

The costs and benefits of a free trade area among Forum island countries

Yolinda Yok Yee Chan

Economic Planning Officer, Ministry of Foreign Affairs and External Trade, Suva

For the Forum island countries, the world-wide push for a more liberal international trading environment could appear to be, at least in the short term, detrimental to their trading prospects. These small island economies are largely dependent for export earnings on a few commodities that are sold under preferential trade arrangements. The continued decline in tariff barriers throughout the world is perceived by some concerned policymakers to have the likely effects of dissipating the current trading advantages enjoyed by their respective countries under preferential trading arrangements such as SPARTECA with Australia and New Zealand, and the Lomé Convention with the European Union (EU).

The poor economic performance in Forum economies in recent years has promoted suggestions that the region has now reached a stage where it needs to monitor and evaluate the pace and direction of trade liberalisation carefully. It follows that the small Forum economies need to find the balance where they reduce protection only to the point to which they continue to spur local efficiency, productivity and competitiveness without sacrificing large parts of the domestic industries and causing higher unemployment.

Against this perceived socioeconomic concern, and given the global tendency

towards regionalism, Forum island countries, especially Fiji, have in recent years begun to pursue vigorously trade liberalisation alternatives such as bilateral trading agreements (BTAs) and free trade areas (FTAs) with other Forum island countries in the hope of using these channels to secure and enhance export markets through regional cooperation. More importantly, the enhancement of regional relationships is regarded as an imperative due to the need for solidarity in international trade negotiation fora to counter the inequality in bargaining power between large regional groups such as the European Union and the island countries of the Pacific.

Although a Forum island country free trade area offers an alternative to trade liberalisation in the Pacific region, welfare gains may be minimal if the region's two major trading partners, Australia and New Zealand are not included. Establishment of a free trade area should only be a stepping stone to further trade liberalisation in the Pacific and not a protectionist regional bloc.

Background

Arrangements that provide trade preferences to members of a regional group are not consistent with GATT Article 1: the most-

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favoured nation (MFN) principle. However, to capture the 'trade creating' benefits of bilateral and regional liberalisation efforts, Article XXIV permits departures from the most-favoured nation obligation provided that the regional integration agreements meet three conditions.¹

The successful completion of the Uruguay Round increased pressure on World Trade Organization (WTO) contracting parties to move away from trade distortion arrangements that are not in conformity of GATT Article XXIV, a point emphasised by the recent GATT panel verdict on the Lomé Convention. In an attempt to render the trade preference arrangements relevant after the year 2000,² the EU has proposed three options to the African, Carribean and Pacific (ACP) countries to make the EU-ACP relationship consistent with its obligations to the WTO

- creating a free trade area (consistent with Article XXIV:5)
- generalising the system of Lomé trade preferences to other non-ACP countries (consistent with Part IV)
- seeking a waiver (under Article XXV:5).

The last option, to continue the current five-year waiver beyond the year 2000, is politically costly for the EU while the first two options are clearly in its trade interests. The EU is keen to have trade reciprocity for its exports in Africa and also to end the colonial heritage implicit in the current EU-ACP relationship by extending its trading preferences to include other developing countries (Grynberg 1998:38-41).

It is in this environment that, despite the fact that the Pacific islands do not conduct much trade between each other, under pressure from the EU, South Pacific trade ministers are scheduled to meet in June to discuss laying the groundwork for a Free Trade Treaty covering the region's 14 independent island states.³ The Ministers acknowledged that without a free trade area in the Pacific, it would be impossible

to negotiate a free trade treaty as proposed by the EU; and without a trade deal with Europe, the future market for tuna, the region's greatest single resource, could be under threat.

Costs and benefits of a free trade area for Forum island countries

The risk of forming a free trade area, as argued by Viner (1950:41-81) and Lipsey (1970), is trade diversion which would ultimately lead to welfare reduction in member states (see also LeClair 1997 for a theoretical analysis of trade diversion measurement). The price distortions created by a free trade area could lead to businesses adopting strategies considered to be sub-optimal from a global welfare perspective. In addition, the formation of a free trade area may tempt member countries to take advantage of its increased size to improve its terms of trade at the expense of third party countries. Moreover, the free trade area members may also be tempted to use their increased bargaining power to gain concessions from others. Such a power game would significantly undermine the operation of the rules-based multilateral system of trade, investment and technology and holds the danger of reverting to the practice of unilateralism and protectionism.

It may be plausible to view a free trade area among the Forum island countries in a more sympathetic context, however, given their general smallness, remoteness from major markets, limited resources and the lack of economies of scale, maybe the only way to overcome the handicap of being 'too small to bother trading with' is to establish a regional bloc. Moreover, given the strong prevailing protectionist attitude in many island countries, the formation of a free trade area may result in a more liberal attitude to the extent that protectionist arguments originating in a country are

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likely to have less weight at the regional level than purely within the national context. For instance, while the political-economy considerations in some Forum island countries make trade liberalisation on a unilateral basis extremely difficult, membership within a free trade area may give the individual governments direction and momentum towards future liberalisation. However, a weak decision-making process at the regional level may provide opportunities for impeding trade liberalisation.

According to Krugman (1991), the assessment of regional trading arrangements depends on whether there is enough inherent regionalism in the structure of transportation costs. He stated that if trading arrangements follow the line of 'natural' trading regions, they would have a much better chance of improving welfare than trade arrangements between 'unnatural' parties. Following this line of argument, it is worth noting that transportation among Forum island countries is currently one of the major obstacles to intra and inter-island trade.

If forming a free trade area in the Pacific is indeed a necessary step to further trade liberalisation for the Pacific micro-states in the 21st Century, the free trade area should at least be designed so as to

- minimise negotiating and administration costs
- eliminate trade barriers among Forum island countries, accompanied by most-favoured nation tariff reductions
- allow the Agreement to be supported by the adoption of a strong program of trade and investment facilitation measures
- make efforts to include the French and the US Pacific territories at the earliest possible date.

In addition, all Forum island countries should consider the adoption of a broad-based tax system such as the valued-added

tax (VAT) as a strategy for raising revenue so that tariffs could be reduced to uniformly low levels or zero by a series of clearly-defined, explicitly timetabled, automatic steps. There should not be any quantitative restrictions; the rules of origin should be designed to facilitate trade rather than restrict trade; and the issues of safeguards, the balance of payments provisions, derogation from the Agreement and an effective dispute settlement body should be clearly specified in the legal text.⁴ Other preconditions for an effective and mutually beneficial free trade area should include the development of comprehensive facilitation measures, covering customs, quarantine procedures, standards and government procurement. The required time involved in negotiations and the amount of both human and capital resources drawn into laying the groundwork and administering the Agreement in order to get the full benefits of the free trade area need to be balanced against the benefits.

As exports among Forum island countries are usually close substitutes rather than complementary commodities, and given the lack of a developed transportation infrastructure, the net economic benefits of a free trade area among the Forum island countries, if any, may be very minimal. Furthermore, if the increased export trade is not viable in the absence of preferences, trade and production within the region are inefficient when measured against the benchmark of international competitiveness. And if the free trade area is not oriented towards further trade liberalisation, supported by a set of well-defined facilitative measures, it is also possible for the free trade area to become just another avenue for political alliances and a club for the informal exchange of economic views among officials.

Chand (1996) suggested that if, in the light of APEC's commitment to have free trade in the Asia Pacific region by the year

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2020, Fiji decides to join a regional body to advance its economic development, accession into the CER⁵ now could be more beneficial for Fiji in the longer term. His reasoning is that both Australia and New Zealand are close neighbours and are currently the most important trading partners of Fiji. Enhancing the trade relationship through close economic cooperation would provide a climate of free trade and improvement in per capita income, and provide political stability that could bring back the much-needed business confidence, a prerequisite to private and foreign investment.⁶

Stoeckel and Davis (1998) also point to greater economic gain from the proposed free trade area if it includes Australia and New Zealand, suggesting that, as a proportion of GDP, the largest gainers are the Solomon Islands, Fiji, Kiribati and the Cook Islands. In absolute terms, Papua New Guinea and Fiji are considered to be the biggest gainers among all other Forum island countries.⁷

Despite the unlikeliness of economic gains from becoming a member of a free trade area—especially if Australia and New Zealand are not included—it would still be a step towards freer trade if it provides the Forum island country governments with the necessary momentum and direction in liberalising the economy. However, the policymakers should also be mindful about the opportunity costs associated with the negotiation and administration of a regional free trade area.

If the Forum island governments are serious about long-term economic growth and development, they should, given their limited capital and human resources, consolidate and devote much of their efforts towards getting the fundamental issues right. In turn, this would stimulate trade and economic activities in their respective countries. What is mostly needed is a more deregulated and liberalised economy in a

stable political environment, supported by a set of sound macroeconomic and microeconomic policies that enables the development of a conducive and friendly investment and business climate as well as a competitive market for both local and foreign producers.

Notes

The views expressed in this Note represent the views of the author alone, and not those of the Fiji Government.

- ¹ The three conditions are that duties and other restrictive regulations are eliminated on ‘substantially all trade’ between partner countries; that the general incidence of duties, tariffs and regulation affecting third parties should not be higher after the establishment of an agreement than it was before; and that the agreement contains a specified plan and schedule for its complete formation within a reasonable period of time.
- ² The waiver for all the trade provisions that were deemed to be WTO inconsistent expires on 29 February 2000.
- ³ The 14 island states of the South Pacific Forum include, Papua New Guinea, Solomon Islands, Vanuatu, Fiji, Tonga, Samoa, Cook Islands, Niue, Tuvalu, Kiribati, Marshall Islands, Nauru, Federated States of Micronesia and Palau. Intra-regional trade among these Forum islands countries amounted to only about US\$95 million a year, with much in the form of re-export of oil.
- ⁴ Scollay, Gilbert and Collins (1998) of the APEC Study Centre, University of Auckland, conducted comprehensive research on the feasibility of a free trade area in the Forum island countries. They came to the conclusion that the quantifiable economic benefits to the Forum island countries of a preferential free trade arrangement would be

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relatively small. However, the formation of a free trade area among Forum island countries could act as a stepping stone to more complete liberalisation.

- ⁵ The CER is the Closer Economic Relationship Agreement between Australia and New Zealand.
- ⁶ According to a Fiji Government Press Release (3/3/99), Fiji's exports to the Melanesian Spearhead Group (MSG) countries (Papua New Guinea, Fiji, Solomon Islands and Vanuatu are current members of the Group which has a total population of about 6.8 million people) accounted for only 1.3 per cent of total exports in 1996, and 1.5 per cent in 1997. Imports from MSG countries accounted for only 0.07 per cent of Fiji's total imports in 1996 and 0.11 per cent in 1997. On the other hand, Fiji's exports to Australia have increased from F\$163,434 million in 1993/94 to F\$306,555 million in 1997/98. In 1996, exports to Australia accounted for 27 per cent of Fiji's total exports while imports from Australia in the same year amounted to 44.3 per cent of Fiji's total imports.
- ⁷ Stoeckel and Davis (1998) came to the conclusion that gains in welfare from a free trade area among Forum island countries amounted to A\$5 million but additional gains in welfare, when Australia and New Zealand are included, would reach A\$200 million.

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