

Fiji within the CER

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Given the global tendency towards regionalism, should a small island nation such as Fiji join the Closer Economic Relations (CER) trade agreement between Australia and New Zealand? In this paper it is argued that, under the assumption that the Asia Pacific region will have free trade by the year 2020 under the auspices of APEC, it is imperative that Fiji join the CER now. Such a move is likely to entail short-term costs. While in the medium term such adjustment costs are inevitable for Fiji only such a policy would be *pareto* improving for all participants in the long run.

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Over the past decade there has been a global tendency towards regionalism. Countries within the European and American continents, as well as a number within the Asia Pacific region, have entered into some form of regional trade agreement. These agreements are believed to facilitate trade and investment within the region, leading to gains in welfare for all participants. The amalgamation of a number of larger countries into a trading bloc can also have significant terms-of-trade effects with the rest of the world. On these grounds the incentive for smaller countries to join such a bloc is significant.

However, the experience of OPEC countries, and of international commodity

agreements in general, suggests that such cartels are intrinsically unstable. The later generation of trade agreements, including the Asia Pacific Economic Cooperation (APEC) trade agreement, are construed as free trade areas which are not purported to use market power for the benefit of their members. Instead, these agreements rely on mutual gains arising out of advantages from increased trade and investment opportunities. This is the concept of 'open regionalism' (see Fane 1995 for a critique). Since the current members of APEC have agreed to achieve free trade by the year 2020, the benefits from preferential agreements among a sub-set of APEC members like the Closer Economic



Relations (CER) between Australia and New Zealand and the Asian Free Trade Area (AFTA) between the ASEAN countries will only be short term.

Assuming that APEC achieves free trade within the region by 2020, this paper considers the short-term benefits of Fiji joining the CER in the immediate future. Given that the rest of the Pacific island economies are small and share a number of other features with Fiji, these findings can be generalised to these island nations. Preliminary discussions on the possibility of Fiji joining the CER agreement were held in 1994 (see Chand 1994 and MARTREX 1994) but these have since been shelved.

There are significant gains to Fiji and, by implication, to other Pacific island nations, from entering the CER: the existing members of the CER are likely to gain from such a move, and the exercise is amenable to implementation with minimal cost.

Potential gains from economic integration for small dispersed economies

The existence of institutions such as the Forum Secretariat, the Forum Fisheries Agency, the South Pacific Commission, the South Pacific Regional Environmental Program, and the University of the South Pacific is recognition of the fact that cooperation has positive net benefits.

Regional organisations, in general, are expensive undertakings that, after inception, have a life of their own. Threats to their existence occur repeatedly, the most common of these arising from the 'free-rider' problem, in which it pays one member to cheat on its commitments in a cooperative arrangement. That a number of regional institutions survive and thrive despite such impediments is evidence of their relevance to the region.

The costs of running regional institutions are obvious, but the benefits are perhaps less transparent. In general, gains from cooperation arise from one or a combination of the following: economies of scale, terms-of-trade benefits, and internalisation of some national externality.

The CER and Fiji

The CER agreement came into force in January 1983 as a successor to the New Zealand Australia Free Trade Agreement (NZAF TA). The agreement was based on the premise that its operation would reduce the transaction costs of trade between the trans-Tasman neighbours, allow industries to take advantage of economies of scale, and result in increased competition from imports within each economy which in turn was perceived to raise economic efficiency (Australia, Bureau of Industry Economics 1995). The 1983 CER agreement resulted in a gradual reduction in the cost of trans-Tasman trade. This was achieved through

- replacement of a 'positive list' with a 'negative list' constituting those items exempt from the agreement
- the gradual removal of tariffs on all goods except those on the negative list within the following five years
- progressive liberalisation of all import quotas
- commitment towards elimination of export subsidies for goods traded between the neighbours
- an undertaking that the parties would consult each other before undertaking any industry assistance that could affect trans-Tasman trade.

It was also agreed that the CER would undergo regular reviews. The 1988 review culminated in an agreement to replace anti-dumping measures with competition



policy as well as a protocol on trade in services. A noteworthy feature of the CER is the limited bureaucracy that it requires. New Zealand, with its concurrence, is treated for the purposes of the agreement as an Australian state. Hence the existing Australian Commonwealth–State framework is able to accommodate all of the provisions within the CER.

The perception that the CER will result in net gains in welfare to both nations is supported by a number of simulations carried out by the Australian Bureau of Industry Economics using computable general equilibrium (CGE) models (Australia, Bureau of Industry Economics 1995). Some of these gains could be static, such as those arising from relocation of production on the basis of comparative advantage, but given the similarity in endowments of the two countries, these gains are likely to be small. Gains from economies of scale—particularly those ascribed to by the endogenous growth literature (see Romer 1990 and Lucas 1988)—could be significantly larger but these gains are difficult to capture within a CGE framework.

The gains from joining the CER for a developing country such as Fiji are likely to be mostly from resource reallocation on the basis of comparative advantage, the static gains from trade and from catch-up. Dynamic gains, such as those espoused by

the endogenous growth literature, are likely to be less significant.

In global terms, Australia and New Zealand are small, but Fiji is tiny. In relative terms Fiji has a population that is approximately 4 per cent that of Australia (Table 1). Fiji has a population that is less than a quarter, a land area one-fifteenth and a GDP one-thirteenth that of New Zealand. Fiji's merchandise trade is negligible from the perspective of both Australia and New Zealand, accounting for approximately one-half (one-tenth) of one per cent of total Australian exports (imports) and one (a quarter of a) per cent of New Zealand exports (imports). The converse is starkly different. Imports from Australia to Fiji account for 42 per cent of total imports and those from New Zealand 22 per cent. Australia accounts for 14 per cent and New Zealand 6 per cent of total exports from Fiji (based on 1993 data from UNCOMTRADE statistics from the International Economic Databank at the Australian National University).

Tourism is the second largest industry after sugar in Fiji and the major non-commodity export. In 1993, 27 per cent of the tourists arriving in Fiji were Australians and 14 per cent were New Zealanders (Fiji, Bureau of Statistics 1994: Table 13.2). Australia and New Zealand are the most important trading partners of Fiji. The size of Fiji relative to that of the

Table 1 Some basic indicators: Australia, Fiji and New Zealand

| | Australia | Fiji | New Zealand |
|--|-----------|-------|-------------|
| Population (millions), 1992 | 17.48 | 0.75 | 3.43 |
| Total land area (million km ²) | 7.68 | 0.018 | 0.27 |
| 1990 GDP (1985 international prices, US\$ billion) | 253 | 3.01 | 39.49 |

Source: Summers, R. and Heston, A., 1991. 'The Penn World Tables: an expanded set of international comparisons', *Quarterly Journal of Economics* CVI:1–45.



existing members of the CER implies that economic developments within Fiji will have a negligible economic impact on either Australia or New Zealand.

The CER was built on the tenet that Australia and New Zealand are very similar in terms of endowments, heritage and legal systems. These similarities also apply to Fiji. Fiji is a market economy with a Westminster system of government and a legal system identical to that of Australia and New Zealand. Commercial, military and trade ties between the three nations are generations old and both Sydney and Auckland have significant Fijian migrant populations. Despite the close links between Fiji and its metropolitan neighbours, the catch-up in terms of the level and rate of growth of per-capita output has been dismal (Table 2).

The life expectancy of Fijians in 1992 was equivalent to the 1970 figure for Australia and New Zealand. However, there has been no tendency towards catch-up in real output per worker in Fiji towards that of its industrialised neighbours (Figure 1). The growth rate of GDP in Fiji has not been any higher than that of its industrialised neighbours, an observation in conflict with both the literature on convergence (Sachs and

Warner 1995) and the hypothesis that lagging economies have an advantage in growth rates relative to economies at the frontier (Chamley 1992).

One explanation for the difference could lie in Fiji's capital intensity relative to Australia and New Zealand. Simple calculations following Kehoe (1994) and Lucas (1990) show that, for a given production technology, the implied capital intensity which would result in per worker output in Australia being 2.56 times that in Fiji is 23.¹ Indeed, Australia has a higher capital intensity than Fiji but it could not be of the magnitude suggested by this analysis. Alternatively, assuming a real interest rate of 5 per cent and the rate of depreciation of physical capital also at 5 per cent—figures that are consistent with those used for calibration in CGE models of industrial countries (Kehoe 1994)—Fijian real interest rates should be more than 84 per cent. Real interest rates in Fiji since 1981 peaked at about 10 per cent in 1986; the figure for 1993 was 5 per cent (Chand 1995). It is clear that differences in capital per worker cannot be the sole explanation for the differences in output between Fiji and its metropolitan neighbours. One of the reasons for the low per capita growth rate of Fiji is its inward orientation (Chand 1995).

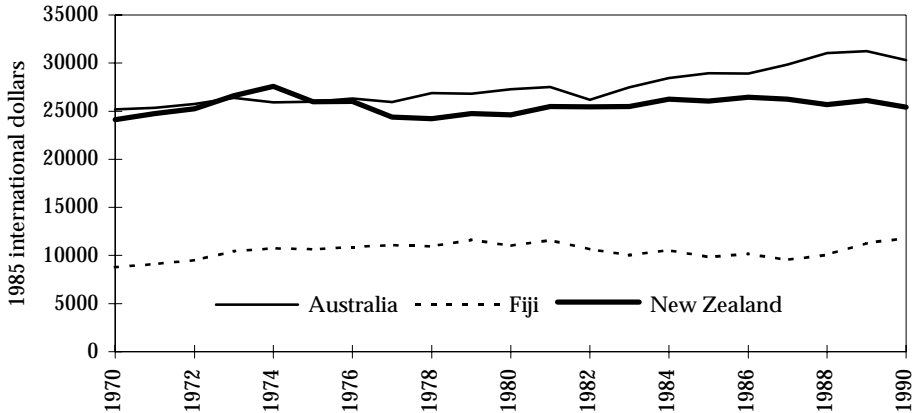
Table 2 Some key comparative statistics: Australia, Fiji and New Zealand, 1970–92

| | Year | Australia | Fiji | New Zealand |
|---|---------|-----------|-------|-------------|
| Life expectancy (years) ^a | 1970 | 71.38 | 64.15 | 71.52 |
| | 1992 | 76.67 | 71.55 | 75.65 |
| Real GDP per worker (1985 international prices) ^a | 1970 | 25218 | 8774 | 24112 |
| | 1992 | 30312 | 11817 | 25413 |
| Growth in per capita GNP (per cent per annum) ^b | 1965–90 | 1.9 | 1.9 | 1.1 |

Source: ^aSummers, R. and Heston, A., 1991. 'The Penn World Tables: an expanded set of international comparisons', *Quarterly Journal of Economics* CVI:1–45.; ^bWorld Bank, 1992. *World Bank World Tables 1992*, World Bank, Washington, DC.



Figure 1 Real GDP per worker: Australia, Fiji and New Zealand, 1970–90



Source: Summers, R. and Heston, A., 1991. 'The Penn World Tables: an expanded set of international comparisons', *Quarterly Journal of Economics* CVI:1–45.

Benefits and costs

Australia has recently gone some way towards establishing its credibility as a low inflation country, whilst New Zealand has been at the forefront in microeconomic reform. In contrast, Fiji has had a stable macroeconomic policy over the last two decades but has performed poorly in terms of microeconomic management (Chand 1995; Elek, Hill and Tabor 1991).

Better macroeconomic management in Fiji can be attributed to two factors: most countries find macroeconomic reform much easier than microeconomic reform; and the central bank in Fiji (the Reserve Bank of Fiji) has had little government intervention in its operation and therefore has been free from political and vested-group pressures, while microeconomic policy has been under the direct control of the Minister for Trade and Commerce. Fiji's entrance into the CER agreement should assist in the development of an improved policy framework encouraging greater private investment,

entrepreneurial activity and technology transfer, resulting in the convergence of per capita GDP to that in the industrial world.

Specifically, benefits from CER membership would arise from four sources. CER membership will lock the Fijian government into a more liberal trade and foreign direct investment policy (see Duncan 1994 for a discussion of this point in the context of South Pacific island nations). The Fijian government has, in a number of budget papers, announced its plans to deregulate the economy. Some of these reforms have been put in place, but they have not been substantial, monotonic or rapid.

Fiji has a more protective trade regime than either Australia or New Zealand (Table 3). This is the case even after the commencement of the liberalisation in 1988. The high effective rates of protection and cases of negative value-added in Fiji have had serious income redistribution consequences, resulting in substantial transfers from consumers to producers,



from primary producers to manufacturers, and often culminating in transfers from the poor to the rich. The beneficiaries of extreme protection are easily identifiable and often involve a handful of companies or individuals. Though the high industry assistance culture of Fiji is highly inequitable, political economy considerations make trade liberalisation on a unilateral basis extremely difficult (Chand 1995). For Fiji, membership within the CER would provide a policy anchor as well as give direction and pace to future liberalisation of Fiji's economy. A pre-commitment to the CER by Fiji's authorities would preclude, or at least reduce, the effect of domestic lobbies on trade

protection. This would be the main benefit of CER membership to Fiji.

A climate of free trade. Membership of the CER would provide a clear signal to Fiji's domestic industries that assistance to industry would be gradually phased out, leading to free trade by 2020. This would reduce policy uncertainty and with it the costs of such uncertainties. In particular, domestic producers, particularly public enterprises such as the Fiji Electricity Authority, Fiji International Telecommunications Limited, and Air Pacific, would face greater competition through the threat of entry by foreign suppliers. Elek, Hill and Tabor (1991:35)

Table 3 Effective rates of protection, selected industries (per cent)

| | Australia ^a | Fiji ^b | New Zealand ^c |
|---|------------------------|-------------------|--------------------------|
| Meat products | 1 | 35 | 0.6 |
| Milk/Dairy products | 2 | N.V.A | 3.0 |
| Edible oils | 15 | N.V.A | n.a. |
| Flour mill and cereal products | 6 | 373 | n.a. |
| Bakery products | 0 | >600 | n.a. |
| Miscellaneous food products ¹ | 4 | N.V.A | 7.9 |
| Clothing ² | 84 | N.V.A | 44.7 |
| Footwear ² | 91 | N.V.A | 44.7 |
| Paper and paper products | 16 | 142 | 9.9 |
| Printing and allied industries | 5 | 468 | 3.6 |
| Other chemical products ³ | 12 | N.V.A | 15.6 |
| Cement and concrete products ⁴ | 1 | >600 | 7.6 |
| Industrial machinery and equipment | 16 | -5 | 15.6 |
| Motor vehicles and parts ⁵ | 45 | N.V.A | 428.5 |
| Jewellery and related articles | 20 | 0 | 1.6 |

Note: ERP data for Fiji are only available for 1991. The choice of industries was based on data availability and the extent of concordance between classifications. ERP data are used instead of nominal levels of tariffs since the former accounts for non-tariff barriers—an important consideration in the case of Fiji.

^a figures are for 1991/92

^b figures are for 1991

^c figures are for 1993

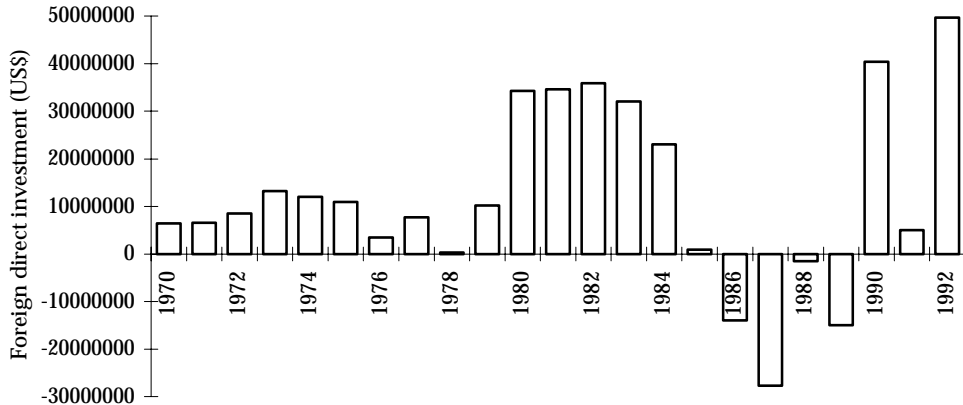
¹ other food products in the case of Australia and New Zealand; ² included as a single category for New Zealand; ³ includes paint, soap, etc; ⁴ for New Zealand this is non-metallic mineral industries; ⁵ bus building in the case of Fiji.

N.V.A denotes negative value-added, the case for which ERP is not defined.

Sources: ^a Australia, Industry Commission, 1995. *Australian Manufacturing and International Trade Data 1968-69 to 1992-93*, Industry Commission, Canberra; ^b Elek, A., Hill, H. and Tabor, S.R., 1991. *Liberalization and diversification in a small island economy: Fiji since the 1987 coups*, Working Papers in Trade and Development 91/4, The Australian National University, Canberra:33; ^c Stroombergen, A., 1994. *Estimates of Rates of Assistance to Manufacturing*, Report to New Zealand Ministry of Commerce, Business and Economic Research Limited, Wellington.



Figure 2 Foreign direct investment in Fiji, 1970–92



Note: Data for 1976 to 1978 are missing so the series has been spliced using long-term capital inflow data from the World Bank Tables.

Source: Summers, R. and Heston, A., 1991. 'The Penn World Tables: an expanded set of international comparisons', *Quarterly Journal of Economics* CVI:1–45.

report that the rate of return on assets of the 18 public enterprises was 4.2 per cent collectively with four of the enterprises having negative returns at the individual level. These pro-competitive effects, should result in increased efficiency and competitiveness of downstream industries. For example, competitive pricing of air transport will have a beneficial impact on tourism in particular, and the rest of the economy in general, given the relative contribution of this industry to aggregate GDP.

Improvements in per capita income.

Closer integration with two industrial economies should raise the rate of catch-up and therefore lead to convergence in per capita income. This catch-up could come from three sources: better resource allocation; access to better technology; and access to the global capital market. CER membership would provide an intermediate stage before the country faces full international competition under

free regional trade. The CER could become a stepping stone for Fiji to graduate into free international competition as a member of APEC.

Political stability. Closer association with Australia and New Zealand would reduce the political instability that arises repeatedly within Fiji. This should raise investor confidence and stem the flight of both human and physical capital that the country faces in episodes of racial tension, often instigated by political considerations. Foreign direct investment in the country has collapsed at each episode of major political disturbance (Figure 2). These are costly in terms of loss in potential output.

The costs to Fiji of joining the CER would be short term, since the country would have to face free regional trade by 2020 under APEC. These costs would arise from the necessary restructuring of the economy. Industries that thrived under assistance from tariffs will either improve



their efficiency and become competitive, or face extinction. The competitive industries will thrive. The economy will be restructured towards industries that have a comparative advantage. In the longer term this will generate benefits, but the restructuring will involve short-term costs through the relocation of factors of production, the possibility of trade diversion, and political pressure from vested interests in the protected industries. The costs of trade diversion could be offset by dynamic gains from economies of scale and increased specialisation. Furthermore, the scope for trade diversion is diminished as external trade barriers are lowered. This could provide the incentive for Fiji to liberalise trade unilaterally.

Freer trade, particularly with a small country that has zero terms of trade impacts, is going to be welfare-enhancing for both Australia and New Zealand, though the magnitude of this effect will be small given the relative size of Fiji. Static gains from trade creation, the potential for which is significant (Mikic, Palac-McMiken and Ratnayake 1994), should be welfare-enhancing for all the participants.

Fiji as a new entrant to the CER: the logistics

The details of any agreement between member nations entering into a trading arrangement are a matter for negotiation between the participants. However, attention will be drawn to a number of issues that could become matters of contention in establishing the negotiation process. First, the existing Commonwealth–State framework that is used effectively between Australia and New Zealand can be expanded to accommodate Fiji at minimal cost. One of

the attractive features of the CER arrangement is that it takes advantage of all potential gains from economic integration without sacrificing sovereignty. As the Australia–New Zealand experience shows, it is also a stable system with minimal overheads relative to the more elaborate customs union arrangements such as the European Union.

One of the issues of contention may be strategies to minimise trade deflection, hence a negative list could be required. The specific commodities that could form part of the negative list include sugar and export processing zone exports. In the case of sugar, exports from Australia could be deflected into the European Union via Fiji, threatening the price support given to Fijian sugar producers under the Lomé convention. Export processing zone exports are already subject to domestic content rules under the South Pacific Regional Trade and Cooperation Agreement (SPARTECA). Domestic content rules, by their inflexibility, entail economic inefficiencies (Krishna and Krueger 1995)—this has already been an issue of contention within SPARTECA. Furthermore, the administration of domestic content rule provisions has been an expensive exercise (Australia, Bureau of Industry Economics 1995). For these reasons, use of domestic content provisions should be kept to a minimum.

It appears that rates of nominal protection in Fiji for all commodities with the exception of jewellery and industrial machinery are higher than in either of the current members of the CER. One simple means of avoiding the use of domestic content rules altogether is to include items that have lower nominal tariffs in Fiji in the negative list. These are matters of detail best left to the negotiators.



Conclusion

The long-term benefits of Fiji entering the CER trade agreement would be positive for all participants. Within the short term, such a move would mean adjustment costs to Fiji only but the benefits in the longer term could be significant. Furthermore, given the APEC commitment to free trade by 2020, the costs of restructuring are inevitable. For Fiji, it would be useful to undertake a detailed analysis of the short-term implications of industry restructuring through a move to join the CER. Such an exercise would prepare policymakers more fully for the proposed move.

Given that in the current context many of the island nations of the South Pacific share the same characteristics as Fiji, the findings for Fiji can be generalised to these nations as well. This larger consideration is left for future research.

Note

1 Assume a per worker production function of the form $y = Ak^\alpha$ where y and k are per worker levels of output and physical capital, respectively, and α —a positive fraction—is the elasticity of output with respect to physical capital. The capital intensity ratio between Australia and Fiji is given as $\frac{k_{AUS}}{k_{FJI}} = \left(\frac{y_{AUS}}{y_{FJI}}\right)^{\frac{1}{\alpha}}$. Setting α at 0.3, the share of capital in total output under competitive assumptions, and substituting in the values of per worker output gives the result that capital intensity in Australia should be 23 times that in Fiji.

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