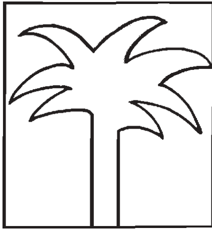

On achieving sound and stable economic policies in the Pacific islands

Ron Duncan

Implicit conditionality on policies in the Pacific island countries stemming from some form of close economic relationship with Australia, such as implicit in NAFTA or the EU, would seem to ensure stable policies more effectively than conditionality placed on Australia's aid.

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Descriptions of the economic policies of the Pacific islands are, broadly, diametrically opposite to what is now widely recognised as being the set of policies and the policy environment needed to provide the basis for sound economic development, namely development of comprehensive property rights, high savings and investment rates, low trade barriers, low levels of state activity in production and marketing, and above all, stable macro and microeconomic policies. Instead, private savings and investment rates are very low with intensive government activity in the production and marketing of goods and services. Property rights are poorly developed, especially in relation to national resources. There are high and variable trade barriers, and policies generally are highly unstable. The poor policies are reflected in the low to negative per capita GDP growth rates, growing unemployment, exploitation of natural resources at unsustainable levels, urban congestion, very high levels of public service employment and very high levels of dependency on foreign aid.

The central message that comes across time and again from studies of the successful developing economies is the importance of sound and stable—particularly stable—economic policies (Bates and Krueger 1993; World Bank 1993; Williamson (ed.) 1994). Policy stability is vital to investor confidence. However, the more unstable and the longer a country's policies have been unstable, the greater the length of time it may take and the more convincing the actions taken may need to be for a government to establish credibility of its reform policies with investors. For the Pacific islands to attract investors to enhance productivity in existing industries and to build new ones, it is necessary for them to put good policies in place and to keep them in place. This means resisting the vested interests that will inevitably plead for the overturning of the new policies. Thus, the important question is: how does a government establish policy stability where it has not prevailed before?

The importance of stable policies

The driving force of development is investment—investment in both physical and human capital. But potential investors, whether thinking of investing in plant and machinery or in their own or their children's education, will not invest unless they have an expectation that there will be a payoff over a sufficiently long period to make their investment worthwhile. Uncertainty can play havoc with expectations of profitability. Investors accept degrees of uncertainty and the larger the profits and the more quickly they are realised, the more uncertainty they are willing to bear. The kind of uncertainty which investors most dislike is that from capriciousness in government policies. This type of risk, known as 'sovereign risk', is very difficult if not impossible to insure against. Other forms of risk, such as interest rate risk, currency risk, or commodity price risk, can be hedged by investors using the financial markets. Production risks, that is, the risks which are inherent in the activity of the firm, are risks that the firms can hedge against in various ways or are prepared to bear. But the risks from changes in government policies are completely outside the firm's control and there are usually no means of hedging against them available in the financial markets. Therefore, the more likely it is (based on the past history of the government) that government policies will be unstable, the less likely firms are to invest; or if they do invest, the keener they will be to develop ways to make the project as short-lived as possible. In those circumstances, the results are often highly exploitative projects instead of sound, sustainable projects.

Policy instability arises from the inability of governments to resist pressure to overturn new policies from interest groups favoured by previous policies. The countries that have been successful in their economic reforms have been able to resist the overturning of the reforms by, first, protecting those government advisers responsible for implementing the reforms from pressure from interest groups (for example, by building independent institutions such as central banks) and second, by providing 'social safety nets' to protect the welfare of those most economically vulnerable to the reforms—usually labour in the industries that will be adversely affected by the reforms (see Bates and Krueger 1993). In this way the ability of the interest groups to sway public opinion by appealing to the plight of the affected workers has been dulled.

Opportunities for economic reform

From experience, the opportunities for putting comprehensive economic reforms into place are limited. It is often argued that there is never a good time for reform. When economic circumstances are positive, it is claimed that there is a lack of interest in reform. When economic activity is depressed, it is argued that it is not an appropriate time, especially from a political viewpoint, to set a process of structural adjustment in train. The recent history of economic reform in many developing economies has been that reforms have been initiated after economic circumstances have reached crisis proportions. In some cases, initiation of the reforms has involved new political leadership—sometimes involving a leader or a group of people able to convince the electorate to move in the direction of substantial change.

Whatever the circumstances, it seems that there has to exist a strong commitment to reform. Then, seeing the reforms through the (usually long) period of adjustment requires protecting them against the interests which lose because of the changes.

Protecting policy reforms

If leaders of Pacific island governments can find the opportunity and the commitment to undertake the comprehensive economic reforms which are necessary, what measures can they take to ensure that the reforms stick? One type of measure seriously worth consideration is adopting one of the forms of international obligation. The principle involved is that by taking on an international obligation, a government can resist domestic appeals to overturn the reforms by arguing that its international obligation prevents it from doing so. At the same time, it places itself in a situation where it can incur actual monetary penalties or, at least, international reproach for breaking its obligation. The GATT is such a mechanism backing trade reform. For example, by lowering and binding tariffs under the GATT, a country can lock in its trade policy reforms. Accepting policy conditionality under the terms of International Monetary Fund or World Bank loans is another form of such international obligation.

Recently, there has been interest in Australia incorporating policy conditionality in the terms of its foreign aid commitments to the Pacific islands. The effectiveness of this form of international obligation is compared here with that undertaken by Mexico through entering the North American Free Trade Agreement (NAFTA) with Canada and the United States.

Experience has shown that the IMF or World Bank conditionality is a weak form of international obligation. Domestic pressure groups, supported by international pressure groups, have found it fairly easy to reverse reforms undertaken with IMF or World Bank conditionality. There has been little in the way of international reproach or the suffering of monetary penalties, such as the withdrawal of finance, from breaking such agreements. It seems that policy conditionalities imposed by Australia under the terms of foreign aid commitments would be even less likely to prevent reform reversal and therefore even less helpful as a support to a government wanting to lock in reform policies and coming under strong domestic pressure.

President Carlos Salinas de Gortari of Mexico, the architect of Mexico's entry into NAFTA, apparently was impressed by the economic progress made by Spain after joining the European Union (EU). Becoming a member of the EU obliges a country to liberalise its trade in goods, services and labour with other members of the customs union. Besides this, membership implies becoming subject to considerable scrutiny and pressure over macroeconomic and microeconomic policies from other members of the union.

The agreement between Canada, Mexico and the United States, while not as comprehensive as the relationships agreed within the EU—especially under the 1992 EU Single Market agreement—has substantially liberalised trade between the three countries. The benefits flowing to the three countries from the trade liberalisation, and its effects on other countries, have been the focus of most of the research on the impact of NAFTA. But as well, and probably much more importantly for Mexico, the NAFTA agreement means implicitly—if not spelled out explicitly—agreement by Mexico to conduct stable and sound macroeconomic policies and to subject its policy to the scrutiny of its partners. On the part of the partners there is an implicit agreement to assist Mexico to sustain such policies. The force of the implicit agreement was demonstrated recently when, following the assassination of the likely new president, the United States made available a US$6 billion loan to counter any pressure on the

Mexican peso and Mexican stock exchange values from capital flight due to loss of investor confidence.

Manchester and McKibbin (1994) have shown how valuable this implicit component of NAFTA is to Mexico. Improved investor confidence in Mexican policies, working through declining risk premiums in Mexico—because the reforms are locked in—and the increased productivity flowing from the resulting massive increase in investment generate GDP increases which dwarf the direct gains from trade flowing from the trade liberalisation. It would be of interest to undertake an analysis of developing economy interest rates or secondary market debt to see if IMF and World Bank conditionality has any such effects in reforming countries.

There would seem to be a good case for those Pacific islands wishing to implement sound and stable economic policies as a basis for economic development to enter into some form of Close Economic Relationship with Australia, or with Australia and New Zealand. The Pacific islands already have close to free entry into Australia and New Zealand for their merchandise exports under the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA). But the concern here is not with reducing trade barriers. As Manchester and McKibbin have shown, there are other much more important economic gains from entering an economic alliance with an industrial country which can flow to a developing economy wishing to lock in economic reforms. Such an alliance has to be of a kind that commits both sides; a formal treaty which obliges the Pacific island countries to adopt sound and stable economic policies while giving an incentive for Australia to closely scrutinise economic policies in the Pacific island counterparts and obliges Australia to provide assistance when needed to underpin those policies. What would provide the incentive for Australia (and New Zealand) to undertake such an obligation? In the case of the EU, there is an overarching political incentive in the form of achieving a unified Europe—between states which have been at war with each other many times. In the case of NAFTA one incentive for the United States to help improve the Mexican economy has been to reduce the pressure for migration across the border. Given the apparent desire in the United States to extend NAFTA to other Latin American countries, or to negotiate a free trade agreement with Chile, there must exist some objective of fostering economic development within the hemisphere as a whole.

Of all the countries in the world, Australia is important only to New Zealand and the Pacific islands, and in the past the Pacific islands have been important to Australia for reasons of security.[1] Thus, a case can be made that Australia has a moral obligation, if not a strategic one, to the Pacific islands. This may even be seen to be manifest in the appointment of a Federal Minister for Development Cooperation and Pacific Island Affairs. Allowing the possibility for the freer flow of labour from the Pacific islands would provide further incentive for Australia to hold up its side of such a treaty.

To conclude, the implicit conditionality on policies of the Pacific island countries stemming from some form of close economic relationship, such as implicit in NAFTA or the EU, would seem to have much greater effectiveness in terms of ensuring stable policies than conditionality imposed on Australia's foreign aid commitments. But regardless of the arrangement, without commitment on the part of the Pacific island governments to economic reforms, there will be little payoff to trying to enforce conditionality, and indeed, little payoff to foreign aid.

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[1] I owe this point to Greg Fry, International Relations, Research School of Pacific and Asian Studies, The Australian National University, Canberra.