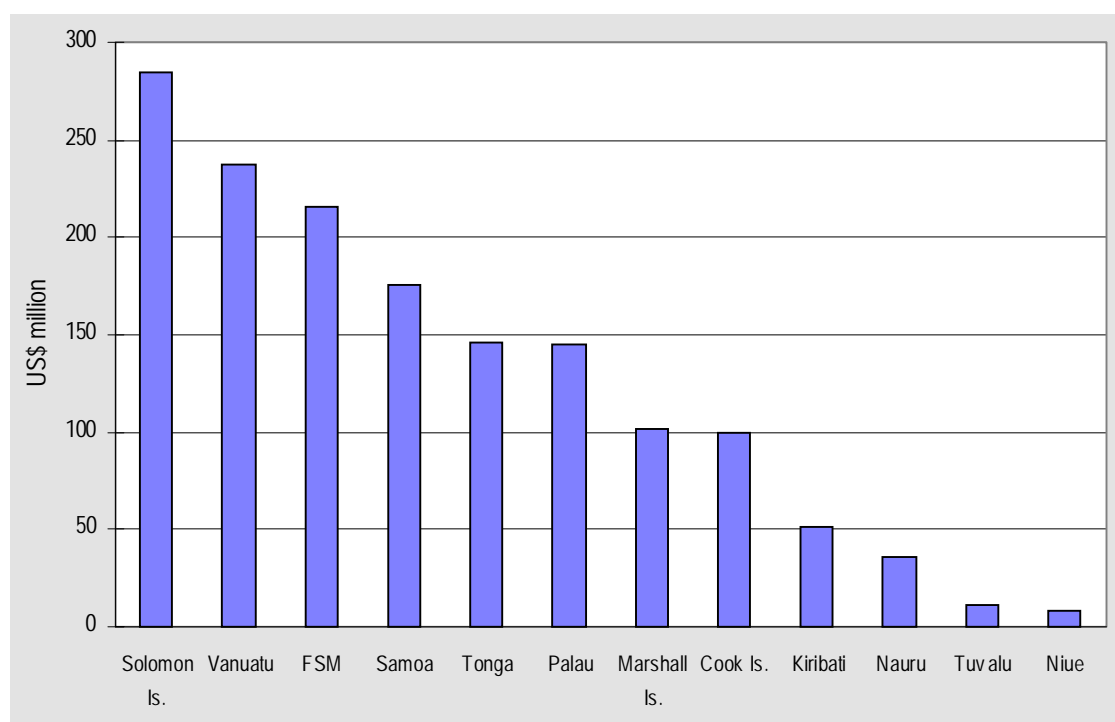
cent of GDP or less, except for Papua New Guinea (8 per cent). This suggests immediately that the range of manufactured goods that are likely to be traded between the FICs in an RTA is probably very narrow, with most of the supply potential residing in a single FIC, Fiji. The potential for trade in the agricultural, forestry and fisheries products which dominate FIC production structures tends to be inhibited by transport and quarantine problems, as well

Table 1. Sectoral composition of GDP (%)

	Cook Islands	Fiji	Kiribati	Marshall Islands	Palau	PNG	Samoa	Solomon Islands	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.

Figure 4. Nominal gross domestic product per capita
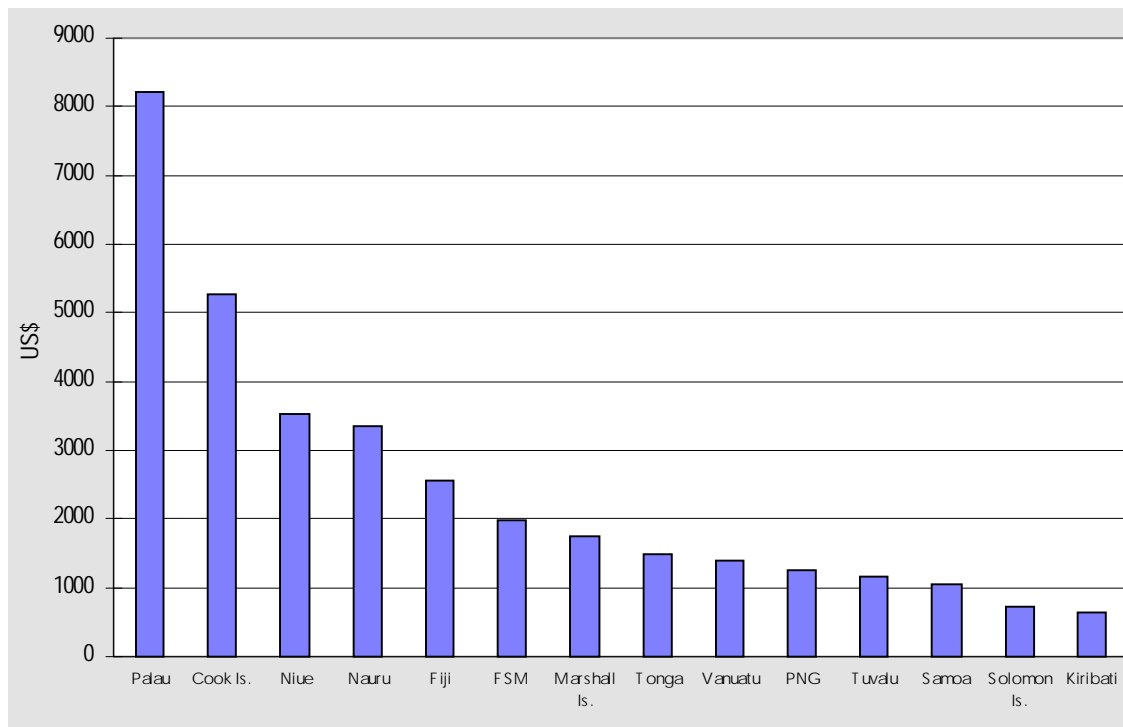
as by the fact that the FICs tend to produce similar products in these sectors.

Trade in services may offer a promising avenue for development of trade between the FICs, and Forum leaders have in fact already expressed interest in extending the FIC FTA to cover services. Service sectors such as tourism may well benefit from closer integration among the FICs. 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.

C. Intra-FIC trade

An impression that the potential for trade among the FICs may tend to be quite limited is reinforced by data presented in figure 5, which shows the share of each FIC's merchandise trade which is accounted for by other FICs (imports, exports and total trade). It is clear that trade between FICs (intra-FIC trade) accounts for only a very small share of the FICs' total trade.

Specifically, the only FICs for which trade with other FICs accounts for more than 10 per cent of total trade are Tuvalu (21 per cent), Kiribati (18 per cent), and Samoa (13 per cent). For half of the FICs, trade with other FICs accounts for less than 3 per cent of total trade. These are the Solomon Islands (2.8 per cent), Fiji (1.6 per cent), Nauru (1.3 per cent), the Marshall Islands (0.8 per cent), Papua New Guinea (0.6 per cent), the Federated States of Micronesia (0.1 per cent) and Palau (0.1 per cent). It is significant that the two largest FICs, Papua New Guinea and Fiji, are both included in this group.

Four FICs source more than 10 per cent of their imports from other FICs: Tuvalu (21 per cent), Kiribati (20 per cent), Samoa (14 per cent) and the Cook Islands (11 per cent). On the other hand there are five FICs, including Papua New Guinea and Fiji, which obtain 1 per cent or less of their imports from fellow FICs: the Marshall Islands, Papua New Guinea, Fiji, the Federated States of Micronesia and Palau. The Solomon Islands and Nauru each obtain between 3 per cent and 4 per cent of

Figure 5. Trade with other FICs
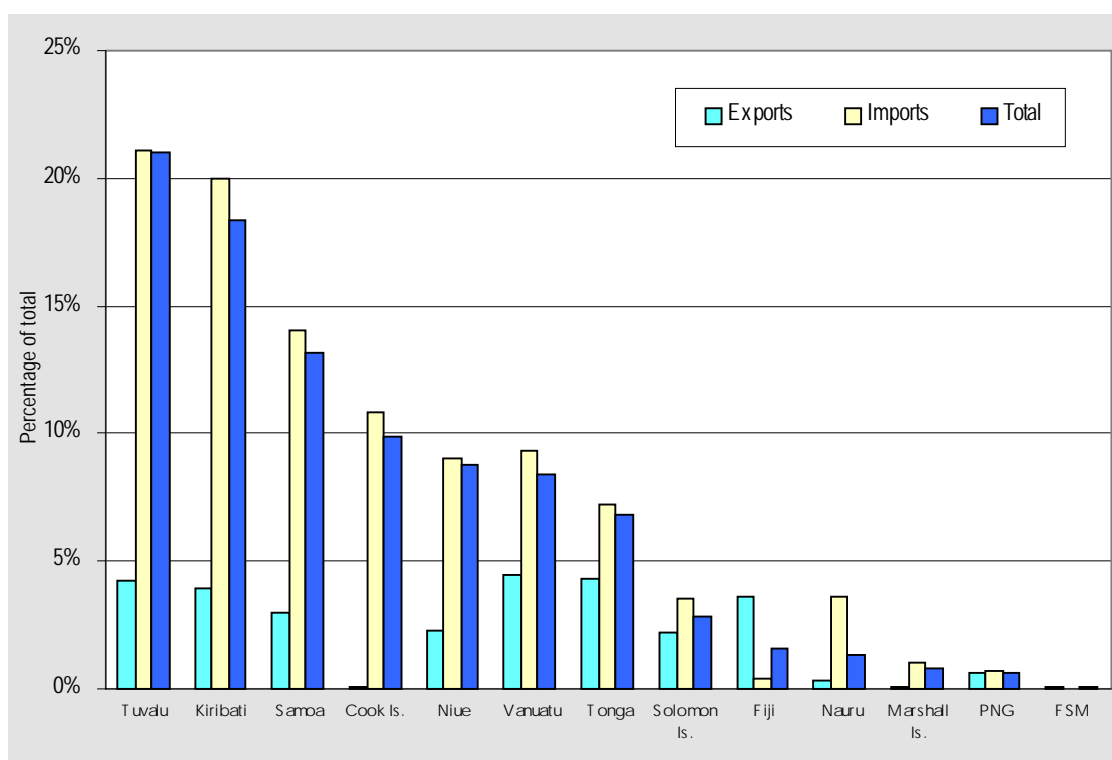
their imports from other FICs. Exports to other FICs do not account for more than 5 per cent of the exports of any FIC. There are six FICs for which exports to other FICs account for less than 1 per cent of total exports: Papua New Guinea, Nauru, the Marshall Islands, the Federated States of Micronesia, Palau and the Cook Islands. There is also a group of six FICs for which exports to other FICs account for between 3 per cent and 5 per cent of total exports: Vanuatu, Tonga, Kiribati, Fiji, Tuvalu and Samoa.

Taken together with the narrow production base in most FICs, this information 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 increases substantially as a result of the establishment of a free trade arrangement among the FICs. In addition to trade barriers, the low level of intra-FIC trade of course also reflects the existence of other significant obstacles to this trade, particularly the high costs of transporta-

tion among the FICs, related both to their small size and to the large distances separating them from each other.

D. Trade with non-FICs

Data on the relative importance to the FICs of different import sources and export destinations are presented in the graphs in appendix 4. The data are for the latest year for which the data could be obtained in the case of each FIC. They show that FIC imports are highly concentrated on long-standing traditional sources. Australia and New Zealand together account for over 90 per cent of the imports of Nauru and Niue respectively, and 78 per cent of Cook Island imports. They also account for between half and two thirds of the imports of seven other FICs: Tonga (67 per cent), Samoa (60 per cent), Vanuatu (55 per cent), Fiji (54 per cent), Kiribati (54 per cent), the Solomon Islands (50 per cent) and Papua New Guinea (56 per cent). In Micronesia there

is also a dominant supply source – the United States – which accounts for 51 per cent of imports into the Marshall Islands and 40 per cent of the imports of the Federated States of Micronesia.

Exports are much more diversified. New Zealand dominates the exports of Niue (98 per cent), but beyond that Australia and New Zealand account for more than 50 per cent of exports only in the case of Samoa (57 per cent), with their share of Cook Island exports being slightly below 50 per cent at 47 per cent. The two countries also enjoy a moderate share of the exports of Fiji (24 per cent) and Papua New Guinea (26 per cent). Beyond that there are relatively small shares of the exports of Tonga (18 per cent), Kiribati (9 per cent) and Vanuatu (5 per cent).

There is also considerable variation among the FICs in the relative importance of other export markets. Japan dominates the exports of the Federated States of Micronesia (78 per cent), Palau, and Tonga (50 per cent), and accounts also for a significant share of the exports of the Solomon Islands (36 per cent), Papua New Guinea (17 per cent), Vanuatu (16 per cent) and the Cook Islands (15 per cent). The European Union accounts for large shares of the exports of Kiribati (57 per cent), Fiji (26 per cent), the Solomon Islands (25 per cent), Vanuatu (22 per cent), Samoa (21 per cent) and Papua New Guinea (15 per cent). The United States has a significant share of the exports of the Cook Islands (25 per cent), Tonga (18 per cent), Fiji (13 per cent) and Kiribati (13 per cent). Other significant markets are the Republic of Korea for the Solomon Islands (15 per cent of total exports) and Bangladesh for Vanuatu (30 per cent of total exports).

The variable importance of Australia and New Zealand as export markets for the FICs is interesting in the light of the common access to these markets which the FICs have enjoyed under SPARTECA. This variability will reflect a mix of various factors affecting the ability of the individual FICs to competitively supply products to the two markets, as well as the relative attractiveness of other markets. This experience may be an indication that there will be similar variability in the ability or inclination of the FICs to exploit opportunities arising from establishment of free trade among themselves.

E. Balance of trade

All but three of the FICs (Papua New Guinea, Solomon Islands and Nauru) have a deficit in merchandise trade. The ratio of merchandise imports to merchandise exports for individual FICs is shown in figure 6. For those FICs with merchandise trade deficits the ratio of imports to exports ranges from 636:1 and 40:1 respectively for Tuvalu (not shown in figure 6, and excluding re-exports) and Niue to 1.6:1 for Fiji. In addition to Niue, there are five FICs for which the ratio is between 10:1 and 5:1 (Cook Islands, Samoa, Kiribati, Tonga and Palau). The ratio is between 5:1 and 3:1 for Vanuatu, the Federated States of Micronesia and the Marshall Islands.

The balance on services trade should of course be considered as part of the overall balance of trade, but unfortunately this information is not available for all FICs. Six FICs (Fiji, Kiribati, Samoa, Palau, Tonga and Vanuatu) enjoy surpluses on their services trade. In none of these cases is the surplus on services trade sufficient to offset the merchandise trade deficit. Fiji and Palau have the largest surpluses on services trade relative to the size of their merchandise trade deficits. Papua New Guinea, the Solomon Islands, Tuvalu and the Federated States of Micronesia all have deficits in their services trade. The services trade deficits of Papua New Guinea and the Solomon Islands are large relative to their merchandise trade surpluses, and in the latter case result in an overall trade deficit. The services deficits of Tuvalu and the Federated States of Micronesia are additional to substantial deficits in merchandise trade.

Figure 6. Ratio of total imports to total exports
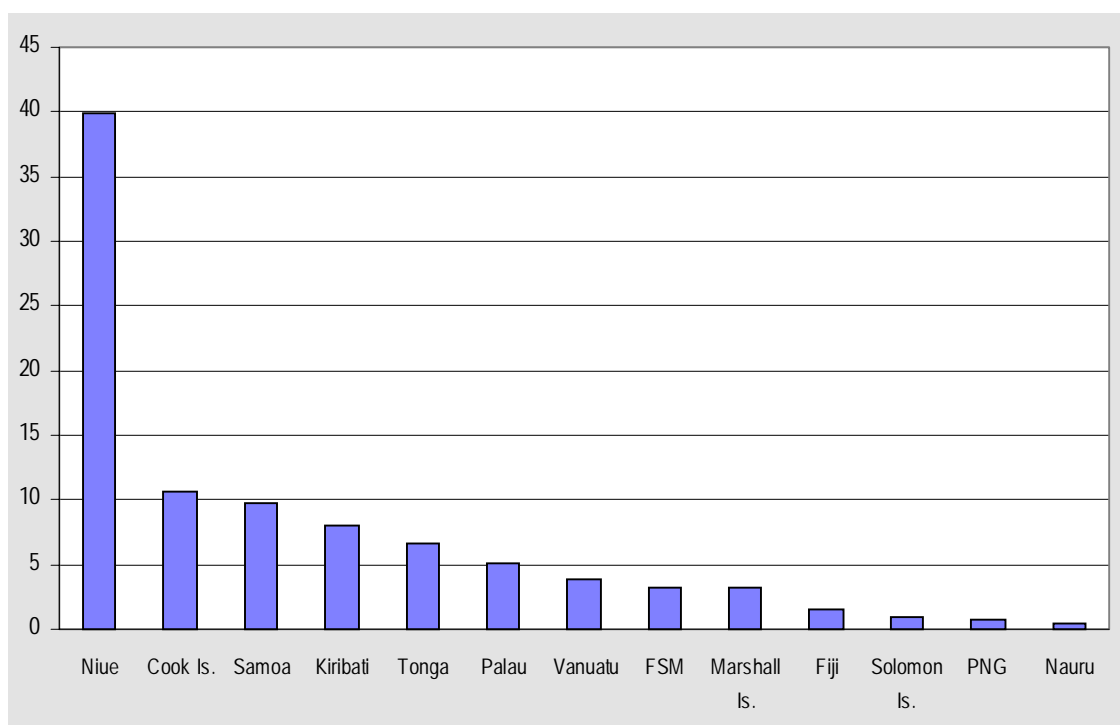
F. Tariffs

Figure 7 shows FIC tariff revenues as a percentage of imports. This provides an implicit measure of the average tariff actually applied to imports in each FIC. This implicit average tariff rate is considerably lower than might be expected on the basis of published tariff schedules in most cases, reflecting substantial undercollection of tariffs. The reasons for undercollection in a number of FICs have been detailed in recent tariff studies by the Forum Secretariat.

Figure 8 shows tariff revenues as a percentage of total tax revenues in the FICs. This clearly indicates the importance of tariff revenues in the tax base of most FIC economies, although as noted later in this report many FICs are moving to implement tax reforms which will result in a lower share of total tariff revenue being provided by tariffs in the future. The impact of a FIC free trade arrangement on tariff revenues depends on the proportion of total trade which will be affected and the distribution of that trade across different tariff classes.

More complete information on FIC tariff rates is provided in appendix 2.

G. 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 – have applied for membership. This is enough to ensure that any RTA involving these FICs will have to comply with relevant WTO obligations. In the case of an RTA involving only FICs it can 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 24 of the GATT, which is now part of the WTO Agreement, together with the "understanding" on its interpretation incorporated into the Final Act of the Uruguay Round. If the RTA also covers services trade it must com-

Figure 7. Tariff collections as percentage of imports

Bar chart showing tariff collections as percentage of imports: Vanuatu ~29, Kiribati ~28, Samoa ~21.5, Tonga ~17.5, PNG ~17, Fiji ~14.5, Solomon Is. ~13, Tuvalu ~13, Cook Is. ~11, Niue ~9.5, Marshall Is. ~9.5, Palau ~4.5, FSM ~1, Nauru ~0.
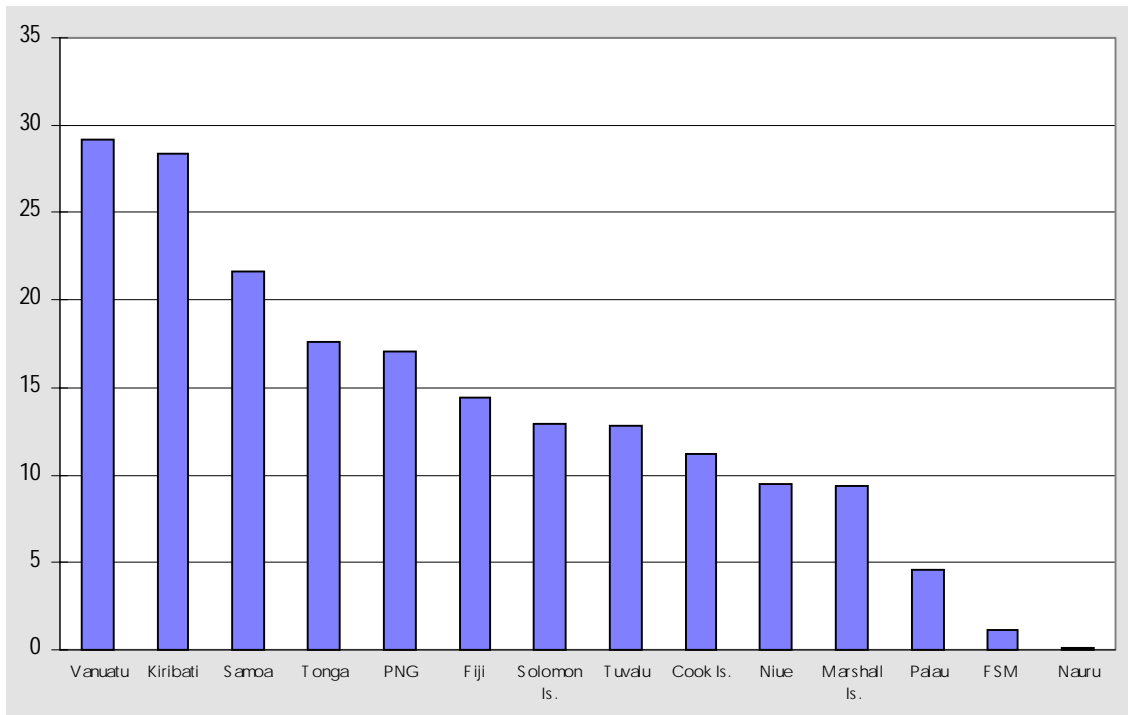
ply in addition with Article V of the General Agreement on Trade in Services (GATS). Forum economic ministers have clearly stated a commitment to implement policies consistent with WTO principles wherever possible. This may be interpreted to imply that a FIC FTA should not necessarily rely on a dispensation under the Enabling Clause but rather aim to meet the higher standards required under Article XXIV.

Figure 8. Tariffs as percentage of total tax revenue

Bar chart showing tariffs as percentage of total tax revenue: Kiribati ~64, Vanuatu ~57.5, Tuvalu ~45, Marshall Is. ~35.5, Samoa ~34, Fiji ~32.5, Tonga ~30.5, Solomon Is. ~25, FSM ~24, PNG ~22.5, Palau ~20.5, Cook Is. ~19.
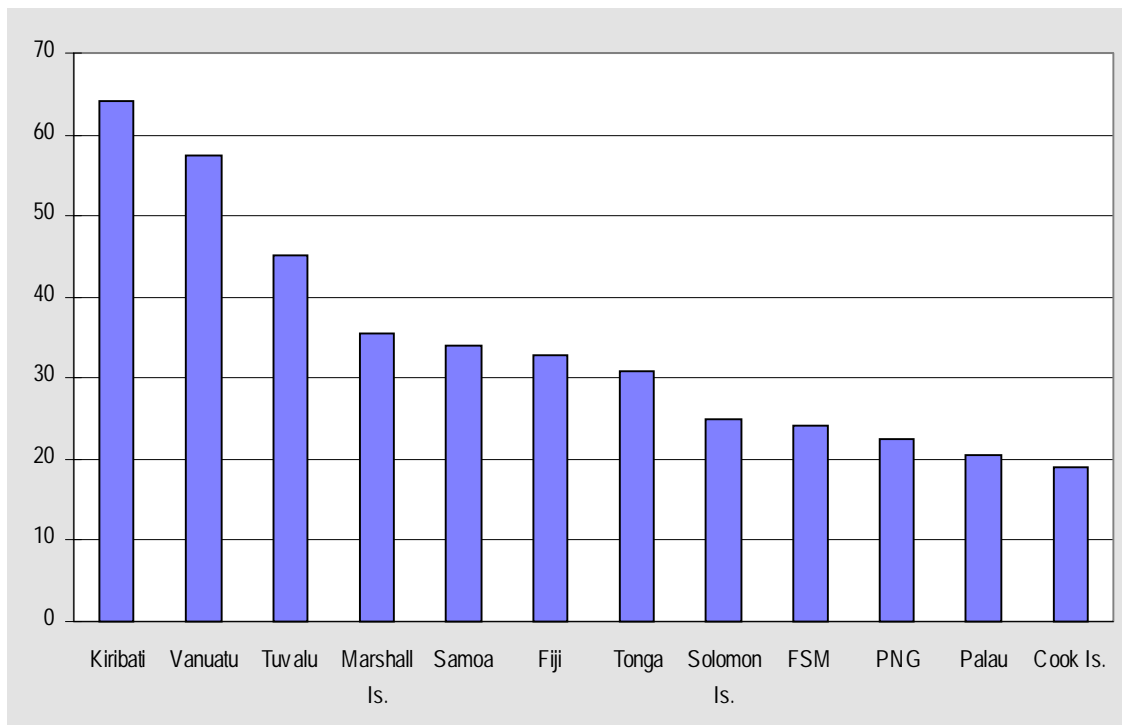
H. Trade preferences

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 Generalized System of Preferences (GSP), which is made available unilaterally by developed countries to all developing countries, although the product coverage varies between developed country markets;

• The Lomé Convention, which provided preferential access to the European Union, along with a range of other benefits for all FIC members of the ACP (African, Caribbean and Pacific) group of States. Until recently this group excluded the Federated States of Micronesia, the Marshall Islands, Palau, Nauru, Niue and the Cook Islands. With the signing in 2000 of the Cotonou Agreement to replace the Lomé Convention, these six FICs have also become members of the ACP group;

• The compacts of Free Association (CFA) with the United States, which provides trade access privileges, as well various important entitlements to financial assistance, for the Federated States of Micronesia, the Marshall Islands and Palau;

• SPARTECA, which provides duty-free access to the Australian and New Zealand markets provided that rules of origin requirements are met;

• The Papua New Guinea Australia Trade and Commercial Relations Agreement (PATCRA), which is applicable only to Papua New Guinea.

These preferences are being heavily eroded as the preference-granting countries reduce their trade barriers in pursuit of both multilateral and unilateral trade liberalization objectives. There is also increasing pressure for existing non-reciprocal preferential trade agreements with developed country partners to be replaced by reciprocal arrangements. The European Union has proposed that the non-reciprocal arrangements applying under the former Lomé Convention should be replaced by reciprocal arrangements embodied in a Regional Economic Partnership Agreement (REPA), although it has left open the possibility that another format could be adopted (Commission of the European Communities, 1997). The Cotonou Agreement is designed as a transitional arrangement, allowing time for new permanent arrangements to be negotiated. It provides for negotiations on the new arrangements to begin in 2002.

It is noteworthy that among the preferential regional trade agreements in which FICs participate, only SPARTECA and the Cotonou Agreement include all 14 FICs in its membership.

I. Regional trade initiatives

There are also a number of preferential regional trading initiatives within the FIC grouping. The most developed of these is the trade agreement of the Melanesian Spearhead Group (MSG), which originally involved three members of the MSG – Papua New Guinea, Solomon Islands and Vanuatu – and has more recently been extended to include Fiji. The members of the MSG trade agreement have agreed to eliminate tariffs on trade between themselves for an agreed list of products (Grynberg and Kabutaulaka 1995). Initially, only a very small number of products was included in this agreement, but subsequent negotiations have progressively expanded the range of products covered, which nevertheless remains quite restricted. While anecdotal evidence indicates some success in expanding trade within the MSG group, the level of this trade remains low. The MSG trade agreement does have a political significance in the context of the FIC FTA, in that it envisages the assertion of a distinct Melanesian identity, as against the Forum-wide concept embodied in the proposed FIC FTA.

Fiji also has long-standing non-reciprocal trade agreements with Kiribati and Tuvalu, and a more recent reciprocal agreement with Tonga, in addition to its arrangements with the other MSG members. Like the MSG trade agreements, Fiji's bilateral trade agreements are all "positive list" agreements, which means that they apply only to a specified list of products.

These lists are generally rather short, particularly in the case of the bilateral agreement with Tonga, which covers only a small number of products. Short lists may reflect a reluctance to commit to meaningful liberalization, although it could also reflect a relatively small portfolio of products of export interest.

II. ISSUES IN DEBATES OVER RTAs – RELEVANCE TO THE FIC FTA

The FICs have already accepted the need to participate in the worldwide trend towards freer trade by progressively liberalizing their trade policies. The appropriate way to evaluate the FIC FTA proposal is therefore on the basis of the contribution it can make to the adoption of more liberal trade regimes, and to the capturing of the economic benefits that can be expected to follow from reductions in trade barriers.

Over the years a considerable number of factors have been proposed as having a considerable bearing on whether RTAs are likely to be beneficial for members, the extent of any negative effects on non-members, and whether RTAs tend to undermine or support the multilateral trading system.   Reference to the economic characteristics of the FICs can help to identify those arguments which are more relevant and less relevant in the case of the proposed FIC FTA.

A.   The traditional Vinerian analysis

Viner (1950) provided the essential insight that programmes for the removal of trade barriers that might unequivocally improve the welfare of the implementing country if implemented on a unilateral or multilateral basis, will not necessarily do so if implemented on a preferential basis. As is well known, this is because RTAs and other preferential agreements, by discriminating in favour of their members, must inevitably discriminate against non-members.

The essential logic of trade liberalization is that countries benefit by importing goods and services which they are relatively ineffi-cient at producing themselves, in exchange for the goods and services which they can produce relatively efficiently. When trade liberalization is undertaken on a most-favoured-nation (MFN) basis, either unilaterally or multilaterally, these efficiency gains are ensured because the increased imports will come from the most efficient international source, and the increased exports will be of products in which the liberalizing country is internationally competitive. MFN liberalization is thus a first-best policy.

Preferential trade agreements do enable members to enjoy gains from trade. Members of such agreements will increase imports of goods and services which their partners can produce more efficiently, and increase their own exports of goods which they themselves can produce more efficiently than their partners. This increase in trade is the *trade creation* effect of a free trade area, and confers economic benefits in the same way as the increase in trade resulting from non-discriminatory trade liberalization. The gains from trade in a preferential trading arrangement will, however, generally be less than the gains available from a corresponding reduction of trade barriers on a non-discriminatory basis, since such arrangements are unlikely to include the most competitive suppliers of all goods and services in their membership. This is especially likely to be true of free trade areas involving small groups of countries, particularly if those countries are themselves small.

Second, the gains from trade creation in a preferential trade arrangement can be partly or wholly negated by an effect called *trade diversion*, which does not arise in the case of non-discriminatory trade liberalization. Trade diversion occurs when the preferences created

under the arrangement cause imports to be switched from non-partner to partner countries, even though they are available from the non-partner countries at a lower cost. This can happen of course because the higher-cost goods from the partner country enter free of duty and other restrictions under the free trade agreement, which may allow them to be sold to customers at a lower price than the lower-cost imports from the non-partner, to which duties and other restrictions continue to be applied. Although consumers may benefit from lower prices, the resource cost to the importing country of acquiring the goods, as measured by the foreign exchange outlay needed to pay for them, has increased.

The potential for negative effects comes about as a result of the violation of the non-discrimination principle, which inevitably means that regional trade liberalization is a second-best economic policy. Whether the economic effects of second-best policies are positive or negative generally depends on the facts of each particular case, and this is indeed the case with RTAs. The conventional analysis of preferential trading arrangements such as free trade areas and customs unions indicates that they may either benefit or harm their members, depending on whether trade creation outweighs trade diversion or vice versa. In part the relative size of trade creation and trade diversion effects depends on the design of each agreement, but it can also be related to economic characteristics of the proposed members and the structure of their international trade.

Laird (1999) reports the general view that the prospects for maximizing trade creation and minimizing trade diversion will be greater the larger the shares of the members' in their partners' pre-existing trade, the larger and more diversified the partners' economies, the closer the partners' domestic prices to world prices, and the greater the initial non-uniformity of the partners' tariff structures. It is quite clear that none of these characteristics, with the possible exception of the last, are found among the FICs.

Rather, the small size and very narrow production base of the FIC economies, together with the low levels of existing intra-FIC trade and the limited potential for increasing it, suggest that the potential for trade creation in a FIC RTA would be quite small. On the other hand, the relatively high tariffs found among the FICs means that the margins of preference created in favour of the members in a FIC RTA could be very substantial, with the corresponding danger that a significant part of any increased trade under such an arrangement would constitute trade diversion rather than trade creation. Taken together, these factors suggest that the welfare effects of a FIC RTA are likely to be very small, and there is a very real question as to whether they are likely also to be negative, owing to a preponderance of trade diversion over trade creation effects.

In any RTA the size of potential trade diversion effects can be reduced if the partners continue to reduce their external trade barriers (i.e. trade barriers applying to imports from non-members) on an MFN basis at the same time as they eliminate trade barriers between each other. Where the apparent risk of trade diversion is high, as in the FIC case, this accompanying MFN liberalization is an especially important condition for increasing the likelihood that the welfare effects of the RTA will be positive. At the same as it ensures enhanced welfare benefits for the members of the RTA, this MFN liberalization helps to limit the negative impact on the exports of internationally competitive non-members, and thus also helps to tilt the balance of global welfare effects towards the positive side.

MFN liberalization in isolation, of course, is the first-best policy and would produce unambiguously positive welfare effects because of the absence of any potential for trade diversion. One can readily hypothesize that the superiority of this option in terms of overall welfare effects is likely to be particularly pronounced in the case of the FICs. One could also hypothesize that an RTA which includes some of the FICs' principal import sources,

such as Australia and New Zealand, would be likely to generate less trade diversion and would accordingly yield superior welfare benefits to the FICs compared with an RTA limited to the FICs themselves.

B.   Tariff revenue

The heavy dependence of the FICs on tariffs as a revenue source for their Governments is also quite clear, as is the fact that no Government can contemplate a sudden collapse in its revenue base. This is therefore a major potential constraint on trade liberalization by the FICs.

One solution, of course, is to restructure tax systems so as develop alternative sources of revenue and thus reduce the dependence on tariffs for revenue purposes. The FICs are aware of this and most are either moving or have plans to move in this direction. Several have introduced a value-added tax as a means of broadening their revenue base, and others are contemplating the introduction of either a value-added tax or some other broad-based consumption tax. In addition, improvements in tariff administration and modernization of customs procedures can be and are being made to improve the revenue flow derived from any given tariff structure, for example by reducing the extent of under-collection of tariffs.

Restructuring of tax and customs systems is thus one of the major adjustments – perhaps the major adjustment – that the FICs are required to make to accommodate a liberalizing trade strategy. The time needed for this adjustment is likely to be a major limiting factor for the speed with which the FICs are able to undertake trade liberalization. Furthermore, the adjustment will be greater the more comprehensive the liberalization, since this will imply a correspondingly large loss of tariff revenue. There is thus a clear inverse relation between the size of the welfare gains to be expected from any given liberalization and the size of the adjustment that must be undertaken.

An initiative such as a FIC FTA would be expected to produce small, possibly negative welfare effects, but at the same time would have a relatively minor impact on tariff revenue collections. The more comprehensive liberalization involved in an RTA including a major trading partner may be projected to yield much larger welfare gains, but it will also cause a much larger loss of tariff revenue, and both effects would be further accentuated in a move to free trade on an MFN basis. The more complete the liberalization, the larger the adjustment, and the longer the period of time likely to be needed to make that adjustment.

There is also the issue of the economic meaning for countries such as the FICs of removing tariffs if the tariffs must be replaced by alternative taxes of equivalent revenue-generating capacity. The advantage of a broad-based tax such as a value-added tax is that it is neutral as between imports and domestic production. In addition, it is relatively easy to zero-rate exports and thus remove the bias against exports which derives from the effect of tariffs on domestic cost structures, without any need for recourse to complicated and administratively onerous drawback schemes. In such cases the removal of tariffs still confers an economic benefit which follows from the removal of their distortionary effects.

This argument is less convincing under the conditions that exist in some of the smaller FICs, where exports are negligible or even zero, and where almost all consumption is import-based. In these cases the replacement of the tariff by a value-added tax or similarly broad-based consumption tax may have little practical significance except as a formal prerequisite for participation in trade agreements which require the removal of tariffs. The fact that exports are negligible does not, however, mean that they are not being inhibited by the presence of tariffs. It is still possible that the removal of the anti-export bias inherent in the tariff could lead to the development of some export potential.

C. Attraction of foreign direct investment

Ethier (1998) argues that the importance of the traditional Vinerian analysis has been overtaken by the new role of RTAs as the means by which small countries seek to compete with each other to attract foreign direct investment (FDI). It is certainly true that the desire to attract FDI has been an important motivation for the formation of some recent RTAs among developing countries, notably the Association of South-East Asian Nations (ASEAN) and indeed also for the participation of developing countries in RTAs with developed countries, for example Mexico's participation in NAFTA. It is certainly true also that the FICs, in common with other developing countries, see an increase in FDI as a hoped-for consequence of their economic reform programmes, of which trade liberalization forms an important part.

It is tempting to suggest that the formation of a FIC FTA may lead to an increase in FDI by creating a larger potential market than that offered by individual FICs. This suggestion must be tempered, however, by recognition that even in combination the FICs comprise a very small market in international terms, and that the physical obstacles to trade between the FICs will remain significant, even if all trade barriers are removed, as noted earlier. It is thus not realistic to expect that a FIC FTA will lead to a quantum leap in FDI into the FICs. The effect may be positive, but it is likely to be relatively small. The most noticeable impact may be on the investment strategies of firms within the FICs themselves, rather than of larger multinational operations that tend to be seeking larger markets.

D. Increased competition

Reductions in X-inefficiency and elimination of monopoly rents due to increased competition are traditionally identified as sources of economic gain in RTAs, and in some circumstances these effects have been argued to be quite large relative to other sources of benefit. The tiny size of FIC markets means that the number of domestic suppliers to many markets will be very small. It is easy to envisage that a producer in, say, Tonga, faced with the prospect of greater competition from a counterpart in, say, Samoa, may be motivated to increase the efficiency of his or her operation. Thus to suggest that this may be a possible source of gain from the FIC FTA seems quite reasonable. Again, however, the gain is likely to be very small, because the number of markets for tradeable goods in which local producers are significant suppliers is relatively small.

E. Other arguments

A consideration of the economic characteristics of the FICs and their trade leads quite reasonably to the suggestion that many of the other, sometimes very sophisticated ideas and arguments advanced to indicate possible economic benefits from the formation of RTAs will be either irrelevant or at best of marginal importance to the analysis of a FIC FTA. Thus, for example, the tiny size of even the combined FIC market is unlikely to provide significant opportunities for exploitation of economies of scale, especially given the fact that a FIC FTA cannot affect the geographical isolation of each individual FIC. It is quite clear also that the FICs are not "natural trading partners" in the sense intended by Krugman (1991). They do not trade intensively with each other and their geographical proximity to each other is more apparent than real as an economic factor; any positive effect is likely to be nullified by the high transport costs for freight between small, widely separated islands. In any event, of course, Bhagwati and Panagariya (1996) have severely criticized the notion that geographical proximity provides a separate argument in favour of the creation of an RTA.

The "non-traditional arguments" identified (and discounted) by Panagariya (1999), such as guaranteed access to markets and shelter from contingent protection, are likewise of little moment in the case of a FIC FTA. Any

markets to which guaranteed market access is likely to be of importance to the FICs lie in their developed country economic partners rather than in their fellow FICs, and likewise contingent protection, to the extent that it is a problem for the FICs at all, is likely to affect them only in developed country markets. The economic effects of a FIC FTA are likely to be too small for it to have any significance in "locking in reforms", another possible "non-traditional benefit" identified in Panagariya (1999). The exception to this comment is that the dependence of some FIC Governments on tariff revenue is so great that even the introduction of a FIC FTA may be sufficient to trigger far-reaching reform of tax systems in some FICs, and these reforms are likely to be irreversible.

Lawrence (1997) suggests that the creation of free trade areas tends to lead to encouragement for deeper integration. Whether this should be counted as a benefit depends of course on whether the integration arrangement is itself welfare-enhancing. Deeper integration involving the harmonization of policies may not be welfare-enhancing if the policy differences being harmonized actually have a sound economic rationale. In any event, there are significant obstacles to most forms of deeper integration among the FICs, although ambitions in that direction clearly exist in the case of at least some FICs.

On the other hand, the trade facilitation measures which increasingly accompany the liberalization packages in RTAs do typically yield enhanced welfare benefits. Scollay (1998) argues that if trade facilitation measures were included in a FIC FTA, they could well be the largest source of economic gain from the arrangement. The dominant share of agriculture and fisheries in the production structures of most FICs, together with the underdeveloped state of quarantine services in the region, suggests that facilitation measures in the quarantine area might be particularly effective in encouraging growth in beneficial trade.

Customs procedures are another trade facilitation area where substantial improvement is possible. Although arrangements for cooperation exist between the FICs in both the quarantine and customs areas, Scollay (1998) identifies a number of ways in which this cooperation could be substantially enhanced.

Liberalization of trade in services is another aspect of deeper integration that might well be considered at a fairly early date as a useful extension of a FIC FTA, as noted earlier.

Given the tiny size of the FICs, a FIC FTA will clearly have minimal economic effects on non-members. Terms-of-trade effects will be non-existent and although the risk of trade diversion may be significant for the FICs themselves, it will of negligible economic consequence for their trading partners. FIC FTA will clearly not have anywhere near enough economic significance to strategically affect the behaviour of other countries in the multilateral trading system, although it may have some significance for the FICs' own trade relations with their major developed country economic partners, as discussed later. It is sometimes argued that RTAs may impede unilateral or multilateral liberalization by creating vested interests that benefit from the preferences granted in the regional arrangement. However, given the likely minor trade effects of a FIC FTA, any vested interests created by its formation are unlikely to be large enough to seriously affect trade policy in the FICs, let alone have any consequences for multilateral liberalization.

One possible negative effect of an RTA identified in Panagariya (1999) is that members of an RTA may be tempted to raise MFN tariffs to compensate for revenue lost due to the formation of the RTA. This policy is likely to be at least partly self-defeating, since raising MFN tariffs would tend to encourage further switching of imports to the RTA partners. In any event, the fact that the FICs already appear to be moving towards restructuring their tax systems to ensure sustainability of govern-

ment revenue in the face of trade liberalization, combined with their recognition of the importance of their ongoing commitment to MFN trade liberalization to their overall economic welfare, means that it is also probably safe to discount this possibility.

F.   Conclusions

The conclusions from this section are quite clear. While there may be some minor economic benefits associated with increased competition and encouragement of FDI, analysis of the benefits and costs of a FIC FTA reduces in very large measure to the traditional Vinerian concerns with the relative size of trade creation and trade diversion effects, set against the constraints created by the FICs' dependence on tariff revenue. Trade facilitation is the other area where substantial economic benefits are possible, with services trade offering perhaps further opportunities in the future. There is also an important question as to how far an arrangement such as a FIC FTA serves as an effective "stepping stone" to wider liberalization with greater potential for positive welfare effects. However, suggestions that the Vinerian analysis has lost its relevance are clearly premature, to say the least, in the case of economies such as the FICs.

III.   EVALUATION OF THE FIC FTA

Scollay (1998) reports the results of some rudimentary computable general equilibrium (CGE) simulations carried out to test some of the hypotheses identified in the previous section regarding the economic effects of a FIC FTA. A summary of the results of these simulations is given in table 2. Similar simulations, using essentially the same data set, were performed by Stoeckel et al. (1998) for an FTA including Australia and New Zealand as well as the FICs; and, finally, Scollay and Gilbert (1998) report the extension of the simulation exercise to consider full MFN liberalization by the FICs. For comparison purposes the principal results from these three studies are shown together in table 3.

Although widespread and serious data deficiencies meant that construction of the models used in these simulations was very time-consuming, they are nevertheless very crude. The crudeness of the models and the serious deficiencies in the data on which they are based preclude any serious weight being given 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.

Table 2. All countries: estimated changes in key economic variables

	Percentage change in imports from FICs	Percentage change in imports from rest of world	Percentage change in exports	Percentage change in tariff revenue	Percentage change in total employment	Change in welfare as a percentage of GDP
Cook Islands	7.88	-0.53	1.36	-11.24	0.26	-0.19
Federated States of Micronesia	0.09	0.00	0.01	-0.01	0.00	0.00
Fiji	7.72	0.22	0.14	-0.40	0.31	0.23
Kiribati	13.32	-2.58	14.71	-21.87	0.80	-1.87
Marshall Islands	10.02	0.07	0.49	-0.93	0.34	0.15
Nauru	0.07	0.01	0.00	-3.55	0.01	0.02
Niue	6.62	-0.13	8.81	-9.09	1.22	0.13
Palau	3.43	0.00	0.01	-0.20	0.00	0.00
Papua New Guinea	92.45	-0.34	0.04	-0.72	0.05	0.03
Samoa	11.98	-1.04	4.73	-14.99	0.66	-0.68
Solomon Islands	6.10	0.16	0.46	-3.41	0.43	0.20
Tonga	10.54	-0.11	1.75	-7.40	0.59	0.01
Tuvalu	3.14	0.27	6.94	-21.40	1.06	-0.01
Vanuatu	2.67	2.58	5.06	-28.54	1.95	0.21
Additional simulations: reduction of rest-of-world tariff by 25%						
Cook Islands	5.97	1.44	4.00	-31.63	1.90	0.60
Kiribati	10.66	2.34	30.27	-37.00	3.82	0.45
Samoa	9.76	2.92	11.49	-32.33	2.54	0.16
Tuvalu	3.08	1.39	16.32	-38.61	3.27	1.16

Table 3. Summary of results for FIC Free Trade scenarios

All countries: estimated changes in economic welfare as a percentage of GDP

	FIC free trade area		FIC free trade area With Australia and New Zealand		MFN liberalization	
	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

A fuller description of the modelling process and its unavoidable limitations is given in appendix 3.

One of the many difficulties was the shortage and in many cases almost complete absence of reliable labour market data, or sometimes even of any labour market data at all. Nevertheless, it seemed clear from examination of the evidence available, including detailed interviews with responsible officials, that considerable underemployment exists in the FICs, particularly in the subsistence sector. In view of this, it seemed inappropriate to use the full employment assumption typically used in CGE modelling, which implies that increases in overall labour demand can be reflected only in wage increases. An assumption at the other extreme would be that the level of unemployment or underemployment is such that increases in labour demand could be accommodated through increases in employment, without any need for wages to rise. In the absence of any reliable data on which an intermediate scenario could be based, these two cases, which represent opposite ends of the spectrum of possible assumptions, were the two scenarios modelled. It could be hypothesized that reality might lie closer to the "unemployment" end of the spectrum in the case of a FIC FTA, where the effects on trade and production structures would be relatively small, and progressively closer to the "full employment end" of the spectrum as the scope of the liberalization being modelled increases. There is simply no way of being more precise than that.

Given the limitations of the results as outlined above, it would be unwise to base any conclusions too heavily upon them. They are, however, interesting and useful for the broad corroboration they provide for a number of hypotheses based on the standard analysis of FTAs in the light of the economic characteristics of the FICs and their trade.

In the simulations reported in Scollay (1998) for the "unemployment" scenario, which was taken as the "base case", the following are the principal features of the results as shown in table 2:

- 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 also increase for half the FICs, and the percentages of both increases and decreases are very small, which suggests that trade diversion may not be as great a problem as might have been feared.

- Exports rise is all cases (except 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 per cent of GDP or less).

Scollay (1998) provides some comment on whether the projected increases in trade between FICs are realistic. Although it is impossible to validate the results of the simulations 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 per cent simultaneously with the formation of the FTA. The results of these simulations are also shown in table 2. In each case, this 25 per cent MFN tariff reduction was sufficient to convert the welfare losses into welfare gains, and furthermore, in each case also reductions in imports from the rest of the world are converted into increases. This provided striking confirmation of the importance of ingoing MFN liberalization in parallel with any move to form an FTA.

The comparison of the three different cases in table 3 is also interesting for the confirmation it provides of earlier hypotheses. 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 (and in most cases increase significantly) 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 liberalization.

A.   Conclusions

The analysis reported so far allows some fairly clear conclusions to be drawn about the proposal for a FIC-only FTA:

- The economic effects are likely to be very small, and may be negative for some FICs.

- It is critically important that MFN liberalization be continued in parallel with the establishment of the FTA. This will avert the possibility of negative welfare effects and enhance the size of likely positive welfare effects.

- The economic benefits are not likely to be sufficient to justify a FIC-only FTA as an ultimate objective of economic policy. Greater welfare gains are potentially attainable through more comprehensive liberalization.

- Some FICs will experience significant losses of tariff revenue even under a FIC-only FTA. The losses will be much greater under an FTA including Australia and New Zealand, and greater still under full MFN liberalization by the FICs.

- A FIC-only FTA may therefore have value as an initial step in a liberalization strategy, requiring relatively modest adjust-

ments, and allowing time for the more far-reaching adjustments to be put in place which will be needed to accommodate more comprehensive liberalization initiatives.

• A FIC FTA should be supported by a strong programme of trade and investment facilitation measures, especially in the quarantine and customs areas. The gains from this may be as significant as, or more significant than, the gains from removing tariffs between members.

A further conclusion is that if a decision is made to proceed with a FIC FTA, it should be designed so as to minimize negotiat-

ing and administration costs, otherwise these costs will be very likely to outweigh the relatively minor economic benefits likely to come from the arrangement. Scollay (1998) strongly recommends a "negative list" approach whereby trade is liberalized in all products except for a (preferably short) list of exclusions. This is contrasted with the "positive list" or "product-by-product" approach often used in the negotiation of FTAs between developing countries, which tends to be very intensive in the use of negotiating and administrative resources. Under the "positive list" approach, furthermore, experience shows that progress in removing trade barriers often slows down quite rapidly as the negotiations widen to take in increasingly sensitive products.

IV. THE FIC FTA PROPOSAL

The decision by FIC leaders to proceed with negotiation of a FIC FTA indicates that they accepted the argument outlined in Laird (1999) that the smaller immediate gains from such an arrangement are an acceptable price to pay to keep initial adjustment costs within tolerable limits. In particular, the FICs appear to have endorsed a "stepping stone" approach whereby a small initial step allows collective liberalization to move forward while allowing time to prepare for the adjustments likely to accompany subsequent larger steps. The establishment of a FIC FTA as an initial step also serves a "confidence building" and "capacity building" function, providing an initial low-cost taste of the benefits of liberalization, and experience in the negotiation and management of trade agreements, thus helping to develop confidence and capacity to engage in further joint liberalization initiatives. Political considerations were also clearly important, notably the perceived need to provide a greater sense of solidarity among the FICs in international trade policy matters. This was seen as an important counterweight both to the variable participation of FICs in most of their trade agreements with developed countries, and to the tendency to form trade coalitions on ethnocentric lines as reflected in the emergence of the Melanesian Spearhead Group trade agreement.

A draft negotiating text for a FIC Free Trade Agreement has been prepared (Myburgh, 1999). Its principal features are:

• Tariffs are to be phased out over 10 years on an automatic timetabled basis.

• The approach to non-tariff barriers is that they are to be eliminated as and when they are identified, if necessary through tariffication. This approach was considered preferable to spending resources on developing and negotiating detailed rules to address a problem which is considered to be minor.

• A "negative list" approach is adopted, with provisions to limit the size of negative lists and gradually phase them out.

• Rules of origin are not product-specific and provide exporters with the option of using the "change of customs heading" (CCH) basis or a 40 per cent area content rule.

• "Emergency actions" (anti-dumping and countervailing measures, safeguard and balance-of-payment measures) are allowed under strict conditions.

• An "infant industry" provision permits suspension of the agreement for nominated products to allow "infant industries" to develop, again under strict conditions, including an automatic lapsing of the suspension if the development does not proceed within a stated time frame.

• Principles for conduct of government procurement are included, although their implementation is non-binding and on a "best efforts" basis.

• There is a three-stage dispute settlement process, progressing from consultation to mediation to arbitration.

• The operation of the agreement is to be reviewed after five years, and at regular intervals thereafter.

The key considerations in these design features are, first, to minimize negotiating and administrative costs so that these offset any positive welfare effects as little as possible, as explained above. This is reflected in the automaticity built in to the tariff reduction schedules and especially in the adoption of a "negative list" approach. Second, the provisions on emergency actions and infant industries reflect the vulnerability of the FICs and the need to provide for the possible future evolution of their development strategies. The provisions are intended to ensure that the FICs have sufficient flexibility to deal with unusually severe economic disturbances and to implement fresh development initiatives that may be proposed in future, while at the same time providing sufficient disciplines to ensure that this flexibility is not used to undermine the agreement by reintroducing unjustified protection on a discretionary basis. Third, it is intended that the agreement will as far as possible meet the standards laid down in GATT Article XXIV. Fourth, and relatedly, the agreement is designed as a genuine trade liberalization initiative, and this is reflected in its wide coverage, the relatively liberal rules of origin, and the automaticity of its provisions.

The economic arguments in favour of this last point are not necessarily clear-cut. Laird (1999) points out that in the case of a trade-diverting agreement it might be preferable to keep its coverage as narrow as possible in order to minimize the economic damage – and there are some grounds to be concerned about possible trade diversion in a FIC FTA, as noted earlier. However, since a FIC FTA is regarded as no more than a step in what is intended to be a more comprehensive liberalization process, it was felt that the arguments in favour of wide coverage should prevail. It was also considered that this could not be regarded as a threat to the development process in the FICs, in view of their very narrow production base, which means that there are relatively few industries or potential industries which will be put under pressure by the dismantling of protection. These relatively few cases can be readily accommodated under the "negative list" provisions.

Following completion of the negotiations for establishment of a FIC FTA, it is envisaged that detailed proposals will be developed and implemented for trade facilitation measures to accompany the FTA, particularly in the quarantine and customs areas. Extension of the agreement to cover trade in services has already been mooted, and the FICs have indicated a firm interest in extending the agreement to include the French and United States Pacific territories.[1] Studies on both the latter issues are being commissioned.

[1] New Caledonia, French Polynesia, and Wallis and Futuna; Guam, Commonwealth of the Northern Mariana Islands, American Samoa.

V. LINKS TO PREFERENTIAL ARRANGEMENTS WITH DEVELOPED COUNTRY PARTNERS

The World Bank (2000) has suggested that developing countries may be better served by entering into RTAs with developed countries rather than with other developing countries. However, the proposed FIC FTA is not an isolated venture into preferential trade on the part of the FICs. The FICs already have largely unrestricted and non-reciprocal duty-free access to both the Australian and New Zealand markets under SPARTECA and to the European Union market under the Lomé Convention. The Federated States of Micronesia, the Marshall Islands and Palau (the "compact countries") have similar access to the United States market under the CFA. Furthermore, the FICs are facing what may turn out to be irresistible pressures to convert existing non-reciprocal preferential arrangements with developed countries into reciprocal arrangements.

The European Union, as is well known, and as noted earlier in this paper, has proposed that the non-reciprocal preferential access arrangements extended over many years through the trade provisions of the Lomé Convention should be replaced by reciprocal market access provisions to be embodied in a series of Regional Economic Partnership Agreements (REPAs), which it plans to sign with groups of countries in the ACP regions. The Cotonou Agreement, signed in mid-2000, replaces the Lomé Convention and provides for negotiations on REPAs, or alternatives which might be proposed by the ACP States and accepted by the European Union, to begin in 2002, with implementation to begin in 2008. Australia and New Zealand have clearly indicated that as full members of the Pacific Islands Forum they expect to be included in the FIC FTA as full members, and the Forum leaders have in fact agreed that a formula must be found which provides appropriate "application of the [FIC FTA] measures to Australia and New Zealand"; these need not imply full membership, however. Inclusion of Australia and New Zealand in an FTA with the FICs may trigger provisions in the Lomé Convention requiring that the FICs do not grant any other developed country greater market access than they grant to the European Union, as well as similar provision in the CFA with the United States for the three former United States trust territories. If the FICs grant preferential access to the European Union or the United States there is no formal legal requirement to grant equivalent access to Australia and New Zealand, but the politics of the situation are such, given the latter two countries' position as full members of (and also the major donors to) the Pacific Islands Forum, that the granting of such access would almost certainly be unavoidable.

The design of new agreements to accommodate all these considerations, while at the same time meeting the non-discrimination provisions of the GATT and the relevant GATT/WTO rules on RTAs, raises many difficult issues. Some of the difficulties would be lessened if a FIC RTA was established as a customs union, with a common external tariff, thus making it easier for the FICs to enter new trade agreements as a group. A customs union is, however, unlikely in the foreseeable future. The issues involved in the design of the new agreements are beyond the scope of this paper, and will not be discussed further here.

The proposed FIC FTA will thus be just one element in an interconnected web of preferential trade arrangements in which the FICs are involved. The web is developing in ways which will obviate any disadvantage the FICs

might have suffered from not opening up their markets to developed country partners, and which in the process will of course also serve to further neutralize any further trade-diverting effects of a FIC FTA. The FIC FTA proposal also raises questions about how it will fit into the overall architecture of trading arrangements in which the FICs are involved.

A FIC-only FTA causes relatively few complications. It could be notified under the "Enabling Clause" to the Trade and Development Committee of the WTO, where it might expect an easy passage. The FICs would be left free to negotiate new agreements with their major developed country partners independently of the provisions of the FIC FTA, although they may wish to suggest that some provisions of the FIC FTA be used as a model for these agreements – other things being equal, it is clearly in the FICs' interests to standardize as far as possible the provisions of the preferential agreements in which they are involved (except where differences are required in order to take account of development considerations), so as to minimize the administrative complexities involved.

An FTA which includes Australia and New Zealand, on the other hand will have to notified under Article XXIV and examined by the Committee on Regional Trade Agreements, where it will be subject to more rigorous scrutiny, and where a number of potential difficulties in terms of Article XXIV may be raised. The market access provisions of the Lomé Convention and the CFA would in this case inevitably ensure that the negotiation and development of the FTA would become linked to the FICs' negotiations with the European Union and the United States. If Australia and New Zealand are not included as full members of the FTA, an alternative formula for linking them to the provisions of the FTA will have to be found, both to satisfy the mandate from Forum leaders and to accommodate the political reality that Australia and New Zealand are bound to demand treatment equivalent to any market access granted to the European Union in forth-coming negotiations.

Regardless of the architecture adopted, it seems likely, in view of the legal claims and/or likely politically irresistible demands of the major developed country economic partners for equivalent treatment in terms of market access, that the FICs will have to contemplate simultaneously opening up their markets to Australia and New Zealand, the European Union and the United States – and possibly also Japan, given that that country, a major aid donor in the region, is unlikely to take kindly to discrimination against it in favour of other developed countries. In other words, in terms of the "stepping stone" approach to liberalization, the step after a FIC FTA is likely to have to be a very large one, moving the FICs a considerable part of the way towards full MFN liberalization.

The previous discussion suggests that a large second "step" of this nature would have a positive effect on the welfare gains from preferential liberalization, since it would help to counter the trade diversion that might arise not only in an FTA among the FICs but also if the FICs granted preferential access to only one of their developed country trading partners. Panagariya (1999) provides some grounds for apprehension about the latter possibility by outlining a set of conditions under which a small high-tariff country might suffer particularly large economic losses in an RTA with a larger low-tariff country. This could occur if the larger country failed to fully displace imports from other sources in the smaller country's market, and if under these conditions the price of imports did not fall. In this case, the exporters in the larger country "capture" the tariff revenue previously received by the smaller country's Government. The disparate size of the partners means that this loss will not be offset by a similar effect operating on trade in the other direction. The potential dangers of a situation such as this are avoided if preferential access is simultaneously granted to each of the main sources of imports.

However, while a larger second "step" may be positive for the welfare gains from trade liberalization, it also implies a correspondingly larger adjustment, particularly in terms of the need to provide for alternative sources of revenue to replace the lost tariff revenue. This is likely to affect the length of the time frame within which the FICs are prepared to contemplate taking this second step.

The FICs clearly face a major challenge in managing interlinked negotiations with their major developed country economic partners in such a way that they retain control over the pace of their own liberalization, ensure that the resulting agreements do not involve them in unnecessary complexities or administrative burdens, and at the same time secure an acceptable level of compensation for the additional market access they will be compelled to offer.

VI. CONCLUSION

If the proposed FIC FTA is taken out of context it can easily be presented as an initiative which makes little economic sense. Taken, however, in the context of the economic characteristics of the FICs and the trade policy issues which they face, it can be viewed as a small but useful element in an ongoing strategy of trade liberalization. An understanding of the implications of a FIC FTA, furthermore, requires an assessment of the ways in which it may be linked to the trade negotiations which the FICs will be obliged to conduct with their major developed country economic partners.

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APPENDIXES

APPENDIX 1

Economic characteristics of the FICs: GDP,
per capita GDP, and population

	Nominal GDP (US$ million)	GDP per capita (US$)	Population (000)
Cook Islands	99.3	5 269	18.8
Federated States of Micronesia	215.8	1 976	109.2
Fiji	1 981.6	2 565	772.7
Kiribati	51.1	651	78.5
Marshall Islands	102.1	1 738	58.7
Nauru	35.9	3 355	11.2
Niue	8.1	3 522	2.5
Palau	145.1	8 204	17.7
Papua New Guinea	5 130.8	1 239	414.8
Samoa	175.3	1 037	169.0
Solomon Islands	284.5	720	395.2
Tonga	145.4	1 492	99.0
Tuvalu	11.1	1 107	9.5
Vanuatu	237.6	1 411	168.4

Sources: National economic data.

APPENDIX 2

TARIFFS FIC

	Tariffs as % of imports	Tariffs as % of tax revenue	Tariffs as % of total revenue
Cook Islands	11		
Federated States of Micronesia	1	24.0	3.3
Fiji	14	32.8	21.9
Kiribati	28	64.1	22.2
Marshall Islands	9	35.3	23.7
Nauru	0	1.0	0.0
Niue	9		
Palau	5	20.0	5.0
Papua New Guinea		22.3	18.0
Samoa	22	34.0	16.4
Solomon Islands	12	23.7	14.3
Tonga	18	30.7	21.2
Tuvalu	13	45.8	6.7
Vanuatu	29	57.5	48.1

APPENDIX 3

Notes on CGE modelling and results reported in Scollay (1998)

An economy-wide or general equilibrium analysis is needed to capture the full extent of the costs and benefits of establishing a preferential trading arrangement. This is because the removal of trade barriers changes the relative prices within an economy, and this can give rise to changes in resource allocation throughout the economy. Increases in output and employment in one sector, for example, may be offset by decreases in another, since the resources needed to increase output must come from somewhere. An analysis which focuses only on the sector directly affected by the removal of trade barriers is therefore likely to overstate, or in some cases understate, the effect of the change.

Similarly, changes in trade between the FICs arising from establishment of a preferential free trade area do not occur in a vacuum. Trade with third countries will also be affected. An increase in income brought about by establishment of the free trade area, for example, will act to increase imports from third countries. On the other hand, trade diversion caused by the preferences provided for FIC exports will act to reduce imports from third countries, and represents an important potential cost of a preferential free trade area, as discussed in this paper. Effects on trade with both members and non-members must therefore be taken into account in arriving at an assessment of the costs and benefits of preferential free trade. Once again, an economy-wide or general equilibrium analysis is needed to capture these effects.

A computable general equilibrium (CGE) analysis of the effects of preferential free trade was therefore undertaken. The procedure is to construct a simplified model of each economy, consisting of a set of equations designed to capture the key characteristics of the economy and its overseas trade. The models embody the best available information on the structure of each economy, together with standard economic assumptions relating to the way in which economic behaviour responds to relative price changes. Production, trade and tariff data collected from each FIC were inserted into the model. The model was then used to simulate the effect of the preferential removal of all tariffs on imports from FICs, leaving tariffs unchanged on imports from all other countries. For simplicity, the tariff removal was modelled as a "once-and-for all" change, whereas the likelihood is that in practice it would be phased in over time. The analysis models the adjustment of each economy to the tariff change, assuming all other factors affecting the economy are held constant, and without regard to how the adjustment might be spread over time.

Primarily because of data limitations each economy is broken down into only a small number of sectors. For most FICs four sectors are used: primary production, manufacturing, traded services and non-traded services. Greater data availability allowed a larger number of sectors to be used in the cases of Papua New Guinea (eight sectors), Fiji (seven sectors) and Vanuatu (six sectors).

The removal of tariffs was also modelled at an aggregate level. The ratio of total tariff revenue to total import values was taken as the best indication of average tariff rates. This produced a lower estimate than might be expected on the basis of published tariff rates, in part because of the large number of tariff exemptions granted in some FICs. Even allowing for this factor, however, the average tariff calculated in this way must be regarded as an underestimate of the average level of protection, since it takes no account of the extent to which potential trade is inhibited or prevented from occurring by prohibitive tariffs.

Removal of tariffs on trade between FICs was the only change considered in the analysis. The results therefore reflect only the effects of the relative price changes brought about by removing tariffs. They do not capture any of the other potential effects of creating a free trade area. In the model the effect of removing the tariff is divided between a reduction in the price at which goods from individual FICs are sold in other FIC markets, and an increase in the price which FIC producers receive for their exports to other FICs.

The analysis was conducted under two separate scenarios. In the first scenario the existence of substantial unemployment prior to the tariff change was assumed. This means that some sectors in the economy can expand without needing to attract labour from other sectors, so that the wage level remains unchanged. In the second scenario full employment was assumed, which means that expanding sectors need to attract labour from other sectors, which in turn means that the wage level must increase.

In many FICs official estimates of unemployment are not available. However, careful questioning about the employment situation during consultations often produced comments to the effect that substantial unemployment did in fact exist, or that labour could be attracted from the informal sector relatively easily with little impact on wages or informal sector output. In a number of FICs moves are under way to reduce the size of the public sector, and ample scope was considered to exist for resources to be released from the public sector into the private sector. Where unemployment statistics are available, they do indicate substantial levels of unemployment, as in Fiji, where the measured unemployment rate was 6 per cent in 1996, and in Tuvalu, where it was 13 per cent in 1994.

Taking this evidence into account, it is considered that the scenario assuming substantial unemployment prior to the tariff change provides the most realistic basis for the analysis, particularly since only a small proportion

of the FICs' trade will be affected by the tariff change. Alternative results under the scenario assuming full employment are presented for comparison purposes. These produce consistently less favourable welfare effects, as would be expected.

In addition to the standard caveats regarding the interpretation of CGE modelling results, there are several important limitations of the analysis in Scollay (1998) which need to be taken into account in evaluating the results of that study. The very high level of aggregation in the models, with each economy broken down into only a small number of sectors, means that they cannot capture the full diversity of the economy's likely response at the level of individual products or even industries, particularly as the average tariff reduction is assumed to apply across all imports. For some products and/or industries the effects will be much more pronounced than the model results indicate, while for others the effects will be less pronounced. There are likely to be special factors applying in some industries which would affect their response to a tariff change, but these cannot be detected in the models. A more detailed study of individual economies is needed in order to identify these differences.

The most important limitations are perhaps those relating to data sources. Because a consistent approach was considered desirable, the same type of data was used in modelling each economy. There was, however, considerable diversity in the quality and coverage of the data obtained from individual FIC economies. In some cases inconsistencies in the data had to be removed, and in other cases "ad hoc" assumptions had to be made to fill gaps in the coverage of the data. During consultations it was sometimes suggested that the official trade data used in the modelling exercise might be questionable. The quality of labour market data available in the FIC economies was generally poor, and in some cases extremely poor.

While it is reassuring that the results obtained were reasonably consistent across all
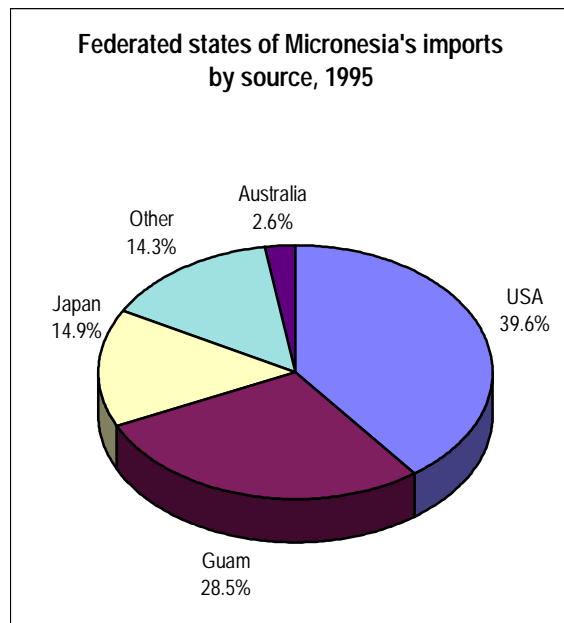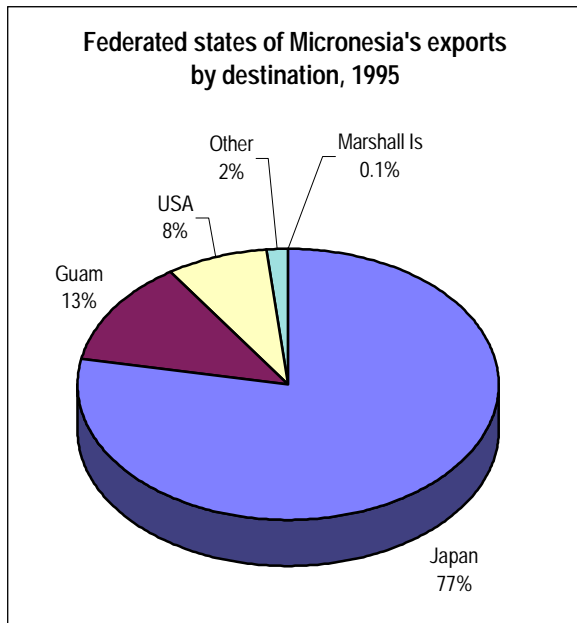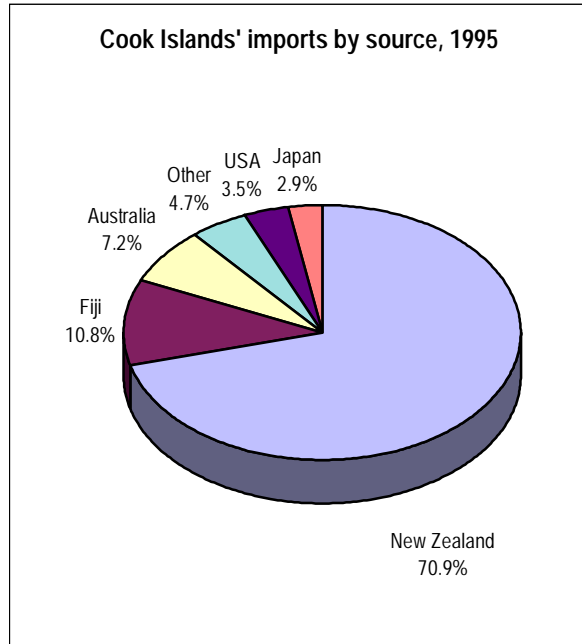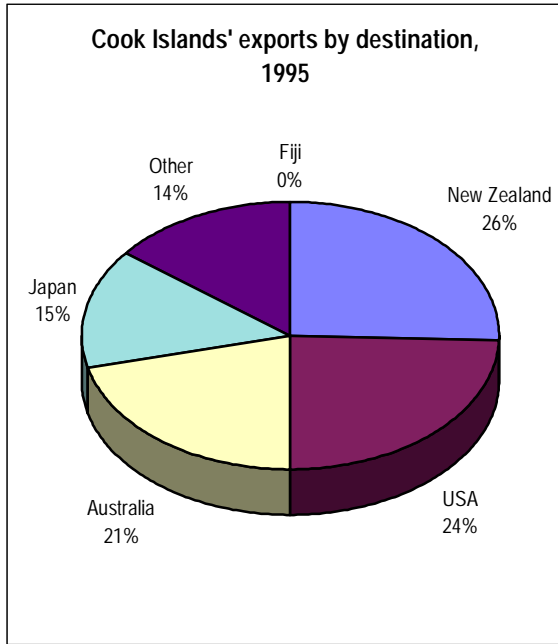
the FICs, the limitations outlined above are such that these results should be taken as indicative only. It would be unwise to rely on them for more than an indication of the direction and order of magnitude of the economic effects of forming a free trade area among the FICs.
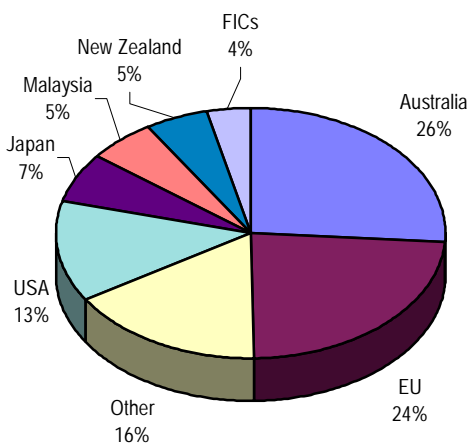
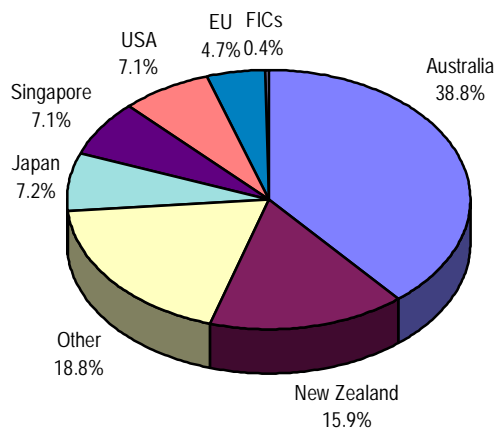Further technical details on the models used can be found in Scollay (1998).

APPENDIX 4
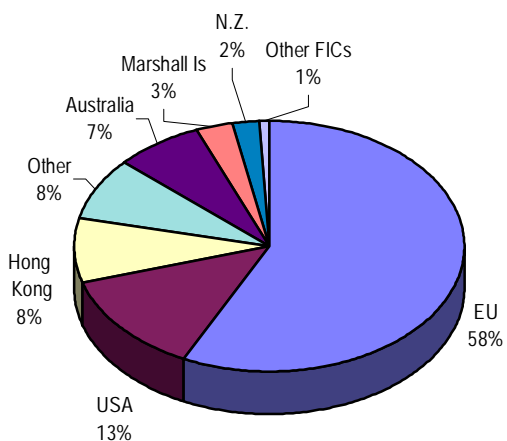
FIC exports and imports by destination and source

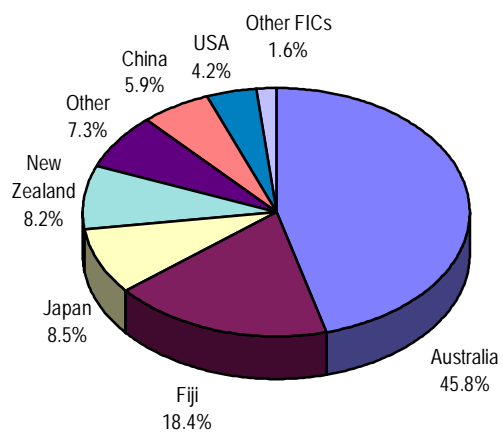**Cook Islands' exports by destination, 1995**

Other 14%
Fiji 0%
New Zealand 26%
Japan 15%
Australia 21%
USA 24%

Cook Islands' imports by source, 1995

Other 4.7%
USA 3.5%
Japan 2.9%
Australia 7.2%
Fiji 10.8%
New Zealand 70.9%

Federated states of Micronesia's exports by destination, 1995

Other 2%
Marshall Is 0.1%
USA 8%
Guam 13%
Japan 77%

Federated states of Micronesia's imports by source, 1995

Australia 2.6%
Other 14.3%
Japan 14.9%
USA 39.6%
Guam 28.5%

Fiji's exports by destination, 1995

- FICs 4%
- New Zealand 5%
- Malaysia 5%
- Japan 7%
- USA 13%
- Other 16%
- EU 24%
- Australia 26%

Fiji's imports by source, 1995

- USA 7.1%
- EU 4.7%
- FICs 0.4%
- Singapore 7.1%
- Japan 7.2%
- Other 18.8%
- Australia 38.8%
- New Zealand 15.9%

Kiribati's exports by destination, 1996

- N.Z. 2%
- Marshall Is 3%
- Other FICs 1%
- Australia 7%
- Other 8%
- Hong Kong 8%
- USA 13%
- EU 58%

Kiribati's imports by source, 1996

- China 5.9%
- USA 4.2%
- Other FICs 1.6%
- Other 7.3%
- New Zealand 8.2%
- Japan 8.5%
- Fiji 18.4%
- Australia 45.8%

Marshall Islands' imports by source, 1995

Australia 1.9%
FICs 1.0%
Japan 7.4%
Guam 14.6%
USA 51.1%
Other 24.0%

Nauru's exports by destination

FICs 0.3%
Other 99.7%

Nauru's imports by source, 1997

Japan 5%
FICs 2%
Other 1%
Australia 92%
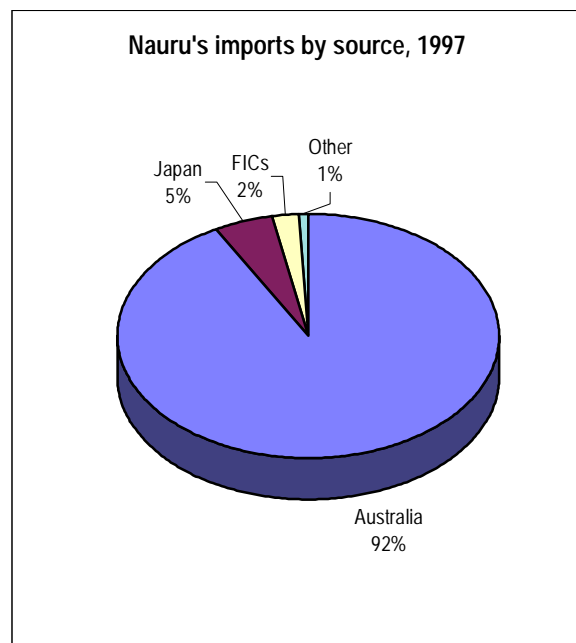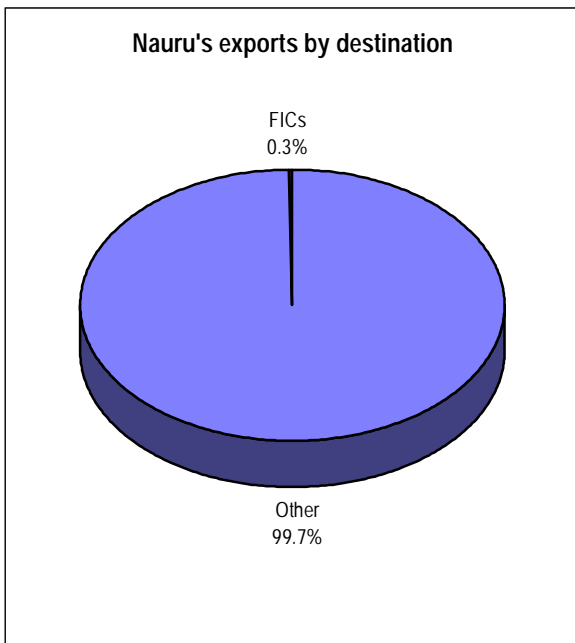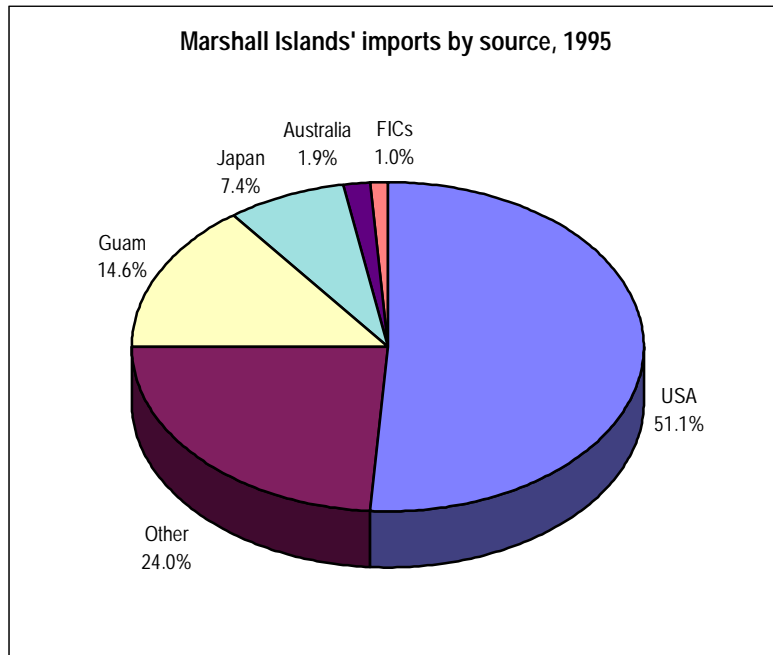
Niue's exports by destination, 1995

Fiji
2.3%

New Zealand
97.7%
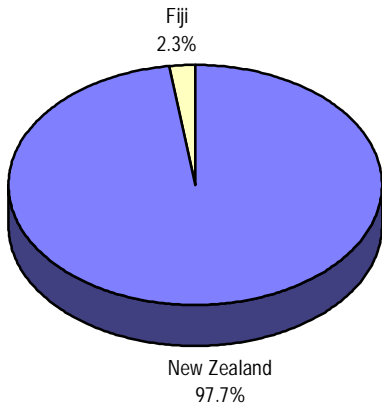
Niue's imports by source, 1995

Fiji
9.0%

New Zealand
91.0%
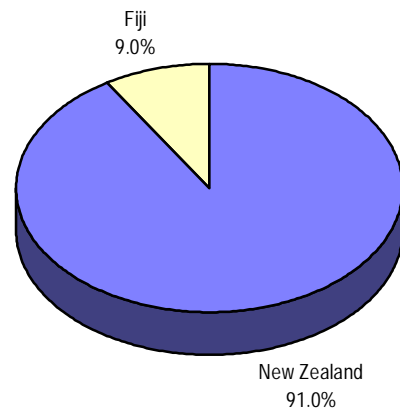
Papua New Guinea's exports by destination, 1997

FICs
1%

Australia
26%

Other
32%

New Zealand
0%

Philippines
3%

Japan
17%

Rep. of Korea
4%

USA
2%

EU
15%
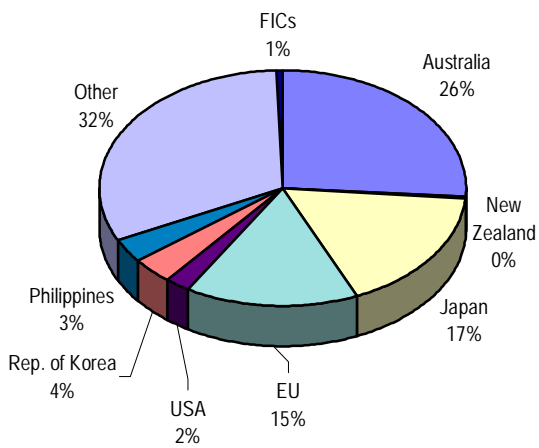
Papua New Guinea's imports by source, 1997

Other
11.5%

FICs
0.9%

Australia
51.6%

Singapore
11.4%

USA
6.8%

EU
4.2%

Japan
9.1%

New Zealand
4.4%

Samoa's exports by destination, 1996

- FICs 3.3%
- Other 6.8%
- Australia 9.2%
- American Samoa 15.3%
- EU 17.3%
- New Zealand 48.1%

Samoa's imports by source, 1996

- Other 12.6%
- USA 12.8%
- Fiji 14.2%
- Australia 22.1%
- New Zealand 38.3%
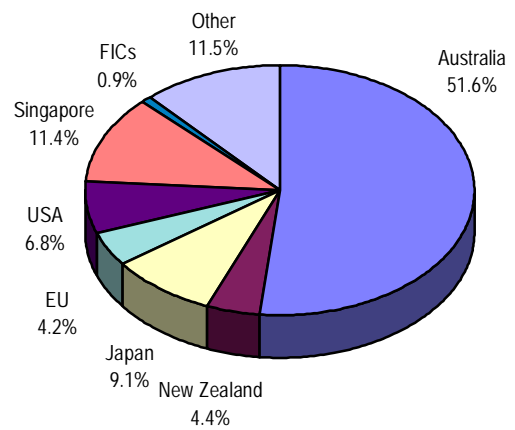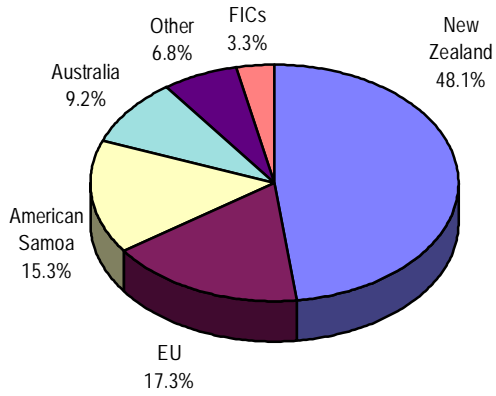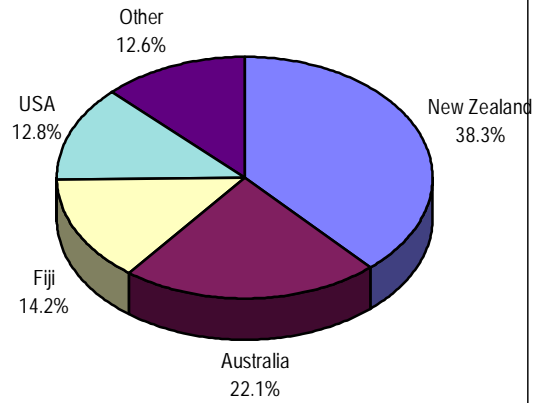
Solomon Islands' exports by destination, 1995

- FICs 2%
- Australia 2%
- Rep. of Korea 15%
- Other 19%
- EU 25%
- Japan 37%
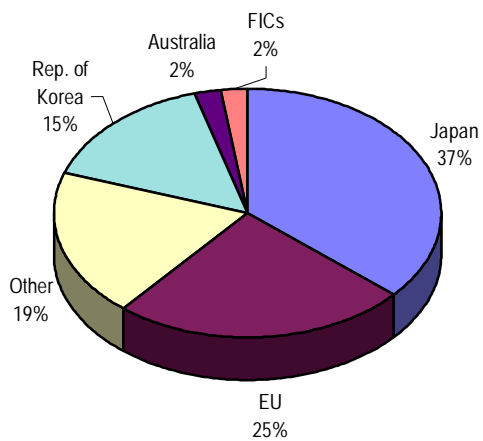
Solomon Islands' imports by source, 1995

- Thailand 3.4%
- FICs 3.5%
- EU 3.5%
- China 3.6%
- New Zealand 8.9%
- Singapore 9.3%
- Japan 11.8%
- Other 15.0%
- Australia 41.0%

Tonga's exports by destination, 1996

- Australia 3.7%
- American Samoa 3.8%
- Fiji 4%
- Other 6%
- New Zealand 15%
- USA 18%
- Other FICs 0.3%
- Japan 49%

Tonga's imports by source, 1996

- EU 2.3%
- China 1.2%
- Other 4.0%
- Japan 6.9%
- Fiji 7.1%
- USA 11.3%
- Other FICs 0.1%
- New Zealand 37.5%
- Australia 29.7%
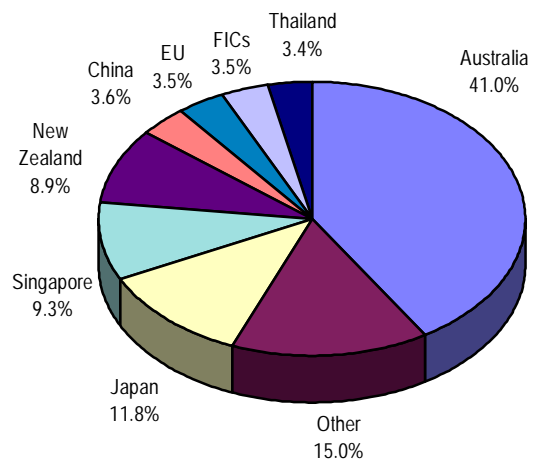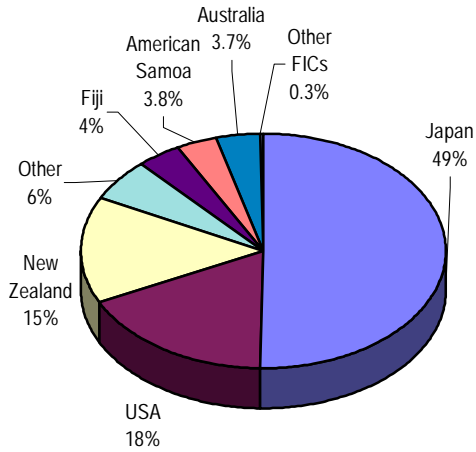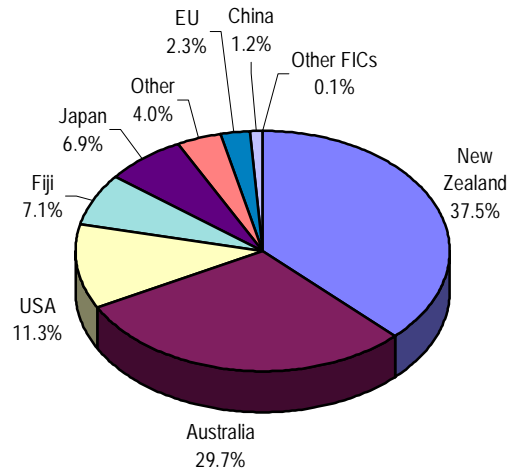
Vanuatu's exports by destination, 1996

- New Caledonia 4.4%
- Australia 3.5%
- New Zealand 1.8%
- FICs 4.5%
- Rep. of Korea 6.0%
- Other 11.1%
- Japan 16.2%
- Bangladesh 30.9%
- EU 21.6%
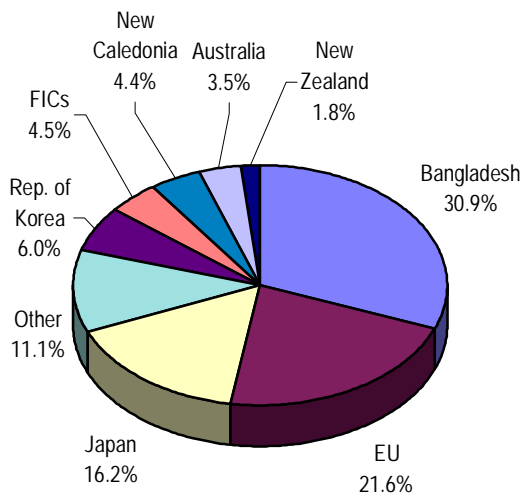
Vanuatu's imports by source, 1996

- Hong Kong 3.0%
- Other FICs 2.0%
- Japan 5%
- Fiji 7%
- New Caledonia 8%
- New Zealand 12%
- Australia 44%
- Other 19%

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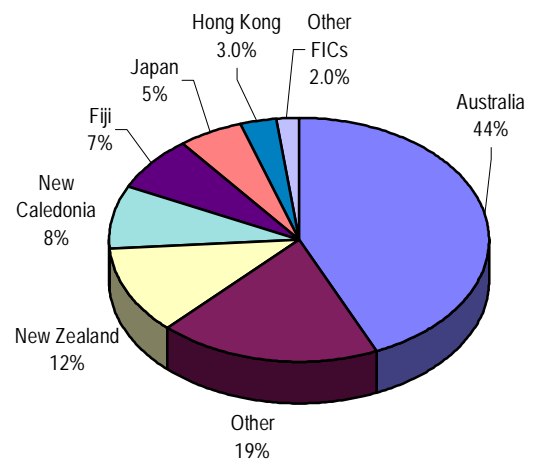
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