ADB Pacific Economic Monitor

MIDYEAR REVIEW

July 2013 www.adb.org/pacmonitor

The *Monitor* provides an update of developments in Pacific economies and explores topical policy issues.

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Highlights

- **Emerging risks to growth.** Midway through the year, the economies of ADB's 14 developing member countries in the Pacific are performing broadly in line with earlier growth projections, with regional growth expected to moderate slightly in 2013. The expected slowdown is more pronounced than anticipated at the start of the year, with growth in the region now projected to moderate to 5.0% in 2013, down from 7.6% in the previous year. The 2013 growth projection for Timor-Leste has been downgraded as government spending was well below budgeted levels in the first quarter. Similar risks to near-term growth prospects are emerging in Papua New Guinea (PNG).
- Growth in the Pacific islands (i.e., the Pacific region excluding PNG and Timor-Leste) is now projected to slow to 2.0% in 2013 from 2.5% last year. The outlook has softened from earlier in the year, mostly due to a substantial downgrade in the growth projection for Solomon Islands, which, in turn, is driven by weaker-than-expected gold production in early 2013. Growth projections for Kiribati and Nauru have also been downgraded, reflecting continuing delays in the implementation of planned infrastructure projects in the former, and heightened political risks and a more subdued outlook for phosphate exports in the latter.
- Inflation in the Pacific region is now projected to accelerate to 5.7% in 2013, as rising public expenditure and weakening regional currencies are seen to fuel price pressures. Inflation expectations, however, have lessened compared with earlier in the year, primarily because the impact of Cyclone Evan on prices in Fiji and Samoa has been lower than anticipated. In contrast, the 2013 inflation projection for Solomon Islands is raised owing to heavy price pressures at the start of the year.
- **Higher growth in 2014 in line with improved global prospects.** The International Monetary Fund's latest assessment of 2013 global growth prospects is slightly more subdued, with growth now projected to be about the same pace as last year. This reflects the negative impact of public spending cuts on US growth and lingering issues in the Euro area as it heads into a second consecutive year of recession. A recovery is expected in 2014 due to higher growth in Asia and the US, and a projected end of the recession in Europe.
- The more positive global economic outlook is expected to spill over into the Pacific and increase growth in the region to 5.5% in 2014. Commencement of PNG's liquefied natural gas exports, along with post-cyclone reconstruction efforts and infrastructure work in a few smaller Pacific islands, prompt the higher growth forecast. Inflation is projected to accelerate to 5.9% in 2014 with increased economic activity.
- **Changing economic ties.** The briefs in this issue consider regional cooperation and integration (RCI) developments in the Pacific. The first brief examines the rising importance of trade between the economies of the South Pacific and developing Asia. The second brief, contributed by the East-West Center, considers the performance of North Pacific economies in historical context, and assesses their economic prospects after the expiration of the compacts of free association with the US. The third brief offers new estimates of trade costs in the Pacific, comparing these with existing indicators. The final contribution, from the Crawford School of Public Policy, outlines RCI efforts in the Caribbean and possible lessons these hold for the Pacific.

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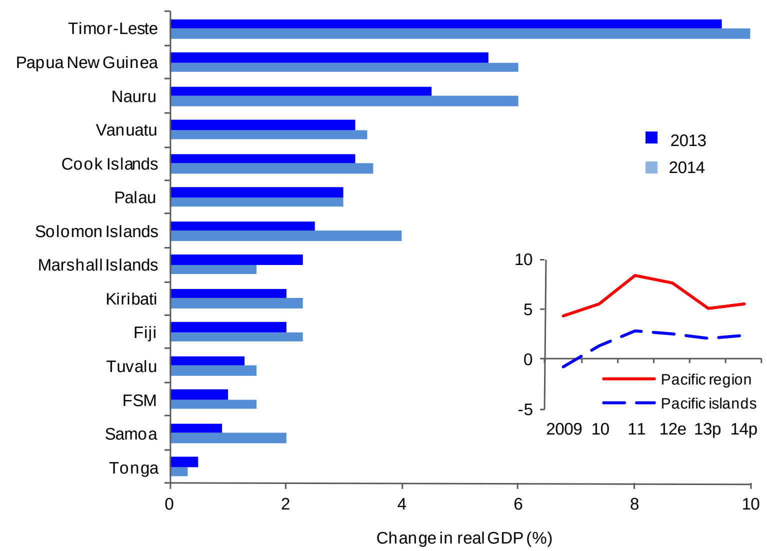
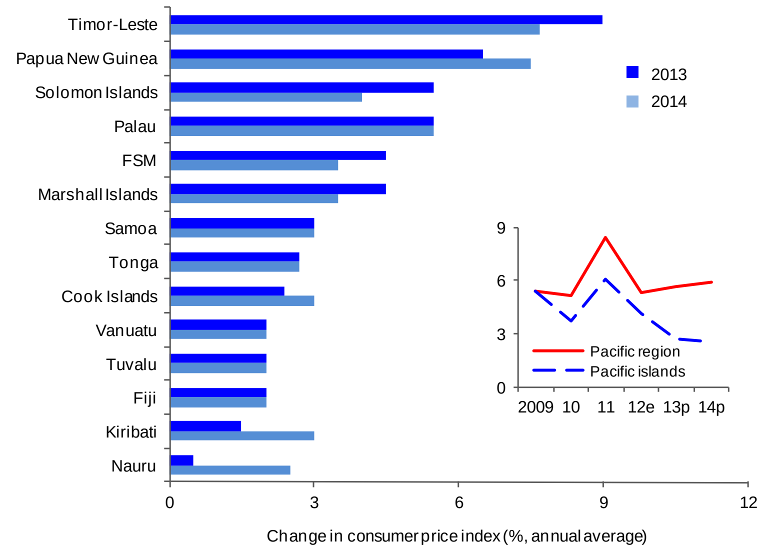
Abbreviations

$	US dollar, unless otherwise stated
A$	Australian dollar
ACI	ASEAN, India, and the PRC
ADB	Asian Development Bank
CARICOM	Caribbean Community
CARIFTA	Caribbean Free Trade Association
c.i.f.	cost of insurance and freight
CNMI	Commonwealth of the Northern Mariana Islands
CSME	Caribbean Single Market and Economy
EU	European Union
F$	Fiji dollar
fas	free alongside
fob	free on board
FSM	Federated States of Micronesia
FY	fiscal year
IMF	International Monetary Fund
GDP	gross domestic product
lhs	left-hand scale
LNG	liquefied natural gas
LPI	logistics performance index
m.a.	moving average
MSG	Melanesian Spearhead Group
NZ$	New Zealand dollar
OECS	Organiation of Eastern Caribbean States
PNG	Papua New Guinea
PRC	People's Republic of China
rhs	right-hand scale
RPC	Regional Processing Center
RMI	Republic of the Marshall Islands
TTPI	Trust Territory of Pacific Islands
US	United States
VAT	value-added tax
y-o-y	year-on-year

Asian Development Bank Projections
GDP growth



Inflation



e=estimate, FSM=Federated States of Micronesia, GDP=gross domestic product, p=projection
Note: Projections are as of June 2013 and refer to fiscal years. Regional averages of gross domestic product (GDP) growth and inflation are computed using weights derived from levels of gross national income in current US dollars following the World Bank Atlas method. Averages for the Pacific islands exclude Papua New Guinea and Timor-Leste. Timor-Leste GDP is exclusive of the offshore petroleum industry and the contribution of the United Nations.
Source: ADB estimates.

Notes

This *Monitor* uses year-on-year (y-o-y) percentage changes to reduce the impact of seasonality, and 3-month moving averages (m.a.) to reduce the impact of volatility in monthly data.

Fiscal years end on 30 June for the Cook Islands, Nauru, Samoa, and Tonga; 30 September in the Marshall Islands, the Federated States of Micronesia, and Palau; and 31 December elsewhere.

International and regional developments

Growth to remain steady in 2013

- The world economy is projected to grow by 3.3% in 2013, about the same pace as last year, according to the International Monetary Fund's (IMF) latest *World Economic Outlook* (April 2013). This growth forecast is slightly lower than the IMF's January forecast, largely reflecting the negative impact of public spending cuts on US growth. The US economy is seen to grow by 1.9% in 2013 (compared with 2.2% in 2012), as the recovery of the credit and housing markets spurs private demand. The Euro area is set to enter a second year of recession as fiscal consolidation and bank deleveraging continue. The 2013 and 2014 growth forecasts for Japan were revised upward (although they remain below 2012 growth) due to recent expansionary fiscal and monetary policies.

- The *Asian Development Outlook 2013* projects growth in developing Asia will rebound to about 6.6% in the next 2 years (from 6.1% in 2012). Higher growth is supported by strong domestic demand and improved export performance. Growth is seen to accelerate in the People's Republic of China (PRC) and India, and remain steady in Southeast Asia.

- Growth in Australia is projected to moderate from 3.6% in 2012 to 3.0% in 2013 due to scaling back of mining investment, fiscal consolidation, and slowdown in private consumption. Higher economic growth in the PRC could fuel increased demand and higher prices for Australia's major exports. After a slump in mid-2012, prices of iron ore and, to a lesser extent, coal recovered in early 2013. Australia's unemployment rate of 5.6% in March was the highest since late 2009. The Reserve Bank of Australia cut the benchmark interest rate to its lowest level at 2.75% in May 2013 in an effort to stimulate lending and aggregate demand.

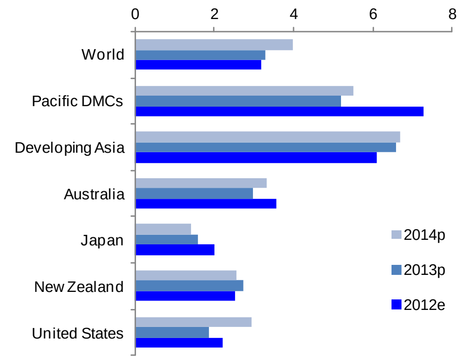
- The New Zealand economy is expected to grow by 2.7% in 2013, about the same pace as last year. Growth is supported by continued reconstruction activity in Canterbury and strong housing demand and private consumption. Downside risks include the impact of a severe drought on agricultural output and continuing fiscal consolidation. Overall unemployment remains high at over 6%, with the unemployment rate among Pacific workers running at 15%.

- The IMF expects commodity prices to fall modestly over the next 2 years. Fuel prices are projected to decline by an average of 3.6% per annum, but remain above $100 per barrel. From a 9.8% decrease in 2012, nonfuel commodity prices are expected to fall further, by an average of 2.6%, over the next 2 years. Prices of coconut oil and timber have fallen by about 60% and 25%, respectively, in the first quarter of 2013, from their peak levels in 2011. In the first quarter of 2013, food prices have fallen by 9% relative to their peak levels in mid-2012.

Exports decline on lower international commodity prices

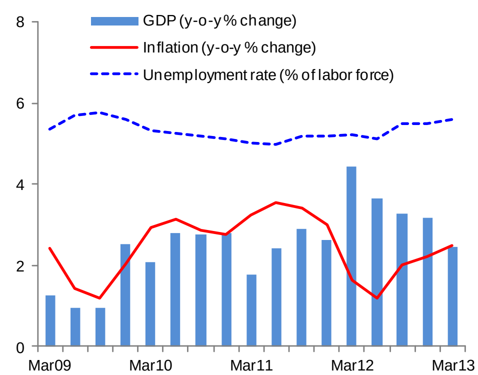
- Declining international prices depressed the values of principal exports from the Pacific to Australia. The value of Pacific export goods fell by 27.3% (y-o-y) during the first quarter of 2013. The value of gold and petroleum from Papua New Guinea (PNG) to Australia, which together accounted for 76.4% of regional exports to Australia, fell by 32.0% during the same period. The value of imports from Australia to the Pacific decreased during

GDP growth
(%, annual)



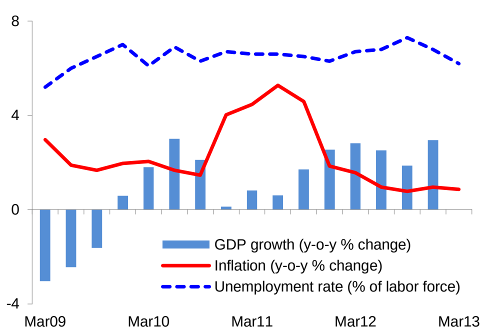
DMC=developing member country, e=estimate, p=projection
Sources: International Monetary Fund. 2013. *World Economic Outlook Update* (April 2013); ADB. 2013.*Asian Development Outlook*; and ADB estimates.

Australia economic indicators
(quarterly)



GDP=gross domestic product, y-o-y=year-on-year
Source: Australian Bureau of Statistics.

New Zealand economic indicators
(quarterly)



GDP=gross domestic product, lhs=left-hand scale, rhs=right-hand scale, y-o-y=year-on-year
Source: Statistics New Zealand.

International and regional developments

the first quarter of 2013, but by a lesser amount (4.8%). The Pacific recorded a trade deficit of A$98 million in the first quarter of 2013, which represents a reversal of the trade surpluses from recent years.

- The value of Pacific exports to New Zealand decreased by 17.1% (y-o-y) in the first quarter of 2013. Fiji's exports—mainly vegetables and baked goods—were 18.4% lower than in the first quarter of 2012. Fiji accounted for about half of total Pacific exports to New Zealand during the period. Nauru's phosphate exports (24.3% of the total) were also down by 6.5% (y-o-y). On the other hand, the value of Pacific imports from New Zealand rose by 23.2% (y-o-y) in the first quarter of 2013. Fiji's importation of boats, valued at NZ$39.7 million, accounted for much of this increase. The region's trade deficit with respect to New Zealand widened by 29.4% (y-o-y) to NZ$229.2 million in the first quarter of 2013.

- Pacific fuel imports from Singapore fell by 27.6% (y-o-y) in the first quarter of 2013 as demand for both diesel and gasoline declined. Volumes imported by PNG during this period declined by 8.2%, although PNG still accounted for 53.8% of the region's total fuel imports from Singapore. Fiji's fuel imports (28.2% of the total volume) also dropped by 51.2%. These declines suggest a regional shift toward other fuel suppliers. The value of PNG's fuel imports from New Zealand increased sharply in January–March 2013.

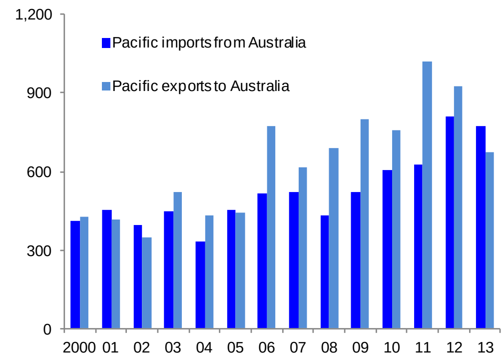
Tourism to the Pacific dampened by Cyclone Evan

- Infrastructure damage caused by Cyclone Evan in December 2012 resulted in weaker tourism to Fiji and Samoa in early 2013. Sharper declines were recorded in Samoa—where the cyclone's impact was more severe and widespread—although tourism from major source markets showed signs of recovery by March.

- Australian tourism to the South Pacific fell by about 9% (y-o-y) in the first quarter of 2013. Reported departures from Australia to Fiji and Samoa declined most sharply, by 12% and 19% (y-o-y), respectively. As in the past, Vanuatu appears to have benefited from travelers choosing to visit there rather than Fiji, recording an 8% increase in the number of Australian tourists in the first quarter of 2013. The Cook Islands continued to enjoy robust growth in Australian tourist arrivals via the Air New Zealand Sydney–Rarotonga flights underwritten by the Cook Islands government. In contrast, Tonga saw a decline in the number of Australian tourists as the effects of its aggressive marketing campaign appears to have dissipated.

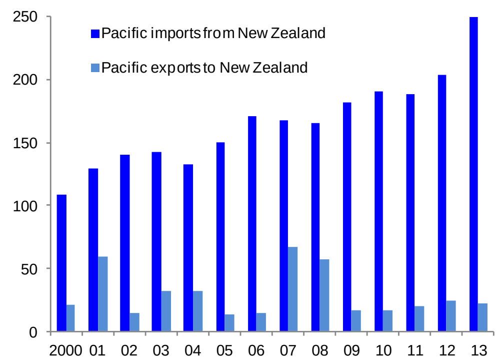
- Departures from New Zealand to South Pacific destinations increased by 1.7% (y-o-y) in the first quarter of 2013. Tourist departures to Fiji and Samoa weakened in the immediate aftermath of Cyclone Evan. Departures from New Zealand to Fiji continued to grow (by 2.2%) albeit at a much lower level than in 2012 when arrivals grew by 8.2% in the first quarter (y-o-y). New Zealand departures to Samoa contracted by about 6.6% in the first quarter of 2013 relative to the first quarter of 2012. New Zealand tourism to other South Pacific destinations picked up over the same period, most notably for Tonga (10.7%), and also for Vanuatu (7.9%) and the Cook Islands (4.1%).

Pacific trade with Australia (A$ million, January–March totals)



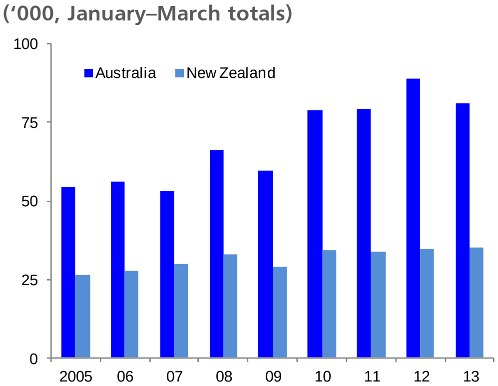
Source: Australian Bureau of Statistics.

Pacific trade with New Zealand (NZ$ million, January–March totals)



Source: Statistics New Zealand.

Tourist departures to Pacific destinations ('000, January–March totals)



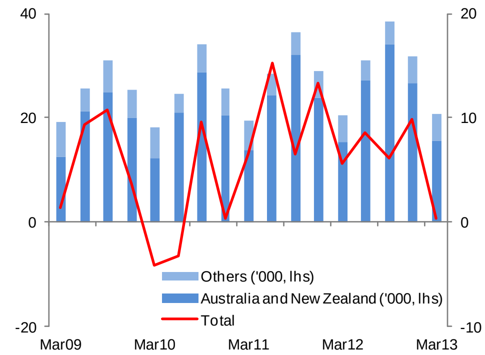
Sources: Australian Bureau of Statistics and Statistics New Zealand.

Lead authors: Christopher Edmonds, Isabel Ferino, Joel Hernandez, Rommel Rabanal, and Cara Tinio.

Cook Islands

- The FY2012 (ended 30 June) estimate of GDP growth has been revised upward from 3.3% to 4.6%. The country registered a 7.2% increase in tourist arrivals and received significant capital investments funded by development partners. It is estimated that growth will fall to 3.2% of GDP in FY2013 on the back of a 24.8% reduction in capital investment. Inflation is estimated to have slowed from 2.8% in FY2012 to 2.4% in FY2013 due to falling food and utility prices.
- Total government revenue in FY2013 is estimated to have increased by 3.3% (y-o-y) to NZ$158.7 million. Total expenditure is estimated to have increased by 2.9% (y-o-y) to NZ$166.4 million, despite a 29.4% decrease in the cost of underwriting Air New Zealand flights as a result of lower fuel prices and higher load factors. The budget deficit is estimated to have declined from 2% of GDP in FY2012 to 1.8% of GDP in FY2013—below the government's deficit target of 2% of GDP.
- Net value-added tax (VAT) collections through the third quarter of FY2013 were 14% above the same period last year. The bulk of the increase was due to increased spending by tourists. Hotels and motels, and wholesale and retail trade, together accounted for 56% of total net VAT collections in FY2012.
- The Cook Islands economy is projected to accelerate to 3.5% in FY2014 due to an expected 5.7% rise in tourist arrivals. Inflation is expected to revert to its long-run average of 3.0%.

Visitor arrivals ('000, quarterly)



lhs=left-hand scale, rhs=right-hand scale
Source: Cook Islands Statistics Office.

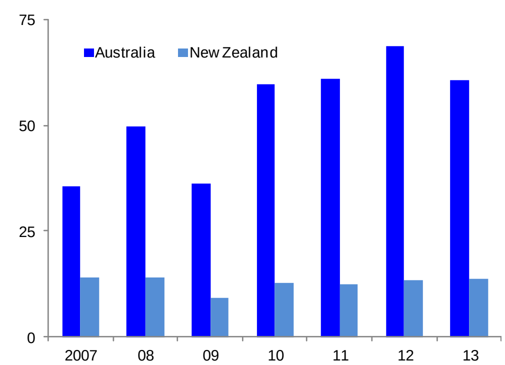
Lead author: Malie Lototele.

Fiji

Recent developments

- Tourist arrivals in January 2013 were 7.9% lower than in the record breaking month of January last year, largely due to the impact of Cyclone Evan in late December. Visitor arrivals from Australia and New Zealand—Fiji's two main source markets—declined by 9.9% (y-o-y) according to the Fiji Bureau of Statistics. Cruise ship arrivals recorded a 51.8% increase year-on-year from January—and now make up about 14.5% of total overseas arrivals. The Fiji Hotel and Tourism Association reports bookings are up about 5% over last year's figures. Looking forward, visitor numbers over the next 6 months are looking favorable with very solid bookings forecast.
- Gold is one of the country's top exports, but production declined by 20% in 2012 according to Vatukoula Gold Mines, larger than the 8% decline reported by the Reserve Bank of Fiji. In May 2013, Chinese-owned DRK Energy purchased a 19.2% stake in the Vatukoula gold mine. DRK and Vatukoula will work together on a planned expansion program aimed at boosting production for export. Increasing investment into the country's mining industry gives added urgency to finalize the country's mining act.
- The Reserve Bank of Fiji reports that consumer spending rebounded in 2012, supported by the reduction of personal income tax rates, the increase in the minimum salary for public sector workers, and a 5% increase in remittances. Net value-added tax (VAT) collections increased by 9.3% to F$675.9 million in 2012. Gross VAT collections registered growth of 24.1% on an annual basis, led by increases in both domestic (25.1%) and customs (23.2%) collections. The large number of Fiji National Provident Fund pensioners (31%) who opted to exit the pension

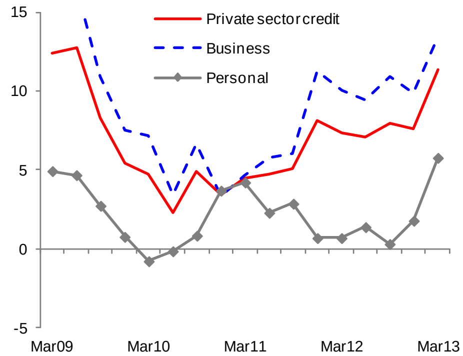
Departures from Australia and New Zealand ('000, January–March totals)



Sources: Australian Bureau of Statistics and Statistics New Zealand.

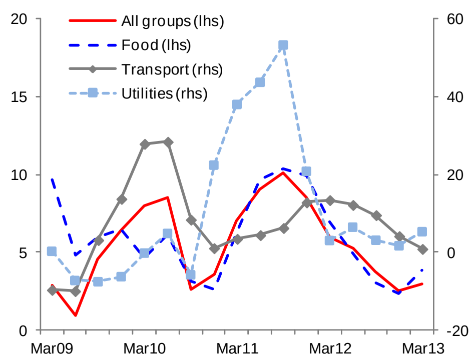
Fiji

Private credit growth
(year-on-year % change, quarterly)



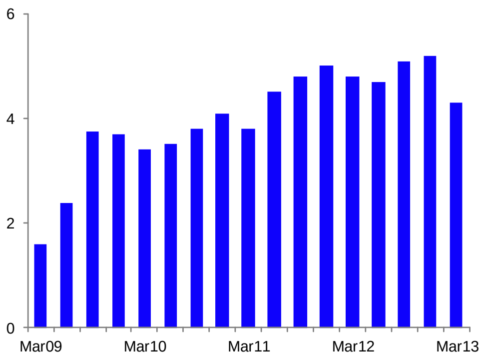
Source: Reserve Bank of Fiji.

Inflation
(year-on-year % change, quarterly)



Source: Reserve Bank of Fiji.

Foreign reserves
(months of import, end of period)



Source: Reserve Bank of Fiji.

Lead author: Caroline Currie.

scheme through taking a lump sum withdrawal may also have contributed to the increase. However, higher consumption does not appear to be associated with private credit growth, which ran at only 4.7% in 2012 according to figures released by the Reserve Bank of Fiji. In early 2013, private credit growth is at 6.0% (y-o-y).

- Inflation was 3% in the first quarter of 2013 from a high of 10.1% in the third quarter of 2011. In April it fell to just 1%, the lowest y-o-y increase in more than 3 years.

Outlook

- The ADB growth forecast remains unchanged at 2.0% for 2013 and rises to 2.3% in 2014. The performance of the Fiji economy will be most strongly influenced by domestic developments—particularly domestic construction activity, business confidence, and persistent structural weaknesses (e.g., sugar industry performance, land reform, uncertain political situation). Developments in the PRC and Australia are seen as secondary drivers of growth in Fiji.

- The government's expansionary fiscal policy stance will see the budget deficit widen to 2.8% of GDP in 2013. This outlook mainly reflects higher capital investment in road works. Further out to 2014, ongoing infrastructure needs could lead to continued high capital expenditure, although a strong focus on fiscal consolidation in the medium term is indicated in Fiji's 2013 budget. The government debt burden is forecast to increase to 51.5% in 2013 to accommodate the increased capital spending.

- With declining commodity prices and recent trends toward reduced inflation, ADB is forecasting inflation to moderate further over the year, and to average 2.0% in 2013 and to stay at that level in 2014—with upside risks should consumer confidence improve in the post-election period.

- Fiji faces challenges in the short- to medium-term to address fiscal sustainability, particularly in terms of accumulating government debt. According to Standard and Poor's 2013 ratings assessment of Fiji, the state's guarantee on debt to fund the purchase of the new fleet of airplanes will increase contingent liabilities to nearly 30% of GDP and raise public debt to more than 80% of GDP.

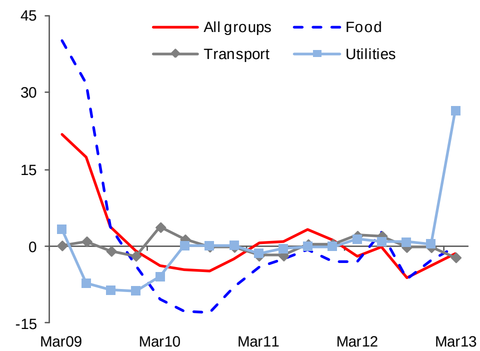
Key issues

- Geographically, Fiji is the natural hub of the South Pacific, but its suspension from the Pacific Islands Forum has prevented it from participating in regional decision making in recent years. Fiji is an active participant in Melanesian Spearhead Group (MSG) initiatives and in the Group of 77 (G77) developing countries at the United Nations. Fiji also recently hosted the African, Caribbean, and Pacific Trade Ministers' Meeting. Significant growth is projected in intra-MSG trade this year and next year. Fiji's total trade with the Pacific islands countries has increased from less than 1% in 2000 to 4.5% today, and approximately 45% of this trade is with the MSG countries.

Kiribati

- The government revised its 2012 growth estimate to 2.5%, down from 3.0%. The official forecast now sees economic growth slowing to 2.0% in 2013 due to continued delays in the implementation of planned infrastructure projects. Fisheries license fees are seen to decline—reverting to their long-term average. The implementation of road and airport projects financed by development partners is expected to begin in the fourth quarter of 2013. The increased construction activity is expected to raise growth to 2.3% in 2014.
- Following deflation of 3.0% in 2012, prices contracted further by 1.4% in the first quarter of 2013. This marked the fifth consecutive quarter of deflation, and food and transport prices continue to decline. Inflation is projected to rise to 1.5% in 2013 and 3.0% in 2014 due to the weakening Australian dollar.
- Kiribati negotiated an agreement allowing European Union (EU)-based fishing companies to deploy four purse seiner and six longline vessels in Kiribati's waters. The EU pays an annual amount equivalent to $1.26 million for 15,000 metric tons per year from the Kiribati exclusive economic zone and $453,817 to support sustainable fishing in Kiribati. Although the agreement represents a good example of beneficial economic engagement, critics have questioned whether it undercuts the parties to the Nauru Agreement and whether Kiribati could have negotiated more favorable terms.

Inflation, by major commodity groups (y-o-y % change, quarterly)



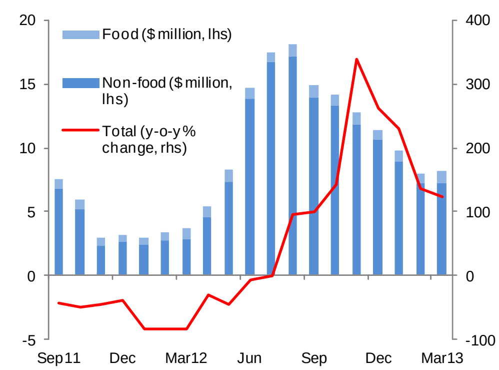
Source: Kiribati National Statistics Office.

Lead author: Malie Lototele.

Marshall Islands

- The Republic of the Marshall Islands' (RMI) imports from the US increased by 187.6% (y-o-y) in the first half of FY2013 (ends 30 September). This was driven mainly by a resumption of fuel imports from the US.
- The RMI economy is still expected to grow by 2.3% in FY2013 and 1.5% in FY2014, mostly due to public works projects funded by development partners. The inflation outlook likewise remains at 4.5% in FY2013 and 3.5% in FY2014.
- Downside risks to the economic outlook include delays in the implementation of infrastructure projects as well as the severe drought in northern RMI. Despite mitigation measures undertaken by the RMI government and development partners, the drought has severely depleted the area's water supply, sharply reduced agricultural production, and affected over 10,000 Marshallese. The drought is seen to continue at least until July. After rains resume, crop recovery is estimated to take about a year.
- The RMI is pursuing greater cooperation with Taipei,China, particularly in the fisheries sector. Such cooperation could advance private investment from Taipei,China into RMI fishing companies and decrease dependence on public spending supported by US Compact grants that are set to expire in FY2023.
- Greater linkages with Taipei,China would require amendments to RMI's investment-related laws and regulations to make them more business-friendly. The RMI government has indicated that this matter will be explored when Parliament convenes its regular session in August.

Imports from the US (monthly)

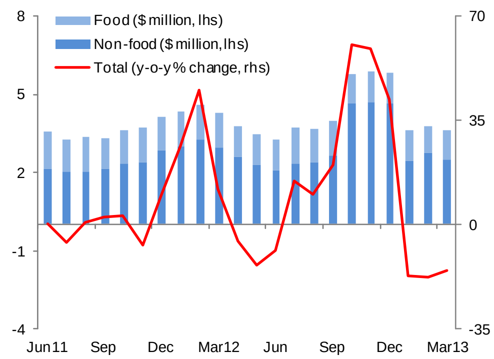


lhs=left-hand scale, rhs=right-hand scale
Source: US Census Bureau.

Lead author: Cara Tinio.

Micronesia, Federated States of

Imports from the US (3-month m.a.)



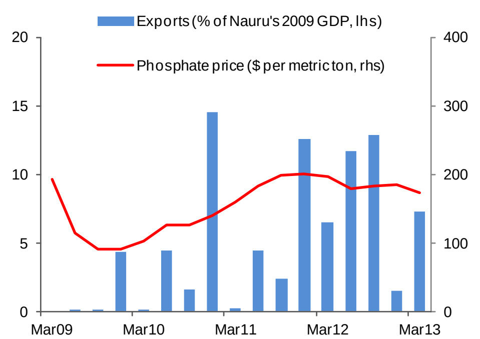
lhs=left-hand scale, rhs=right-hand scale
Source: US Census Bureau.

Lead author: Rommel Rabanal.

- Between October 2012 and March 2013, the value of the Federated States of Micronesia's (FSM) imports from the US grew by 12.6%, primarily driven by purchases of machinery, transport equipment, and manufactured goods associated with airport improvement projects. However, food imports fell by 11.6% over the same period after falling by 6.0% over FY2012 (ends 30 September). This could indicate weakness in consumer spending. Overall imports weakened further in the second quarter of FY2013, as the airport projects were completed and food imports declined more sharply.
- The FY2013 growth outlook remains unchanged from earlier in the year and GDP growth projections are therefore maintained at 1.0% for FY2013 and 1.5% in FY2014. A pickup in growth is expected when work on the ADB-supported Pohnpei Port upgrade is scheduled to commence. Inflation is still projected to trend down from 4.5% in FY2013 to 3.5% in FY2014 due to expected declines in international food and fuel prices.
- Enhancing the FSM's integration with the world economy (e.g., by developing economic linkages with a broader set of countries) will be crucial in stimulating private-sector-led growth. Recent airport improvement projects, along with the proposed Pohnpei Port project, represent important infrastructure improvements that could help facilitate expansions in trade and tourism flows over the longer term. Improved interisland connectivity can also result in greater use of the FSM's national resources.

Nauru

Phosphate exports to Australia and New Zealand (quarterly)



lhs=left-hand scale, rhs=right-hand scale
Sources: Australian Bureau of Statistics, Statistics New Zealand, and World Bank Commodity Price Data (Pink Sheets).

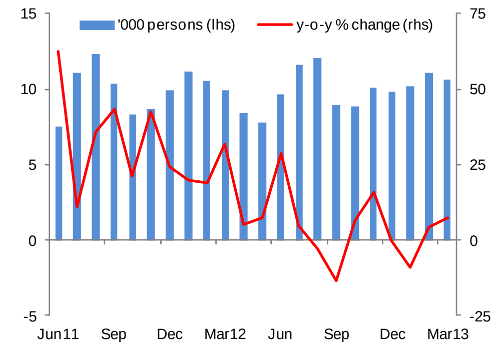
Lead author: Milovan Lucich.

- Growth forecasts for FY2013 (ends 30 June) and FY2014 have been downgraded to 4.5% and 6.0% respectively. The downgrade reflects increased political uncertainty and a weaker outlook for phosphate exports.
- In February 2013, deep divisions emerged in the Nauru cabinet. The Fisheries Minister was sacked, and two of the four remaining ministers resigned. Parliament was unable to reach a quorum for most of the next three months and a state of emergency was declared in May 2013. Fresh elections were held in June 2013 resulting in 6 new Parliamentarians out of a Parliament of 20.
- The political situation has delayed the expansion of the Regional Processing Centre (RPC) from its current capacity of 418 persons to the planned 1,500. While five permanent facilities have been built at the first RPC site—replacing the tents that were previously used to accommodate asylum seekers—terms of lease for two additional sites have not been negotiated. Around 160 Nauruans are currently employed at the RPC. This number would more than double if additional sites are brought on line.
- Phosphate exports are expected to decline by around 15% in FY2013 compared with the previous year. This reflects disruptions due to use of Republic of Nauru Phosphate Corporation equipment for RPC construction, management changes, and poor weather. Phosphate exports are expected to hold steady in FY2014 as mining exhausts primary phosphate reserves and taps into deeper secondary phosphate resources.

Palau

- Estimated growth for FY2012 (ended 30 September) was raised to 6.3% due to revisions in national accounts. The revised numbers show the impacts of the 2008–2009 global financial and economic crisis were deeper and more prolonged, and the recovery was stronger, than previously indicated.
- Over the first half of FY2013, visitor arrivals grew by 3.6%, a marked slowdown from last year. Growth in arrivals was particularly weak in the second quarter, mainly due to continued sharp reductions in the number of tourists from Taipei,China. Temporary suspension of Palau Airways' operations in Taipei,China in late April due to problems with aircraft leases has exacerbated the downward trend.
- The slowdown in visitor arrivals was expected, so the FY2013 GDP growth projection is maintained at 3.0%. Uncertainty regarding the government's investment plans clouds the FY2014 outlook, but GDP growth is projected to hold steady at 3.0%. Inflation projections are also maintained at 5.5% for FY2013 and FY2014.
- To sustain growth in visitor arrivals, Palau will need to develop new source markets as well as sustain its established tourism markets. Currently, about two-thirds of international arrivals to Palau comes from Japan and Taipei,China. Expanding linkages with relatively untapped tourist markets in East and Southeast Asia could help the Palau tourism sector to sustain its growth.

Visitor arrivals ('000, monthly)



lhs=left-hand scale, rhs=right-hand scale
Source: Palau Visitors Authority.

Lead author: Rommel Rabanal.

Papua New Guinea

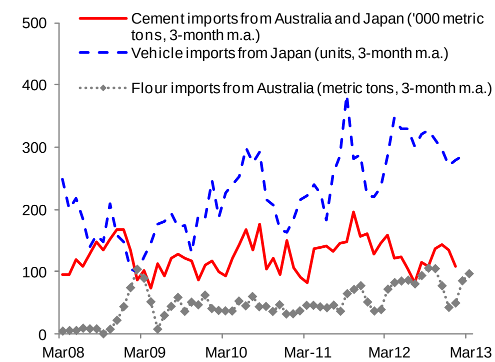
Recent developments

- Signs of the expected slowdown in economic growth from 9.8% in 2012 to 5.5% in 2013 are appearing, but the economy remains robust and businesses upbeat. As spillovers from liquefied natural gas (LNG) project construction slowly dissipate, increasing production from a new mining operation, and a large budget deficit equal to 7.2% of GDP are boosting economic activity. Recent Central Bank calculations suggest that counter cyclical fiscal policy could contribute up to 2% of real output growth in 2013.
- Cement imports from PNG's major suppliers in Australia and Japan, a lead economic indicator for construction activity, declined in the first quarter. However, other lead indicators, such as car imports from Japan and chicken and flour imports from Australia, continue to rise to new record levels, and private sector employment increased by 6.4% during 2012. Private sector credit growth has also begun to strengthen, rising above 10% per annum during the first quarter of 2013.

Outlook

- PNG's medium-term outlook remains broadly positive, with growth of 6.0% projected for 2014. However, some challenges are growing. Prices of the major export commodities have fallen since the start of 2013—gold by 13%, copper by 9%, and oil by 5%. Revenues will thus be lower than expected. Authorities will either have to cut spending or find additional funding to maintain the deficit at the planned level.
- Inflation is expected to rise to 6.5% in 2013, up from 4.1% in 2012. This partly reflects the easing kina exchange rate, which by the end of May 2013 had declined by 4% against the US dollar and by 10% against the Australian dollar since July 2012. The

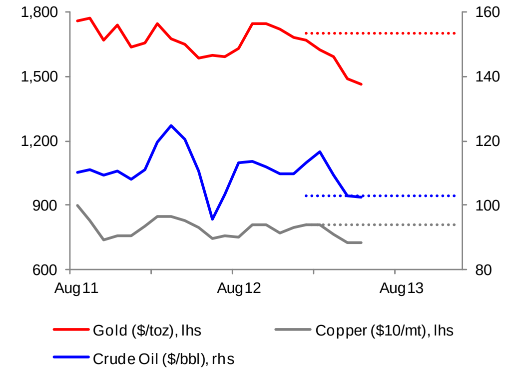
Leading economic indicators (monthly)



Sources: Australia Bureau of Statistics and Japan Ministry of Finance.

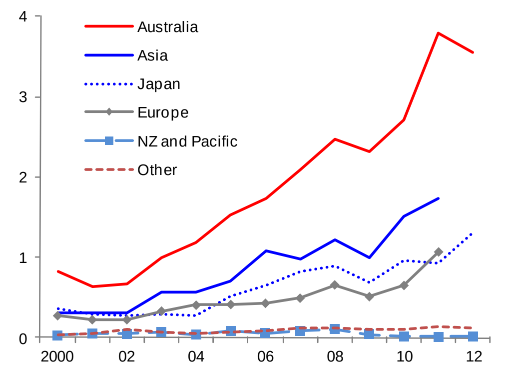
Papua New Guinea

Commodity prices vs. 2013 budget projections (%, annual average)



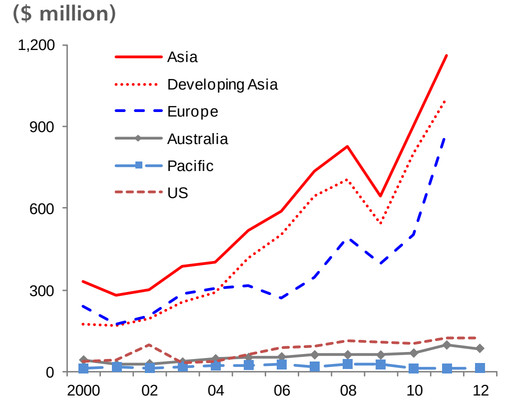
$=US dollar, bbl=barrel, lhs=left-hand scale, mt=metric ton, rhs=right-hand scale, toz=troy ounce
Note: Dashed lines are 2013 budget projections.
Sources: PNG Department of Treasury 2013 National Budget and World Bank Commodity Price Data (Pink Sheets).

PNG exports by region ($ billion, annual)



Note: This analysis is undertaken with the latest available data from the United Nations Comtrade database. As PNG does not provide regular updates to Comtrade, export flows are calculated via partner country reporting of imports originating from PNG. Where possible, aggregate figures have been compared against those published by the Central Bank of PNG, which support the major trends identified in the analysis; however, differences between these and official government figures do exist.
Source: United Nations Comtrade database.

PNG exports excluding minerals, by region ($ million)



Source: United Nations Comtrade database.

government's fiscal stimulus is also adding to inflationary expectations, with Bank of Papua New Guinea calculations suggesting it could add up to 1.5% to price growth in 2013.

- LNG exports are on track to commence in late 2014 and will provide a significant boost to growth. Over the medium term, if commodity prices trend lower, they would adversely impact potential new mining and hydrocarbon investments and lower the overall growth outlook. The outcomes of a recently announced taxation policy review might also affect future investment into the mining sector. Policy makers will need to balance maximizing public revenues from natural resources with encouraging new investments.

Key issues

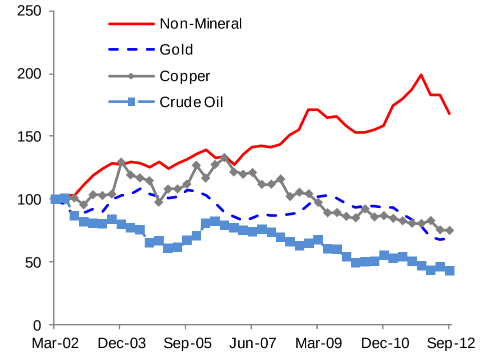
- PNG's medium-term outlook also hinges on its ability to harness new export opportunities. The country's economic growth has been supported by a rapid increase in exports, which rose in value from 40% to 51% of GDP between 2000 and 2012. Exports of gold, copper, and oil led this growth, and now account for roughly two-thirds of total export earnings.
- The growth of mining and hydrocarbon (henceforth mineral) exports has reinforced PNG's historic trade partnerships with Australia and Japan. These two countries now purchase roughly 75% of PNG's total exports, with Australia alone responsible for 55% in 2012. The growing emphasis on mineral trade with these partners has overshadowed important developments in the pattern of nonmineral exports (predominantly agriculture, forestry and fisheries), suggesting progress toward a more diverse set of trading partners and export products.
- Between 2000 and 2011, PNG's nonmineral export earnings rose in value by 230%, from $660 million to $2.2 billion. In contrast to the focus on mineral exports to historic trade partners, the two major sources of this nonmineral export growth have been emerging Asian and European markets.
- Trade with the People's Republic of China has been a major driver of this growth, underpinned by exports of forestry products and, to a lesser extent, copra and seafood. Further, PNG's exports of coffee, cocoa, spices, vegetable oils, and rubber to Malaysia quadrupled between 2007 and 2011. India, Indonesia, the Philippines, Singapore, and Thailand have also emerged as significant export markets, expanding their cumulative purchases of agriculture and fisheries products from $70 million to $260 million during this period.
- PNG's exports have also been making significant inroads into European markets, with total sales to the region increasing almost fourfold from $220 million in 2000 to $810 million in 2011. Germany has led this growth, with purchases of seafood, coffee, cocoa, tea, spices, vegetable oils, and rubber rising from $100 million in 2000 to $400 million in 2012. Both the Netherlands and the United Kingdom have also begun purchasing an increasing range of goods from PNG markets since the middle of the last decade, with sales of seafood, copra, cocoa, and spices increasing from approximately $90 million in 2006 to $200 million in 2012.
- Understanding the changing composition and direction of PNG's exports is important for a number of reasons. It highlights that although aggregate exports remain heavily focused on the sale of a few high-value commodities to traditional trade partners,

Papua New Guinea

growth in Asia is creating many new business opportunities for PNG producers. In fact, with production volumes for gold, copper, and oil trending downward over the past decade (with rising export revenues driven entirely by higher international prices), increased trade in agriculture, forestry, and fisheries products has been the most dynamic element in PNG trade. Output patterns vary across commodities, but on average, production of nonmineral exports has risen by an average 6% per annum over the past decade.

- Nonmineral exports also have a larger, more direct impact on income-earning opportunities and poverty reduction. Developing strategies to further harness opportunities within these markets should be a priority for future development strategies to make the distribution of the benefits of economic growth more equally distributed across the population.
- Yet despite recent gains, PNG's mineral and nonmineral exports both continue to be dominated by primary (unprocessed) commodities. Developing PNG's value chain will require a coordinated effort to address the myriad factors currently imposing heavy costs on domestic producers. Foremost will be addressing the deficiencies in national infrastructure and enhancing regulation of markets to ensure free competition can take place. As these issues are addressed, PNG will attract higher levels of foreign investment to facilitate a much-needed transfer of skills, technology, and capital. By creating a more productive domestic value chain, regional integration can become a central strategy for creating more economic opportunities for more people over the coming decade.

Production volumes (March 2002=100)



Source: Bank of Papua New Guinea quarterly bulletins.

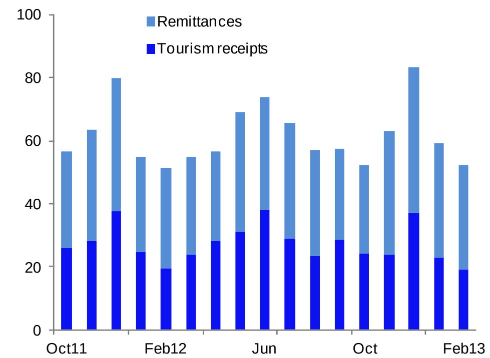
Lead author: Aaron Batten.

Samoa

Recent developments

- Real GDP was 4.3% lower in the first half of FY2013 (ends June 30) compared with the same period in FY2012, reflecting the winding down of post-tsunami construction activity and early impacts of Cyclone Evan. In the same period, the government continued with its efforts to bring down the deficit to target levels by 2015, which contributed to the slowdown.
- The number of international visitors to Samoa was 4.3% higher in December 2012 compared with December 2011. This partly reflects Air New Zealand offering discounted fares following Cyclone Evan. Visitor arrivals in January and February 2013 were sharply lower (down 8.2% and 12.2%, respectively) than in the same months of the previous year. There was a corresponding decline in tourism receipts for both months.
- Private remittances increased by 20.1% to $45.8 million in December 2012, 9% higher than in December 2011. For the first 8 months of FY2013, total private remittances amounted to $281 million, almost 9% higher than in the same period of FY2012.

Key sources of income (tala million)



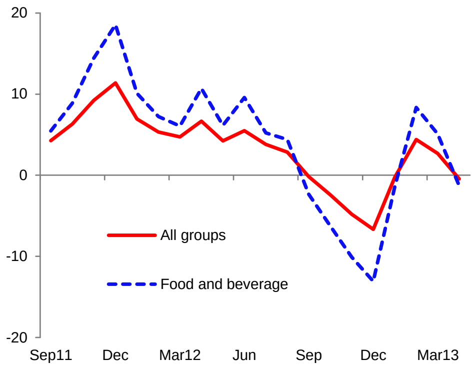
Source: Central Bank of Samoa.

Outlook

- ADB's growth outlook for Samoa remains unchanged at 0.9% for FY2013 and 2.0% in FY2014 as construction activity to rehabilitate and rebuild social and economic infrastructure gets underway. The damage to infrastructure following Cyclone Evan contributes to the poor economic outlook over the next 2 years.

Samoa

Inflation
(y-o-y % change, monthly)



Source: Samoa Bureau of Statistics.

Lead author: Caroline Currie.

With the fallout from the cyclone, including an expected decline in tax revenues and increased expenditure to restore essential infrastructure, the overall fiscal deficit is expected to increase to 6.9% of GDP for FY2013, rising to 7%–8% of GDP in FY2014. This is better than predicted by the government when it released its *Post-disaster Needs Assessment* in early March.

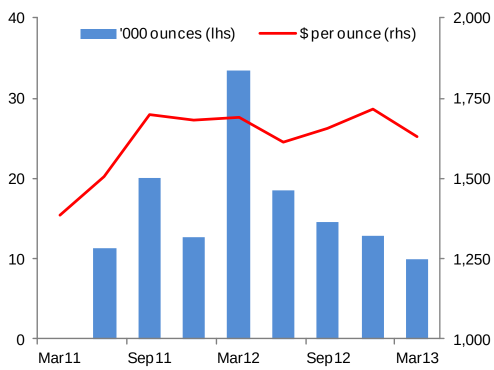
- The country's dependence on external financing to support economic recovery is expected to raise the nominal external debt level of the country to 61.8% of GDP in FY2013 and 66.8% in FY2014, well above the 40% threshold set by the Samoan authorities.
- Domestic food prices spiked in February-March 2013 as a result of damage from Cyclone Evan, but subsequently stabilized as supply networks were restored. Domestic price pressures are expected to continue to ease over time. Coupled with declining international commodity prices, inflation is expected to remain at around 3% into FY2014.

Key issues

- Samoa achieved a significant milestone by becoming the first Pacific Islands Forum country to ratify the Pacific Island Countries Trade Agreement (PICTA) Trade in Services Protocol. Trade in services is increasingly recognized as a key contributor to Samoa's economy. The ratification of the Protocol reaffirms Samoa's commitment to further develop business links with other Forum Island Countries.

Solomon Islands

Gold exports
(quarterly)



lhs=left-hand scale, rhs=right-hand scale
Source: Central Bank of Solomon Islands and World Bank Commodity Price Data (Pink Sheets).

Recent developments

- GDP estimates for 2012 have been revised to 4.8%—down from an earlier figure of 5.5%—as the agricultural sector performed worse than expected.
- Preliminary estimates show that log exports fell by 16.0% (y-o-y) and gold exports fell by 70.3% (y-o-y) in the first quarter of 2013. The Gold Ridge mine operator, St. Barbara Limited, reported that gold production declined by 27.0% (y-o-y) in the first quarter and the company has downgraded its full year production forecast by 10%.
- These outcomes came on the back of weaker international commodity prices and the impact of Cyclone Sandra. Timber prices fell to a 2-year low in March 2013 at $314 per cubic meter. Gold prices fell by 5.4% to $1,430 per ounce in the first quarter of 2013. The viability of the Gold Ridge mine operation would be at risk if gold prices fall further. The mining company estimates its operating cost at roughly $1,400 per ounce.
- Agricultural and fishery production are also down in 2013. Cocoa and copra production declined by 24.2% and 64.4% (y-o-y) in the first 3 months of the year. The fishing catch fell by 23.7% due to bad weather. However, palm oil production increased by 4.4% in the first quarter of the year.

Solomon Islands

- Inflation increased by 7.1% (y-o-y) in the first quarter, driven largely by higher utility prices. Despite low global prices, retail petrol is at a 5-month high, at $1.53 per liter, due to lagged effects of earlier high prices.
- Lower export receipts and higher import payments resulted in a trade deficit equivalent to 2.7% of GDP in March 2013. However, foreign reserves remain high at 11.3 months of import cover in March 2013. Development partner inflows and, more recently, fishing licensing fees have continued to be important sources of foreign exchange.

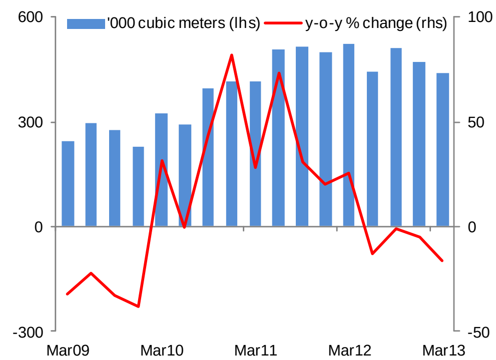
Outlook

- The growth forecast for 2013 has been lowered to 2.5%. This largely reflects weaker than anticipated gold production. Higher recurrent government spending and increased private investment in mining and telecommunications are supporting growth. Growth of 4.0% is maintained for 2014, with gold production expected to rebound.
- Inflation is expected to rise to 5.5% (from the earlier forecast of 4.5%) in 2013 due to higher inflation in the first quarter. Inflation is projected to moderate to 4.0% in 2014 as the lagged effects of higher fuel and food prices dissipate.

Key issues

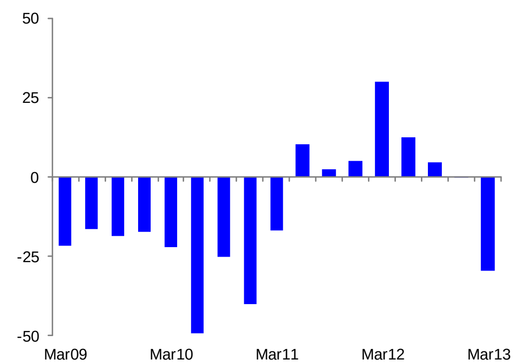
- Much of Solomon Islands remains economically isolated from national and regional markets because of high transport and communication costs. Improved access to more affordable telecommunications can facilitate economic and social development and provide new avenues for the delivery of key social services.
- A 2009 World Bank study found that a 10% increase in broadband penetration was associated with a 1.38% increase in GDP growth in low- and middle-income countries. Economic benefits included (i) reduced transaction costs (e.g., mobile banking), (ii) enhanced business and investment opportunities such as e-commerce, and (iii) improved public service delivery. Benefits in relation to public service delivery included opportunities in e-education and e-health services; and remote delivery of agricultural extension, policing, judicial, employment, disaster management, and other public services.
- The ADB-funded submarine cable system for Solomon Islands is expected to expand the speed and coverage of internet service provision, halve wholesale bandwidth prices, and reduce retail prices by 20%. International connectivity costs are seen to fall by more than 60%. In 2012, the cheapest broadband internet subscription cost roughly $60 per month, which is equivalent to about 28% of average per capita monthly income.
- Social and economic benefits of improved internet connectivity in Solomon Islands are expected to result from increased frequency and quality of communications among countries in the region, which in turn can facilitate growth in trade-related services such as tourism.

Log exports (quarterly)



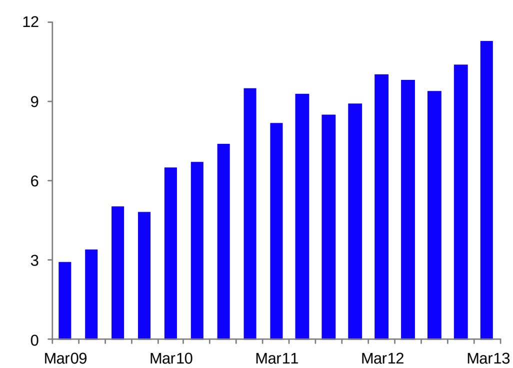
lhs=left-hand scale, rhs=right-hand scale
Source: Central Bank of Solomon Islands.

Trade balance ($ million, quarterly)



Source: Central Bank of Solomon Islands.

Gross foreign reserves (months of import, end of period)

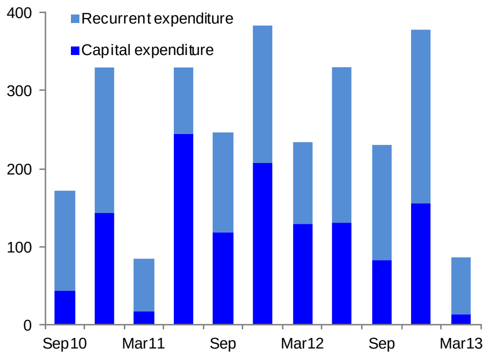


Source: Central Bank of Solomon Islands.

Lead authors: Milovan Lucich and Joel Hernandez.

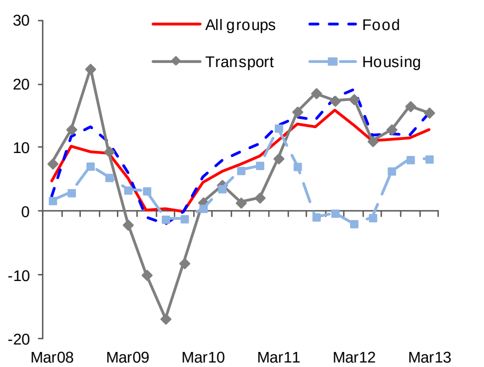
Timor-Leste

Government expenditure, by type ($ million, quarterly)



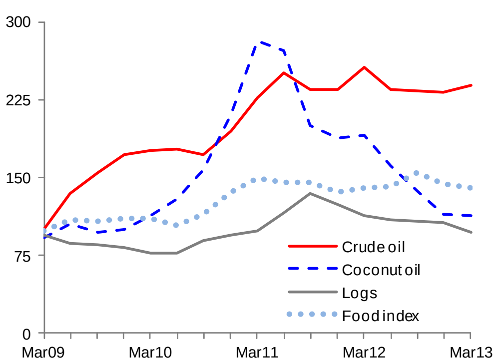
Source: Government of Timor-Leste Transparency Portal.

Consumer price index, by commodity group (y-o-y % change, quarterly)



Source: Timor-Leste National Statistics Directorate.

Commodity prices (Index: January 2009=100)



Source: World Bank Commodity Price Data (Pink Sheets).

Recent developments

- Banking indicators suggest the private sector economy continues to perform well. Deposits grew by 15.7% (y-o-y) in the first quarter of 2013 while private sector credit grew by 22.5%, reaching a new high of $163 million.
- However, total government expenditure of $86.2 million reported for the first quarter of 2013 is down 63% compared with the first quarter of 2012. Capital expenditure was down by 90% (y-o-y) during this period. Large expenditures on the national electrification project in the first quarter of 2012 likely inflated last year's expenditures and helps account for the relative decline this year.
- Actual capital expenditure in the first quarter constituted only 1.5% of the $806.5 million planned for 2013. This raises doubts about whether the ambitious infrastructure development program budgeted for 2013 will be carried out. Recurrent expenditure also fell by about 30% compared with 2012.
- Inflation during the first quarter of 2013 was 12.8% (y-o-y), with food and transport costs rising 15.5% and housing prices rising 8.2%. The price rises run counter to the appreciation of the US dollar against the currencies of some of Timor-Leste's leading trade partners (e.g., Australia and Japan) in the quarter and the fall in oil prices. This suggests that inflationary expectations and internal supply chain bottlenecks continue to fuel inflation.
- In the first quarter of 2013, the value of Timor-Leste's Petroleum Fund increased by $1.2 billion. This raised its total value to $13.0 billion—about $11,500 per capita. The increase was attributable to inflows from oil royalties and taxes (about 78%) and returns on investments (22%). Buoyed by the strong performance of stock markets worldwide, rising valuations of the fund's equity holdings accounted for $208.8 million (17.2% of the total increase in fund value). The balance of the increase ($57.8 million or 4.8% of the total) came from interest earnings of the fund.

Outlook

- First quarter expenditure figures and oil price declines introduce downside risks to the growth forecast for Timor-Leste. Accordingly, growth for 2013 is now projected at 9.5%, which is half a percentage point than earlier forecast.
- The inflation forecast for 2013 is being held at 9.0%. Although inflation ran above forecast in the first quarter, public expenditure was lower than in 2012 and the outlook is for continued declines in international commodity prices and sustained appreciation in the value of the US dollar. In addition, completion of the national electrification project in 2012 appears likely to ease capacity constraints.

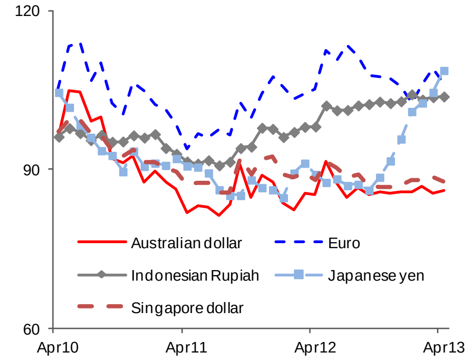
Key issues

- Over the first quarter of 2013, no withdrawals were made from the Petroleum Fund. A May workshop on 2014 fiscal policy yielded useful proposals for ensuring the sustainability of the fund. In addition to a lowering of government expenditures by about $150 million (of which nearly 90% would be from the 2013 capital expenditure budget), the outcomes of the workshop included suggestions for the adoption of fiscal triggers and budget distribution rules to strengthen fiscal policy making.

Timor-Leste

- A key unknown regarding Timor-Leste's fiscal prospects concerns the outcome of continuing disagreements about the exploitation of, and royalties from, the Greater Sunrise oil and gas field. In April, Timor-Leste disputed the validity of the Treaty on Certain Maritime Arrangements in the Timor Sea and commenced international arbitration proceedings against Australia.
- In late February, Timor-Leste hosted a G7+ (group of fragile and conflict-affected states) conference on the Post-2015 Development Agenda. The successful event, which attracted more than 200 delegates from over 50 countries, was the largest international conference held in Dili since independence. Timor-Leste's chairing of the G7+ group illustrates its readiness to become an active participant in regional and international cooperation and integration.
- Timor-Leste has expressed interest in membership in the Association of Southeast Asian Nations (ASEAN). Concerns of some ASEAN members about Timor-Leste's readiness have stalled action on the request, but the country continues to pursue membership while improving its capacity with the assistance of development partners. Analysis suggests the economic impacts of ASEAN membership would be relatively small, owing to the currently low level of trade restrictions between Timor-Leste and ASEAN members. However, membership is seen as an important step in Timor-Leste's efforts to strengthen the competitiveness of its non-oil sectors, cement the sound macroeconomic and structural policies put in place since independence, and link its economy more closely with the economies of Southeast Asia.

Exchange rates
(Index: January 2010=100, foreign currency per $, monthly)



Source: Reserve Bank of Australia.

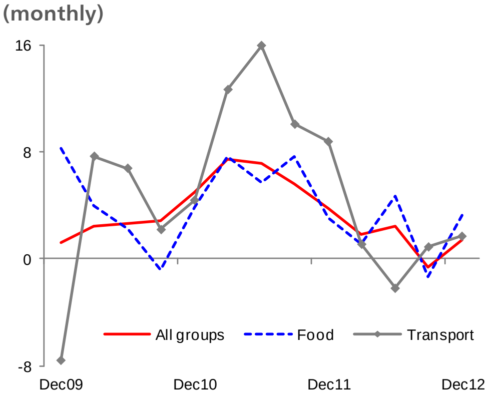
Lead author: Christopher Edmonds.

Tonga

Recent developments

- Preliminary estimates suggest that growth slowed to 0.5% in FY2013 (ended 30 June) from 0.8% in FY2012. The completion of infrastructure construction, financed by EXIM Bank of China loans and continuing declines in remittances and private sector lending, continued to weigh down growth.
- Remittances deteriorated by 15% (y-o-y) in March 2013 and are now estimated to be around 10% of GDP (from a high of 30% that was achieved in FY2008). This will further dampen household consumption and business confidence.
- Overall tourist arrivals declined by around 10% (y-o-y) in the first half of FY2013. Although air arrivals increased by 9%, there was a 50% drop in arrivals by sea (cruise ships and yachts). However, partial indicators showed a 27% increase in tourism receipts, suggesting an increase in average expenditure by tourists.
- Private sector credit has been declining since May 2009. Despite evidence of ample liquidity in the financial system and low interest rates, loans were down to households (by 0.8%) and businesses (14.3%) at the end of March 2013 (y-o-y). This suggests that high levels of nonperforming loans (14.9% of total loans in March 2013) are constraining credit supplied by banks, and demand for credit appears to remain weak amid limited private sector investment opportunities.
- Inflation continued to decelerate from 3.7% (y-o-y) in FY2012 to 0.5% in April 2013. This is in line with falling international food

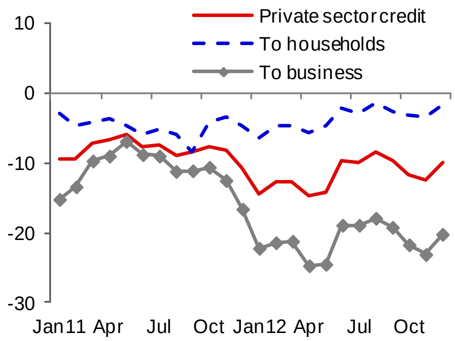
Inflation
(monthly)



Source: National Reserve Bank of Tonga quarterly bulletins.

Tonga

Private sector credit
(y-o-y % change, monthly)



Source: National Reserve Bank of Tonga.

Lead author: Saia Faletau.

and fuel prices and the appreciation of the pa'anga against the currencies of Tonga's main trading partners.

Outlook

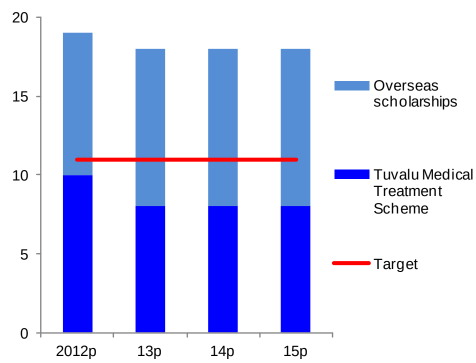
- The growth outlook for FY2014 remains at 0.3%. Exports and remittances are seen to remain low in line with global economic prospects, and only a few development partner-financed infrastructure projects have been confirmed for implementation. Examples of planned projects include Tonga's submarine fiber-optic cable project, slated to come online in July 2013; various renewable energy projects under the Tonga Energy Road Map; road maintenance projects, which will use local contractors; and urban development projects focused on upgrading water and solid waste management infrastructure.
- Given the decline in international fuel and food prices, ADB expects inflation to be at around 2.7% in FY2013 and FY2014.

Key issues

- The imminent connection of Tonga's broadband cable is expected to help increase broadband internet access and affordability. It will also link Tonga to the Southern Cross Cable, the main trans-Pacific system connecting Australia, Fiji, and New Zealand to the US. The improved connectivity is seen to facilitate the delivery of health and education services to outer islands and to help create e-business opportunities. It could also catalyze further progress in subregional cooperation through opportunities for shared services (e.g., customs management).

Tuvalu

Selected expenditure items
(% of recurrent expenditure)



p=projection
Source: Planning and Budget Department. Tuvalu Ministry of Finance and Economic Development. December 2012 *Fiscal Update.*

Lead author: Malie Lototele.

- The government projected that its total core revenue would increase by 6.9% (y-o-y) to A$22.6 million in 2013 largely because of the impact of the higher consumption tax rate and greater tariff collections. Preliminary data from the Treasury Department for the first quarter of this year, however, indicate that both consumption tax revenues and tariff collections are coming in below target.
- Total core expenditure is forecast to increase by 9.0% (y-o-y) to A$29.5 million in 2013. The government continues to struggle to meet medium-term fiscal targets set in cooperation with development partners. In the 2013 budget, wages and salaries are above the targeted 55% of domestic revenues and are unlikely to decline. Expenditures on the Tuvalu Medical Treatment Scheme and overseas scholarships are likely to exceed the targeted 11% share of recurrent expenditures.
- In the first quarter of 2013, inflation ran at 2% (y-o-y). Transport costs increased by 7.4%, while utilities prices rose by 2.9% during the period. Food prices, however, remained stable. The inflation forecast for 2013 is maintained at 2.0%.
- Newly released data from a seafarer recruitment agency show that seafarer remittances declined from $1.2 million in 2001 to $0.3 million in 2012. There has also been a decline in the number of ships contracting with the recruitment agency.
- Tuvalu expects to benefit from the new high-temperature forced air treatment plant installed on Rotuma, Fiji. The plant will provide cost-effective quarantine treatment for fruits and facilitate cheaper imports of fruits and vegetables into Tuvalu.

Vanuatu

Recent developments

- In 2012, the fiscal deficit was equivalent to 1.6% of GDP compared with an original forecast of 0.1%. The larger deficit was in part due to lower than anticipated levels of grants from development partners, and was financed through domestic borrowing. Public debt rose slightly to 21.6% of GDP.
- In March of 2013, eight members of Parliament defected from the majority party and joined the opposition, forcing Sato Kilman to resign as Prime Minister. Parliament elected Moana Carcasses as Prime Minister shortly thereafter, with the support of about two-thirds of the members. The newly formed government will table a revised budget for the second half of the year, which it hopes to pass by July.
- Total exports declined by 20% (y-o-y) in the fourth quarter of 2012 as the demand for, and prices of, agricultural products remained weak. Annual exports declined by 16% in 2012. Foreign reserves in December 2012 were at $187.6 million, equivalent to 7.4 months of imports. By March, however, reserves had declined to 6.7 months of imports (just under $170 million) reflecting reduced development partner inflows.
- Private sector credit grew 4.3% (y-o-y) in March, in line with the modest credit growth experienced in recent years. The Reserve Bank of Vanuatu (RBV) cut the re-discount rate by 50 basis points to 5.5% in March, marking the first rate reduction since December 2008. The RBV kept the statutory reserve deposit rate steady at 7.0%. The policy stance was taken to promote credit growth in the current low inflation environment. The April 2013 IMF Article IV mission cited this interest rate cut as an example of prudent monetary policy. The long-time governor of the RBV was removed by the new government in May 2013.

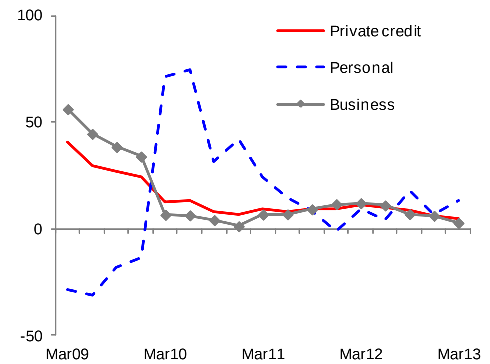
Outlook

- Growth forecasts for 2013 and 2014 are maintained at 3.2% and 3.4%, respectively. Growth will be supported by greater construction spending as well as continued modest increases in tourism. The 2013–2014 inflation forecasts are revised down to 2.0%, within the RBV's 0%–4% target, due to lower than expected outcomes and weakness in commodity prices.

Key issues

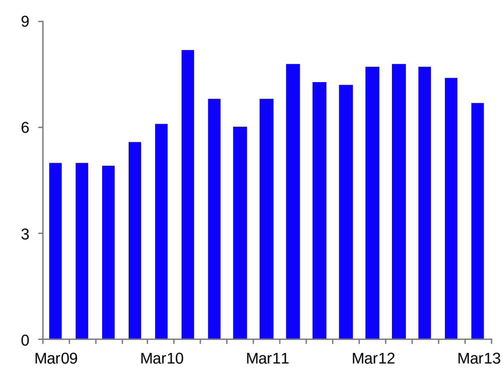
- While recent fiscal deficits have remained relatively small and public debt is low, the limited domestic revenue base remains a concern. Revenues excluding grants continue to average around 18% of GDP, limiting resources available for addressing poverty and spending on much-needed infrastructure.
- The Melanesian Spearhead Group (MSG) free trade agreement is one of two such agreements ratified so far by Vanuatu. The MSG agreement covers Fiji, Papua New Guinea, Solomon Islands, and Vanuatu. A progressive schedule of tariff reductions was initiated in 1998 with elimination of tariffs by 2013. Vanuatu's exports to MSG member economies have been trending higher over the last decade, while imports from Fiji have generally been declining as a percentage of total imports.

Private sector credit
(y-o-y % change, quarterly)



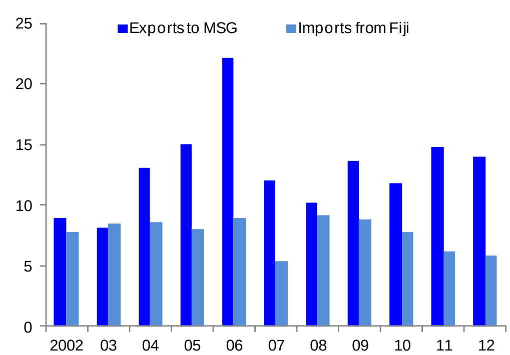
Source: Reserve Bank of Vanuatu.

Foreign reserves
(in months of imports)



Source: Reserve Bank of Vanuatu.

International trade indicators
(% of total, annual)



MSG = Melanesian Spearhead Group
Source: Reserve Bank of Vanuatu.

Lead authors: Milovan Lucich and Joel Hernandez.

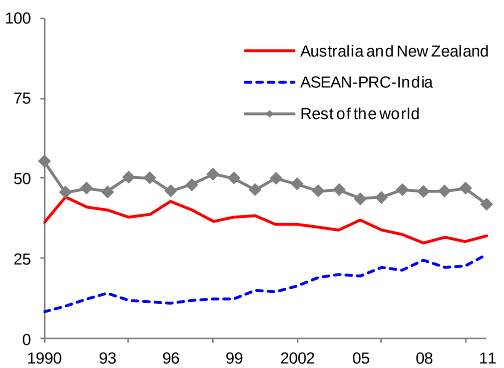
Continental drift: emerging South Pacific trade linkages with developing Asia

In the past, external trade in the Pacific was limited to a few neighboring advanced economy partners, primarily Australia and New Zealand for the South Pacific economies, and Japan and the United States for the North Pacific economies. These long-standing trade relations were a natural consequence of the Pacific's geography and history. However, trade between the Pacific and economies in developing Asia has risen steadily in recent years. Earlier analysis outlined the steady expansion of trade between North Pacific economies and partners in East and Southeast Asia (see *Changing tides—evolving North Pacific economic linkages?* in the December 2012 issue of the *Pacific Economic Monitor*). This brief undertakes a similar analysis of emerging trade linkages between South Pacific economies and Asian partners.

A closer look at Pacific-ACI trade

Although Australia and New Zealand—the traditional trading partners for most of the ADB developing member countries (DMCs) in the South Pacific—still claim the bulk of the region's total world trade, the members of the Association of Southeast Asian Nations (ASEAN), India, and the People's Republic of China (PRC)—hereafter collectively referred to as ACI—have emerged as increasingly vital trading partners for South Pacific DMCs.

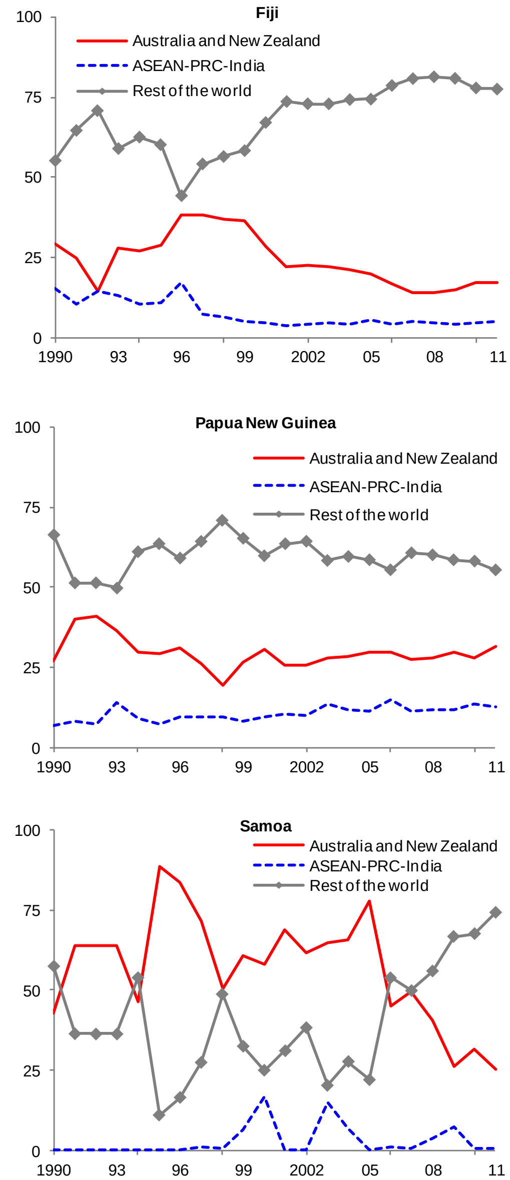
Figure 1: Pacific trade shares, by partner
(% of total trade with the world)



ASEAN=Association of Southeast Asian Nations, PRC=People's Republic of China.
Source: ADB. Asian Regional Integration Center (ARIC) Integration Indicators Database.

In the 1990s, South Pacific–ACI trade accounted for an average of about 12% of the South Pacific's total world trade, compared with the 40% average share commanded by trade with Australia and New Zealand. Since then, this gap has narrowed considerably: in the 2000s, the share of trade with ACI expanded to about

Figure 2a: Pacific export shares, by partner
(% of total exports)



ASEAN=Association of Southeast Asian Nations, PRC=People's Republic of China.
Source: ADB. Asian Regional Integration Center (ARIC) Integration Indicators Database.

20%, while that of trade with Australia and New Zealand declined to 34%. The trade shares have converged even further in recent years, as ACI's share in South Pacific trade averaged 24% in 2009–2011, compared with 31% for Australia and New Zealand (Figure 1). South Pacific trade with ACI increased by an average of 19% annually between 2000 and 2011, faster than the 12% growth recorded by trade with Australia and New Zealand during the same period.

Larger economies such as Papua New Guinea (PNG) and, to a lesser extent, Fiji and Solomon Islands play leading roles in South Pacific trade with ACI. PNG's total trade with ACI rose significantly from about $650 million in 2000 to over $4 billion in 2011. Total 2011 trade with ACI reached over $1 billion for Fiji and over $600 million for Solomon Islands.

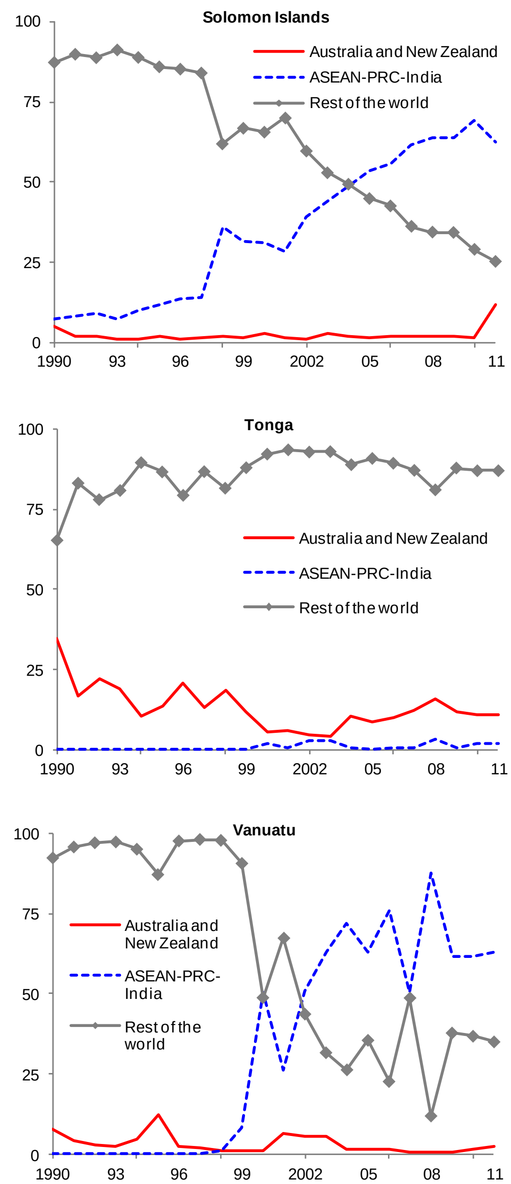
Among the ACI economies, ASEAN is the South Pacific's largest trading partner, accounting for over 60% of total ACI trade with the region during 2006–2011. Total trade between ASEAN and the South Pacific economies increased substantially from just over $300 million in 1990 to over $4 billion in 2011. However, ASEAN trade with the South Pacific has largely been concentrated in a few economies, with PNG and Fiji accounting for a combined average of about 80% of total South Pacific–ASEAN trade from 2006 to 2011.

Total trade between the PRC and the South Pacific expanded from about $60 million in 1990 to almost $2 billion in 2011. PRC trade is mostly with the relatively resource-rich economies of PNG and Solomon Islands. Together, these countries averaged an 85% share of total South Pacific–PRC trade from 2006 to 2011. PRC also accounts for more than half of total ACI trade in Solomon Islands and Tonga over the same period.

The PRC sources mainly raw industrial materials from the South Pacific, importing hardwood logs from PNG and Solomon Islands. However, PRC exports to the South Pacific, mainly of machinery and transport equipment, have also increased rapidly over the past 2 decades. On average, PNG and Solomon Islands posted trade surpluses with respect to the PRC from 2005 to 2011 on the back of their strong commodity exports. Fiji, Samoa, Tonga, and Vanuatu recorded deficits.

Total trade between India and the South Pacific grew from $6 million in 1990 to almost $280 million in 2011. However, this accounted for only 7% of total South Pacific–ACI trade, on average, from 2006 to 2011. As with the PRC and ASEAN, trade with India is concentrated in a few economies: PNG and Fiji

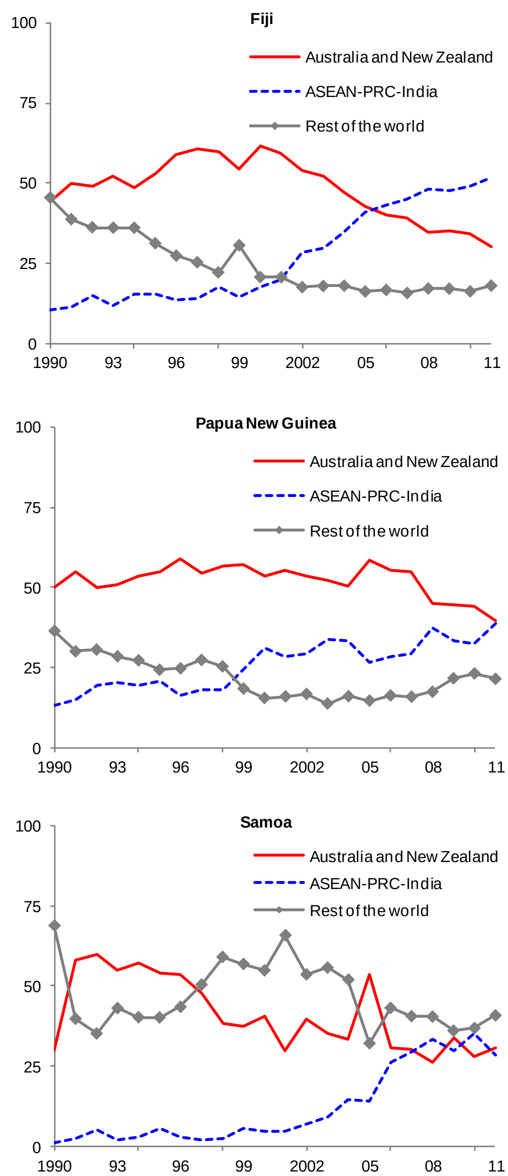
Figure 2b: Pacific export shares, by partner (% of total exports)



ASEAN=Association of Southeast Asian Nations, PRC=People's Republic of China.
Source: ADB. Asian Regional Integration Center (ARIC) Integration Indicators Database.

Continental drift

Figure 3a: Pacific import shares, by partner (% of total imports)



ASEAN=Association of Southeast Asian Nations, PRC=People's Republic of China.
Source: ADB. Asian Regional Integration Center (ARIC) Integration Indicators Database.

averaged shares of about 73% and 19%, respectively, of total South Pacific–India trade over the past 5 years. Large gold exports have helped PNG consistently realize trade surpluses with respect to India in 2006–2011. The other South Pacific economies incurred trade deficits during this period. Major imports from India include pharmaceutical products and electrical machinery.

Changing trade dynamics in the Pacific

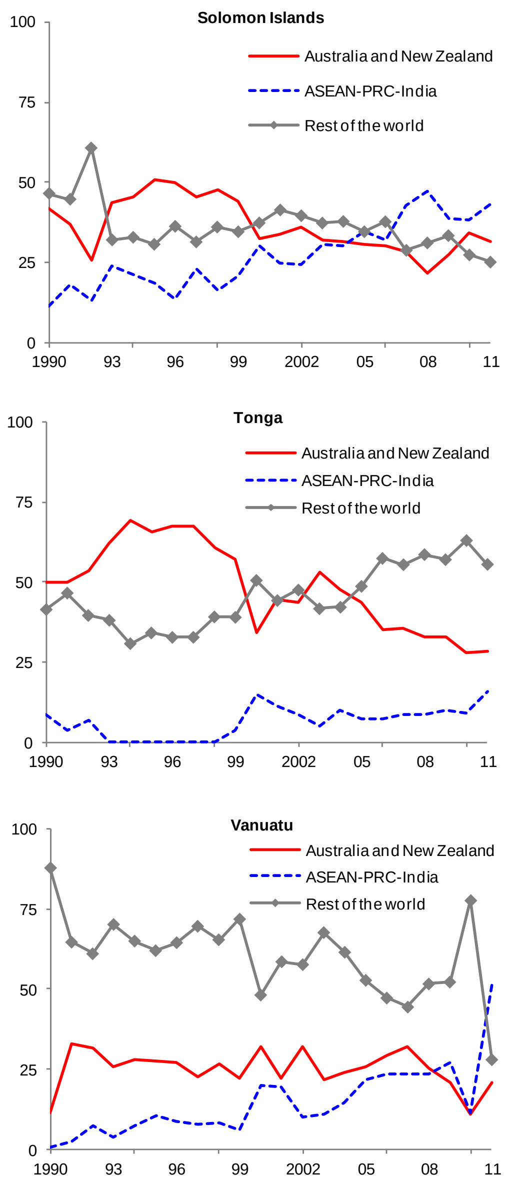
Since 1998, the value of Solomon Islands' trade with ACI has been larger than that of its trade with Australia and New Zealand. The gap has steadily widened over the past decade as Solomon Islands–ACI trade grew by 22% a year in 2000–2011, outpacing the 17% growth in Solomon Islands trade with Australia and New Zealand during the same period. Similar trends are evident in Vanuatu, where the value of ACI trade has surpassed trade with Australia and New Zealand since 2003, and in Fiji, where trade with ACI has slightly exceeded trade with Australia and New Zealand beginning in 2008. The gap between Samoa's trade with ACI, which grew by 18% a year in 2000–2011, and Samoa's trade with Australia and New Zealand, which grew by only 2% in the same period, also narrowed considerably.

Breaking down trade into exports and imports reveals further insights into the changes in trade dynamics occurring in the South Pacific. In Solomon Islands, trade with ACI surpassed trade with Australia and New Zealand primarily due to export shifting (Figures 2a and 2b) as the country shipped more hardwood logs to ASEAN member states, particularly Malaysia, and the PRC. By 2011, almost half of total Solomon Islands exports to the world were being shipped to the PRC. Likewise, Vanuatu's exports to ACI comprised only a small portion of total exports in the 1990s. Since 2000, however, ACI has been Vanuatu's primary export market, mostly of fish and copra to the Philippines and Thailand.

Solomon Islands and Vanuatu are also importing more from ACI, but these shifts have been more recent and less pronounced than the changes in exports. Conversely, in Fiji and Samoa, increased importation is driving the convergence of ACI trade with Australia and New Zealand trade. Since 2006, Fiji's imports from ACI have consistently exceeded imports from Australia and New Zealand, while Samoa's import shares from these sources are now virtually equivalent following large gaps in previous years (Figures 3a and 3b). Petroleum products from Singapore account for a significant portion of the rising imports from ACI in these economies.

Continental drift

Figure 3b: Pacific import shares, by partner (% of total imports)



ASEAN=Association of Southeast Asian Nations, PRC=People's Republic of China.
Source: ADB. Asian Regional Integration Center (ARIC) Integration Indicators Database.

Even though ACI has overtaken Australia and New Zealand as the principal trading partner in certain South Pacific DMCs, this is not to say that trade has been completely diverted away from these traditional partners. In 2011, Australia and New Zealand still accounted for 31.9% of South Pacific external trade compared with ACI's 26.3% share. The value of South Pacific trade with Australia and New Zealand is also growing, albeit more slowly than South Pacific–ACI trade, suggesting that the region's linkages with its traditional economic partners continue to run deep.

Concluding remarks

The ASEAN states, India, and the PRC are emerging as increasingly important trading partners for South Pacific economies. Besides providing new export markets, especially for the relatively resource-rich economies in the region, ACI can supply lower-cost capital equipment and intermediate inputs to production. ACI is also becoming an important source of foreign capital and investment in the South Pacific. PRC already has diverse mining investments in the region, while ASEAN investors are engaged in areas such as fisheries and forestry. India has strong linkages with Fiji's sugar industry. These investment linkages are likely to support further expansion in trade between the South Pacific and ACI. Strengthening trade linkages with ACI, while sustaining existing relations with its traditional trading partners, stands to benefit the Pacific region as it seeks out new opportunities in a rapidly evolving global economic environment.

Lead authors: Rommel Rabanal and Cara Tinio.

References:

ADB. Asian Regional Integration Center (ARIC) Integration Indicators Database.

ADB. 2012. *Pacific Economic Monitor*, December.

United Nations Commodity Trade Statistics (UN Comtrade) Database.

Envisioning the North Pacific economies post 2023

A decade from now, the current economic support arrangements between the United States (US) with the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI), both linked to the US through "free association," are set to expire. This date is significant for policy makers, offering opportunities for new economic support structures. It also presents a chance to examine prior development strategies: what has been accomplished so far since nationhood in 1986 (RMI and FSM) and 1994 (Palau). Finally, 2023 may serve as a catalyst for the opening of a new chapter in how the US and multilateral institutions engage with the North Pacific.

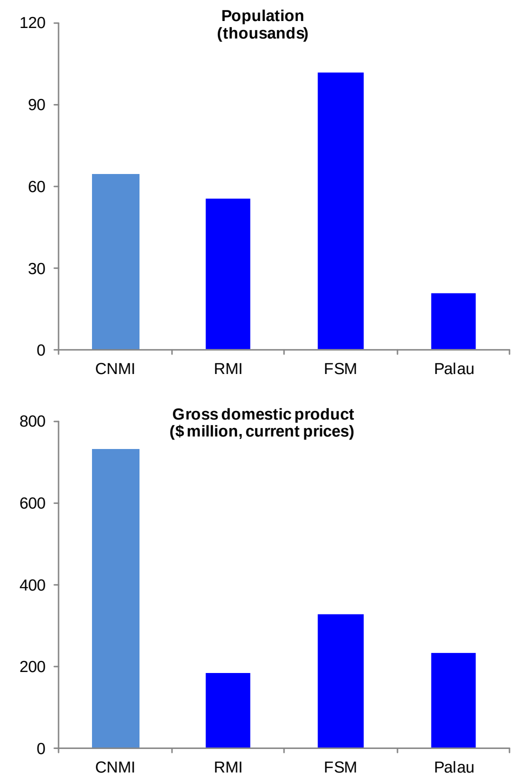
The idea of free association originated in the South Pacific at a time when pressures for decolonization were changing sociopolitical contours globally. The concept of "self-government in free association" was embraced by New Zealand as relations with the Cook Islands and Niue evolved. It provided for greater sovereignty and independence without impeding movement for residency, employment, or education. While Cook Islanders and Niueans elected their own national leaders, they travel internationally with New Zealand passports. This model served as the basis for three emerging nations in the North Pacific.

Background

US involvement in the North Pacific's economic development began following World War II. The United Nations' (UN) establishment of the Trust Territory of the Pacific Islands (TTPI) protected western strategic interests by having the US assume administrative and economic management responsibility for an area that, prior to the war, was under Japanese rule. The UN's concern about the slow pace of economic development and Cold War pressures during the 1960s and 1970s led Washington to provide several hundred million dollars in development funding. Assessing failures of the TTPI era, David Hanlon observed, "The messy entanglements that marked efforts at economic development by the mid-1970s resulted in part from Trust Territory government offices, federal bureaucracies, and international aid agencies working at cross-purposes or against one another in institutionally prescribed ways in the development game."

Washington's offer to the TTPI, through a UN-monitored vote, to become an unincorporated part of the United States was rejected by the districts that became RMI, FSM, and Palau. Instead, they opted for nationhood and self-governance, but with a form of free association providing continued US economic assistance, unfettered US military access, UN membership, and visa-free travel for work or study in the US. (The fourth district of the TTPI, Northern Mariana Islands, decided to join the US.) Foremost among the questions immediately faced by these three new countries was how to grow their economies and increase self-reliance while addressing popular expectations to enhance standards of living.

Figure 1: Key indicators of North Pacific economies (as of FY2012)



CNMI=Commonwealth of the Northern Mariana Islands, RMI=Republic of the Marshall Islands, FSM=Federated States of Micronesia
Note: GDP figure for CNMI is as of 2010.
Sources: Asian Development Outlook database, Secretariat of the Pacific Community-Pacific Regional Information System, and US Bureau of Economic Analysis.

Initial experiences with nationhood

The initial Compact of Free Association was executed in 1986 and included only the FSM and the RMI. Palau proclaimed its independence 8 years later (due to an impasse over proposals to make Palau nuclear free). Direct budgetary and program support to FSM and RMI from 1987 through 2003 is estimated to have totaled $2.1 billion for a population of less than 175,000 (aid equivalent to about $900 on an annual per capita basis). The US channels its economic support through the US Department of Interior—an agency charged primarily with domestic responsibilities (e.g., national parks, federal relations with Native Americans).

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Box 1. The economic long view

Island communities have never depended exclusively on local goods. Long before western contact, travel and trade were prevalent among islanders who relied on indigenous navigational methods. Voyages across this "sea of islands" could extend over thousands of miles. Dynamic, if materially limited, economic systems developed, as suggested by the large limestone discs mined in Palau that became highly valued forms of intergenerational wealth in Yap.

Early colonial and missionary encounters beginning in the 1500s significantly shaped the North Pacific economies as trade with the west expanded. Early copra plantations were complemented by pearl shell exchange and bêche-de-mer fisheries. The provisioning of whaling ships promoted enterprise, and linkages with entrepots such as Manila, Singapore, and Hong Kong, China gave islanders access to new goods.

External contacts focused solely on trade persisted, and movement away from traditional economic activity was limited, until the advent of Japanese administration in 1914. This brought broader transformations toward "modernity." Initiatives to greatly expand educational opportunities created a cadre of islanders who for the first time became public sector employees. Over time, infrastructure was built to support efforts to make the islands more economically vibrant. The period saw significant increases in production: copra production increased tenfold, phosphate mining on the island of Angaur in Palau contributed some 50% of the territorial revenue between 1925-1930, profits from dried tuna exceeded phosphate and copra by the late 1930s, pineapple and other fruits and vegetables benefited from public agricultural extension efforts, and growth of sugar production in Saipan flourished. Markets were assured through open access to the growing Japanese economy of the 1930s. Micronesia historian Francis Hezel captures the economic vitality of this era:

> The territory enjoyed an astonishing trade balance during these years. In 1935 the [Japanese] mandated islands showed over 26 million yen in exports against 15 million yen for imports, and the exports would increase to 40 million yen by the end of the decade. On the basis of population, the tiny territory of Micronesia was the most productive part of the Japanese overseas empire—the per capita trade as early as 1932 was 253 yen, three times the figure for [the Republic of] Korea. (p.198)

This period marked 2 decades of impressive economic growth. Japanese immigrant labor played a key role in achieving this growth. By the eve of World War II, 77,000 Japanese were living in the North Pacific, making the native populations minorities in the islands. Benefits from this economic surge were overwhelmingly derived by Japanese citizens, although local intermarriage undoubtedly helped some islander families.

In an assessment of the economic support provisions of the Compacts, the US General Accountability Office in 2003 concluded:

> ...many Compact-funded projects in the FSM and the RMI experienced problems because of poor planning and management, inadequate construction and maintenance, or misuse of funds. Further the US, FSM, and RMI governments provided little accountability over Compact expenditures and have not ensured that funds were spent effectively or efficiently.

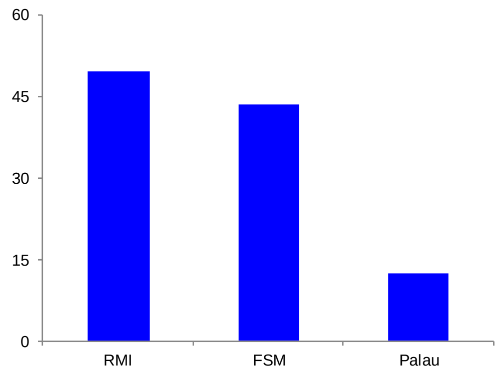
The bilateral economic relationship between the US and the RMI is a particularly complex one. The US is committed to paying several billion dollars in rent for exclusive long-term use of Kwajalein Atoll as a US base. In addition, significant sums have been paid as compensation for claims arising from the US nuclear testing program during the 1940s and 1950s. In 1987, Congress allocated $150 million to the RMI as compensation for nuclear claims, with displaced Bikini Atoll residents receiving $75 million over 15 years and the remainder allocated to a trust fund. A further $90 million was approved for the resettlement trust fund in 1992.

If the first 15 years of the FSM's and RMI's independence illuminated the complexities of island development in an environment lacking strong institutions, it also underscored the need to find more effective ways to identify development investments that yield broad-based returns. Extended negotiations over accountability of US funds for economic development resulted in stricter procedures for the expenditure of Compact funds. The new structure of "Compact II" (2004–2023) gave special emphasis to health and education, with five-person committees established for each country (three US members and two from the country).

Under Compact II, the US and the North Pacific countries also established trust funds for each nation, and agreed to a schedule of annual aid flows that would reduce funds available for recurrent government expenditures (e.g., public worker salaries, government program budgets) and increase funds paid into the trust funds over time. The funds aim to create a resource pool sufficient to generate income needed to sustain the government's fiscal resources after the compacts expire. However, a US Government Accountability Office analysis published before the 2008 global economic crisis predicted management challenges and market volatility of the trust funds makes this unlikely by 2023.

Envisioning the North Pacific economies post 2023

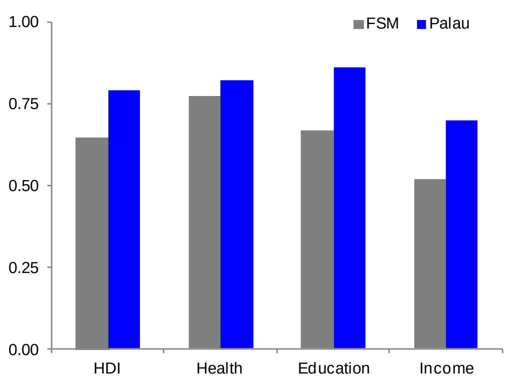
Figure 2: Official development assistance (% of GDP, 2011)



RMI=Republic of the Marshall Islands; FSM=Federated States of Micronesia
Source: ADB estimates based on data from OECD-DAC database.

Palau, with the smallest population (about 20,000) of the three freely associated states, has received less attention by analysts. Since independence in 1994, the World Bank has designated Palau as an "upper middle income country," reflecting its success in becoming an international tourism destination. Achievements in developing Palau's high-income tourist market have made it the most highly globalized North Pacific nation and fostered cultural diversity facilitated by the free flow of capital and people. Palau was ranked 53 out of 187 countries in the latest human development index, placing it significantly above the regional average. US economic support through the Compact was renegotiated in 2010 and awaits US congressional approval. Under the agreement, Palau will receive a total of $250 million in aid over the next 15 years.

Figure 3: Human development indicators (2012)



FSM=Federated States of Micronesia, HDI=human development index
Source: United Nations Development Programme.

Post-2023 prospects for the North Pacific countries

The three freely associated states present a fascinating picture of three nations with distinct resource endowments emerging from a common colonial architecture. It is also interesting to compare the fourth economy that was part of the original UN Trust Territory, but opted to become a commonwealth of the United States. Examination of the possible economic development paths of all four economies within the TTPI presents some critical issues in regard to current approaches to development assistance in these countries.

In 1978, the Northern Mariana Islands followed the model of Puerto Rico as a US commonwealth. For nearly 2 decades, the country achieved robust economic growth and was the envy of neighboring economies. Statistical indicators suggest a dynamic private sector led the country's economic transformation in the 1990s, and its growth performance rivaled other Pacific island economies—even exceeding the high growth registered during the best prewar years of economic performance under Japanese administration. Local commonwealth government control over immigration policies and labor laws were particularly favorable to private sector investment, allowing foreign workers—primarily Filipinos—to be employed in numbers that exceeded the locally born population (by approximately 2:1) at less than half of the prevailing wage rate in the US.

The Commonwealth of the Northern Mariana Islands (CNMI) is sometimes cited as an example of how special incentive structures and integration of an island economy into a much larger economy can spur strong growth. At its peak, CNMI benefited from large Japanese tourist flows and a garment industry able to manufacture under a "Made in USA" label. These enabled CNMI to have a self-reliant private sector based economy able to finance 100% of its government operations through island sourced revenues. However, problems that emerged with a rapid economic downturn in the early 2000s suggest CNMI's growth was unsustainable. Investigations into abusive labor practices resulted in the US federal government's takeover of immigration matters, accompanied by changes mandating federal determination of CNMI wage laws. During the same period, garment manufacturing all but disappeared with the expiration of the Multifibre Arrangement and relocation of the industry to lower-cost economies in

Envisioning the North Pacific economies post 2023

Asia. Lingering land-lease issues with investors and successful efforts to increase Chinese tourist arrivals backfired and resulted in greatly reduced Japanese arrivals. Growth has stalled and as of the end of FY2012, CNMI's total cumulative deficit was about $370 million—more than triple the government's annual budget.

Palau has avoided the low-wage manufacturing trap, its private sector growth has been more gradual, and its government has relied less on external resources—perhaps offering a model for economic and fiscal reform in the FSM and the RMI. However, Palau’s economy has some issues of concern—notably its heavy reliance on guest workers from the Philippines. Over 75% of the nation's private sector jobs are held by Filipinos. To a far greater extent than any other Pacific island nation, Palau has embraced guest workers as a critical ingredient of its economic development strategy, but this has given rise to a dualistic society composed of largely separate communities. By 2009, the number of guest workers, who are ineligible for citizenship, was nearly equal to the number of Palauans employed nationally. An executive order was issued limiting the total number of guest workers. It remains to be seen how this dependency on imported labor, and the associated dual structure of labor market, will influence Palau’s economic performance and social cohesion over the long term.

The RMI offers fascinating contrasts with Palau and CNMI. Economic support from Washington to the RMI from 2004 to 2023 is programmed to total $1.5 billion. Efforts to diversify revenue sources through the registration of international vessels and securing aid from other development partners (e.g., Taipei,China) have met with limited success. The country finds itself facing serious fiscal problems. Current debt is estimated at $104.3 million, equal to about 57.2% of 2012 GDP. The RMI has outstanding loans from multilateral lending institutions that total over $73 million, and US government lending agencies have extended approximately $50 million to state-owned enterprises in the country. Government debt service is currently running at more than $7.5 million (33.2% of government revenues and 11.3% of the value of exports in 2012). Private households also appear to be heavily indebted, with local banks reporting $62.4 million in loans that are repaid primarily through payroll deduction plans.

Options for spurring growth in the RMI appear fairly limited. The US Major Range Test Facility Base in Kwajalein Atoll provides income for landowners, and the base creates opportunities for ancillary economic activity and employment in neighboring Ebeye. Similarly, there may be scope for employment growth in the tuna loining plant in Majuro and small niche tourism. Should global climate adaptation and mitigation funds become available, the RMI is likely to become a significant recipient. For now, the most viable prospect for spurring growth and increasing self-reliance may be to follow the path of Kiribati and Tuvalu through government encouragement of overseas employment. Some 22,400 Marshallese migrants currently reside in the US, and the gradual development of middle class RMI communities abroad creating remittance flows may offer a promising route toward reduced reliance on aid flows.

To a far greater extent than in Palau and the RMI, the FSM government has emphasized development of local capacity and limited immigration as development priorities, even if this has meant lower growth. Creation of a shared national vision among four culturally diverse states (Chuuk, Kosrae, Pohnpei, and Yap) remains an ongoing, though by no means impossible, hurdle. With an educational system that admittedly struggles to achieve adequate performance standards, the FSM wisely remains committed to providing the human capital that is needed for national development. By standard economic measures, the FSM’s conservative approach to development has brought little change in living standards compared with other economies in the North Pacific. GDP per capita income and levels of public debt are well below those of neighboring states. This is reflected in FSM’s ranking of 117 out of 187 in the UN human development index.

Despite low growth and relatively low living standards achieved in the FSM to date, the country appears to have several promising development avenues. Pohnpei’s growth as a north Pacific headquarters for regional organizations is bringing new opportunities for business development similar to those currently found in Suva, Fiji. The increasing importance of Guam as a site for US military facilities offers possibilities for tourism in Chuuk and other states. Yap, in particular, has potential to develop as a unique tourism destination. FSM policy makers’ openness to new forms of commercial endeavors is apparent from the recently established registration office for Japanese corporations. The slower pace of change being pursued in the FSM may, in the short term, offer enhanced economic development prospects over the longer term by allowing time for investments in human capital to come to fruition. Outmigration from the FSM demonstrates that many Micronesians see the benefits of access to employment in a larger economy, and there are approximately 49,800 FSM migrants in the US. While this may be seen as a “safety valve,” prospects for migrants returning to the FSM (and the RMI) with new skills to bolster existing human capacities will exist if economic growth accelerates.

Envisioning the North Pacific economies post 2023

Conclusion

The idea of North Pacific island economies ever being entirely self-sufficient economically, as sometimes envisioned for the freely associated states, is improbable. Even Hawaii, the most advanced economy in the region and now an integral part of the US, is far from self-sufficient, with few exports and a narrowing economic base reliant on tourism and military expenditures.

What this paper suggests, however, is that informed policy decisions do offer feasible avenues toward enhanced self-reliance. The elements of a strategy to advance self-reliance are slowly emerging. Experience with New Zealand's free association offers one element, focusing on migration. Today a majority of Cook Islanders and Niueans reside in New Zealand, with a significant number of islanders who productively circulate back and forth, keeping a foot in both worlds.

Similar trajectories appear likely for the freely associated states (FAS) in the North Pacific. A 2012 survey conducted by the FSM government and supported by the East–West Center found that one-third of all FSM-born citizens are now living outside the country, with those who have moved to the continental US having higher average incomes. Roughly the same proportion of RMI and Palau citizens live abroad. As FAS migrants' incomes increase, so too does the potential for remittance and investment benefits to the homeland. A key research question is what policy instruments best encourage vibrant economic linkages (e.g., remittances and investments) between the freely associated states and their citizens in the US.

A second element involves increased emphasis on human capital. Lessons regarding education may be found in some of the achievements found in Palau and Yap State, as well as among numerous private educational institutions. Improving the health sector must involve both preventive and curative care, with policies designed to support healthy lifestyles and traditional agriculture.

A third avenue to increase self-reliance hinges on making significantly larger investments in the national trust funds, thereby increasing the sovereign wealth reserves of the freely associated states. Experience to date across Asia and the Pacific shows that such funds are by no means a panacea, and prudent sovereign wealth fund management is critical. Still, as the global economy grows, there is scope for trust fund revenues to become a larger share of government revenue.

Without sufficient political support in the US and the freely associated states, movement in these directions is by no means assured. Furthermore, in reality such steps are by their very nature incremental, and unlikely to produce immediate transformative results. In light of the strategic US "pivot" toward Asia and the Pacific, and the freely associated states' continued reliance on budgetary support, it is likely that mutual interests will prevail in ensuring free association post 2023, albeit with some modifications to the economic support structure.

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New trade cost estimates for the Pacific

Trade costs are widely understood to be a significant constraint on Pacific economic integration. Businesses in the Pacific must overcome relatively high transport costs to be competitive in international markets. In addition, the relatively small size of domestic markets means that being able to engage in international trade is more important to overcoming these disadvantages. Several indicators of trade costs are available, but these often have only spotty coverage of the Pacific economies. This brief presents new trade cost estimates, and these are compared with other available trade cost indicators to assess the consistency of different measures—both in terms of the cardinal ranking of Pacific developing member countries (DMCs) and in terms of indicator trends over time. Lastly, trade cost measures based on US data are compared for the Pacific and the Caribbean.

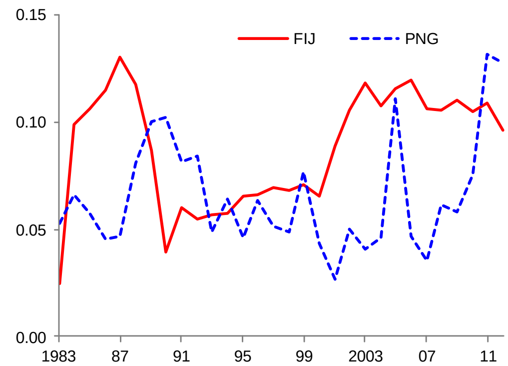
The indicator (referred to as the trade cost ratio) is based on the difference between the reported value of imported goods in cost of insurance and freight (c.i.f.) and free on board (f.o.b.): $TCR=(M_{CIF} - M_{FOB})/ M_{FOB}$. This brief expands an initial analysis presented in the July 2012 issue of the *Monitor* using import data from New Zealand and the US. Both countries are major trading partners for Pacific DMCs, and up-to-date data are readily available. In the case of these two countries, f.o.b. is referred to as value for duty in New Zealand and customs value in the US. The higher the trade cost ratio, the greater the associated costs of exporting (from the perspective of Pacific DMCs) or importing (from the point of view of New Zealand and the US) relative to the value of a particular traded commodity. The c.i.f. value is the cost to the importer of buying the goods and bringing these goods into the country—including costs of insurance and freight, plus the value of the good—and gives the value of the cost of goods at the port of entry as declared by the importer at the customs office. The f.o.b. value is the current market value of goods in the country of origin, including all costs incurred in getting the goods aboard the ship.

Use of c.i.f. and f.o.b. import data from the same country has clear advantages over "mirror statistics" studies that compare c.i.f. import data by the importer and the f.o.b. export data reported by the exporter because the valuation is compiled from a single reporting agency or country.

The Pacific DMCs are categorized into three groups to simplify exposition: (i) those exporting goods with an annual average value of over $10 million (in customs value terms) in the last 5 years; (i) those exporting goods with value between $1 million and $10 million; and (iii) those exporting goods less than $1 million.

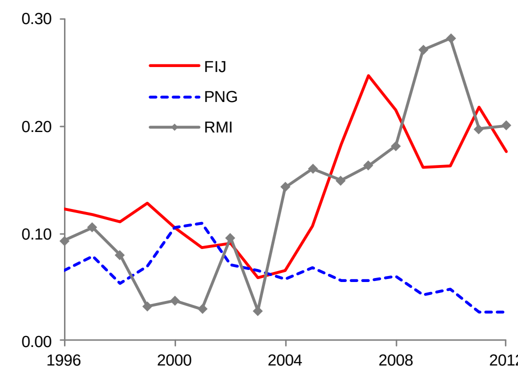
Figures 1 and 2 show Fiji and PNG (group 1 countries for both New Zealand and US) have among the lowest trade cost ratios. PNG has one of the lowest average trade cost ratio (0.06) among the Pacific DMCs, suggesting PNG exports to the US and New Zealand are transported to these destinations at the lowest cost. A declining trade cost ratio over time indicates it is becoming cheaper for PNG to export to the US, while it is becoming slightly more expensive to export to New Zealand. PNG's exports to the US and New Zealand are mostly agricultural products (coffee, tea, and cocoa) and mineral fuels.

Figure 1: Trade cost index values for Pacific countries exports over $10 million per year to New Zealand



FIJ=Fiji, PNG=Papua New Guinea
Source: ADB estimates using Statistics New Zealand data.

Figure 2: Trade cost index values for Pacific countries exports over $10 million per year to the United States



FIJ=Fiji, PNG=Papua New Guinea, RMI=Republic of the Marshall Islands
Source: ADB estimates using US Census Bureau data.

Fiji also has one of the lowest average trade cost ratios (0.09 for exports to New Zealand and 0.14 for exports to the US), and its ratios are increasing over time (the rise more pronounced with the US). Fiji's major exports to the US are mineral water, fish, and sugar. Its exports to New Zealand are predominantly vegetables and breads and pastries. The Republic of the Marshall Islands (RMI) also had exports to the US in excess of $10 million per annum, and its trade cost ratio was ranked sixth and has been increasing over time. During the period, the RMI's trade composition has changed

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and may partly explain the rising trade cost ratio. Coconut oil was the RMI's major export to the US in the late 1990s. By 2002, fish exports started to increase and overtook coconut oil exports which declined in the early 2000s. Though coconut oil exports recovered in 2007 due to favorable international price and improved shipping services, fish exports now account for 80% of total exports and is a stable source of export earnings.

Table 1. Trade cost ratios (Imports from the Pacific by New Zealand)

Total imports over $10 million

Period	FIJ	PNG	Ave.
1986-1990[a]	0.10	0.08	0.09
1991-1995	0.06	0.07	0.06
1996-2000	0.07	0.06	0.06
2001-2005	0.11	0.05	0.08
2006-2010	0.11	0.06	0.08
2011	0.11	0.13	0.12
2012	0.10	0.13	0.11
Average	*0.09*	*0.07*	*0.08*
Std. dev.	*0.03*	*0.03*	*0.03*
Slope[b]	*0.00*	*0.00*	
Pacific rank	*3*	*2*	

Total imports between $1 million to $10 million

Period	COO	NAU	SAM	SOL	TON	VAN	Ave.
1986-1990	0.28	0.34	0.18	0.21	0.26	0.16	0.24
1991-1995	0.42	0.22	0.12	0.19	0.28	0.10	0.22
1996-2000	0.43	0.23	0.14	0.25	0.35	0.10	0.25
2001-2005	0.17	0.14	0.11	0.21	0.24	0.18	0.17
2006-2010	0.11	0.15	0.07	0.14	0.25	0.27	0.17
2011	0.15	0.66	0.08	0.13	0.32	0.11	0.24
2012	0.48	0.21	0.11	0.13	0.31	0.11	0.22
Average	*0.28*	*0.24*	*0.13*	*0.20*	*0.27*	*0.15*	*0.21*
Std. dev.	*0.15*	*0.14*	*0.05*	*0.06*	*0.07*	*0.10*	*0.12*
Slope	*-0.01*	*0.00*	*0.00*	*0.00*	*0.00*	*0.01*	
Pacific rank	*14*	*12*	*5*	*10*	*13*	*7*	

Total imports below $1 million

Period	KIR	RMI	FSM	PAL	TIM	TUV	Ave.
1986-1990	0.13	..	..	..	..	0.05	0.09
1991-1995	0.13	0.18	0.06	..	..	..	0.12
1996-2000	0.24	0.36	0.15	0.00	..	0.02	0.15
2001-2005	0.37	0.13	0.37	0.09	0.09	0.30	0.22
2006-2010	0.08	0.08	0.24	0.09	0.03	0.12	0.11
2011	0.50	0.03	..	0.34	0.04	0.09	0.20
2012	0.07	0.07	0.21	..	..	0.42	0.19
Average	*0.17*	*0.17*	*0.23*	*0.11*	*0.06*	*0.14*	*0.16*
Std. dev.	*0.17*	*0.18*	*0.36*	*0.12*	*0.07*	*0.18*	*0.21*
Slope	*0.01*	*-0.01*	*0.00*	*0.02*	*-0.01*	*0.01*	
Pacific rank	*9*	*8*	*11*	*4*	*1*	*6*	

Ave.=average, COO=Cook Islands, FIJ=Fiji, KIR=Kiribati, RMI=Republic of Marshall Islands, FSM=Federated States of Micronesia, NAU=Nauru, PAL=Palau, PNG=Papua New Guinea, SAM=Samoa, SOL=Solomon Islands, Std. dev.=standard deviation, TIM=Timor-Leste, TON=Tonga, TUV=Tuvalu, VAN=Vanuatu

[a] Figures for time intervals are averages.

[b] The slope indicates the direction of the linear trend over time.

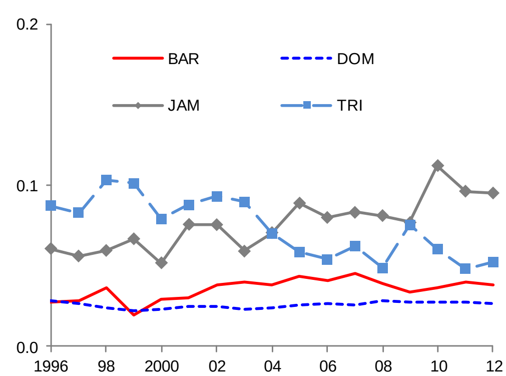
Source: ADB estimates using Statistics New Zealand data.

Group 2 countries (average annual exports valued between $1 and $10 million, 2008–2012) were spread evenly across rankings and displayed no clear trend over time. The Cook Islands had the lowest average trade cost ratio (0.10) for the US, followed by Vanuatu (0.16), Samoa (0.22), Tonga (0.23), the Federated States of Micronesia (FSM) (0.25), and Solomon Islands (0.40). Despite the FSM's close economic partnership with the US, it has seen its trade cost ratio increasing over time—perhaps reflecting lower export values. The expiration of the Multifibre Arrangement (MFA) in 2004 was associated with a significant fall in FSM (and Palau) exports to the US. Trade cost ratios for Samoa and Solomon Islands trade with New Zealand and the US fell over time. For Tonga, trade cost ratios both for the US and New Zealand are rising over time, although more pronounced with the US. For Vanuatu, trade cost ratios with New Zealand have fallen over time and remain stable for exports to the US.

Countries exporting below $1 million annually to New Zealand and the US also tend to be the smallest Pacific economies. This group had mixed rankings, but generally higher than Group 2 countries. For those exporting less than $1 million annually to New Zealand, trade costs are lowest for Timor-Leste (0.06) and highest for the FSM (0.23). For those trading with the US, trade costs were also lowest for Timor-Leste, but highest for Palau (0.19). Analysis of trade cost ratios for countries with less than $1 million average trade values is problematic due to the large swings in export values and presence of zero exports in some years.

To benchmark Pacific performance, the trade cost ratio was also calculated for the Caribbean countries. The results in Figure 3 show that trade costs tend to be lower and more stable in the Caribbean.

Figure 3: Trade cost index values for Caribbean countries



BAR=Barbados, DOM=Dominican Republic, JAM=Jamaica, TRI=Trinidad and Tobago

Source: US Census Bureau.

New trade cost estimates for the Pacific

Table 2. Trade cost ratios
(Imports from the Pacific by the United States)

Total imports over $10 million

Period	FIJ	RMI	PNG	Ave.
1996-2000[a]	0.12	0.07	0.07	0.09
2001-2005	0.08	0.09	0.07	0.08
2006-2010	0.19	0.21	0.05	0.15
2011	0.22	0.20	0.03	0.15
2012	0.18	0.20	0.03	0.13
Average	*0.14*	*0.13*	*0.06*	*0.11*
Std. dev.	*0.06*	*0.08*	*0.02*	*0.07*
Slope[b]	*0.01*	*0.01*	*0.00*	
Pacific Rank	*7*	*6*	*3*	

Total imports between $1 million to $10 million

Period	COO	FSM	SAM	SOL	TON	VAN	Ave.
1996-2000	0.08	0.08	0.32	0.54	0.15	0.18	0.22
2001-2005	0.17	0.07	0.23	0.41	0.23	0.15	0.21
2006-2010	0.04	0.55	0.12	0.35	0.28	0.13	0.25
2011	0.05	0.39	0.12	0.20	0.33	0.32	0.23
2012	0.15	0.28	0.15	0.13	0.28	0.12	0.19
Average	*0.10*	*0.25*	*0.22*	*0.40*	*0.23*	*0.16*	*0.22*
Std. dev.	*0.07*	*0.26*	*0.10*	*0.20*	*0.08*	*0.10*	*0.17*
Slope	*0.00*	*0.03*	*-0.02*	*-0.02*	*0.01*	*0.00*	
Pacific Rank	*5*	*13*	*11*	*14*	*12*	*8*	

Total imports below $1 million

Period	KIR	NAU	PAL	TIM	TUV	Ave.
1996-2000	0.16	0.05	0.07	..	0.00	0.07
2001-2005	0.14	0.11	0.26	0.015	0.03	0.11
2006-2010	0.19	0.04	0.29	0.009	0.08	0.12
2011	0.20	0.05	0.05	0.000	0.00	0.06
2012	0.18	0.04	0.04	..	0.02	0.07
Average	*0.17*	*0.06*	*0.19*	*0.01*	*0.04*	*0.10*
Std. dev.	*0.04*	*0.05*	*0.24*	*0.02*	*0.05*	*0.14*
Slope	*0.00*	*0.00*	*0.01*	*0.00*	*0.00*	
Pacific Rank	*9*	*4*	*10*	*1*	*2*	

Ave.=average, COO=Cook Islands, FIJ=Fiji, KIR=Kiribati, RMI=Republic of Marshall Islands, FSM=Federated States of Micronesia, NAU=Nauru, PAL=Palau, PNG=Papua New Guinea, SAM=Samoa, SOL=Solomon Islands, Std. dev.=standard deviation, TIM=Timor-Leste, TON=Tonga, TUV=Tuvalu, VAN=Vanuatu

[a] Figures for time intervals are averages.

[b] The slope indicates the direction of the linear trend over time.

Source: ADB estimates using US Census Bureau data.

There does not appear to be a strong relation between the distance between the Pacific DMCs and the two export destinations studied. The existence of strong economic ties—such as the US Compacts of Free Association states of the North Pacific and the Cook Islands relationship with New Zealand—and historical ties seems to have limited influence on the trade cost ratios. The Cook Islands trade ratio with the US (0.10), which is significantly lower compared with New Zealand (0.28). The most likely explanation for weak relationships between the trade cost indicator and the distance between trading partners, and between the indicator and the presence of other economic ties, is that changing composition and volume of exports over time influence ratios more than the other economic and historical links. The Cook Islands total export has declined significantly over time from $9 million in 2000 to $3 million in 2011. Pearl exports used to account for the largest share of exports but the drop in international prices and pearl disease resulted in the collapse of the industry. Exports of fish started in 2002 and by 2011, two-thirds of total exports are fish mostly destined for Japan. Trade cost ratios for FSM and Palau exports to the US may also serve as an illustration of this point. In between 1996 to 2004, FSM exports to the US averaged $13 million but by 2012, this fell to less than a million. During the comparable period, Palau exports declined from $10 million to less than $500 thousand. The change in mid-2000 due to loss of textile preferences, most likely as a result of the expiration of the MFA, shifted subsequently the value and types of goods exported as textile exports dried up. The collapse in exports has resulted in higher trade cost ratios by mid-2000s for FSM and Palau, although Palau's trade cost ratio improved significantly after 2007. By 2007, fish exports account for the largest share of FSM's exports to the US.

As Hamanaka and Domingo suggest, it is useful to consider trade cost ratios alongside other measures of trade costs—such as the World Bank's Doing Business rankings. Fiji and PNG have the lowest trade cost ratios among Pacific DMCs, yet they are poorly ranked in the trading across border category of Doing Business. Similarly, Samoa and Tonga have relatively higher trade cost ratios, yet they achieved better rankings in the Doing Business survey. A possible explanation for this is that Doing Business measures and ranks economies based on the cost to trade, number of days to trade, and number of required documents; categories do not fully capture the cost of insurance and freight (such as the pricing of the shipping industry). Economies of scale in transport afforded by higher export volumes bring down the trade cost ratio but do not necessarily influence the Doing Business index. The value of Fiji's exports to New Zealand is at least 16 times higher than Samoa, 21 times higher than Vanuatu, and 29 times higher than Tonga. The value of PNG's exports to the US is 31 times higher than Samoa's, 42 times higher than Tonga's, and 62 times higher than Vanuatu's. Another reason is data availability: the Doing Business ranking started in only mid-2000, while the US and New Zealand import data are available for longer periods (starting in 1996 for US data and starting in 1983 for New Zealand data). With its limited data points, the Doing Business ranking does not capture Solomon Islands' declining trade cost over time.

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Box 1. Alternative measures of trade costs

Doing Business

The World Bank's Doing Business ranking reports indicators on the costs and time associated with trading across borders (i.e., costs to export and import, number of days to trade, and number of documents needed to trade a country's leading export or import products). The indicators are generated from a survey among expert professionals (lawyers, accountants, etc.) who provide relevant information on fees, as well as legal and regulatory requirements. The information provided is based on the assumption that the product is transported in a standardized dry-cargo, 20-foot, full container load, which weighs 10 tons and is valued at $20,000. The trading firm is also assumed to be 100% domestically owned, has at least 60 employees, and exports more than 10% of its sales. Doing Business ranks economies based on the ease of doing business index, which is the simple average of the country's percentile rankings on 10 topics included in the index. A high ranking on the ease of doing business indicates that the regulatory environment is favorable to establishing and operating a local firm. The Doing Business report was first published in 2003. Though the trading across borders data (a major category of the Doing Business report) for the Pacific have been available since 2006, the Pacific developing member countries (DMCs) were not included in the ranking until 2012.

Logistics performance index

The logistics performance index (LPI) provides an indicator of a country's logistics efficiency, which is essential for trade and growth. The LPI is derived from a global online survey of international logistics companies (i.e., multinational freight forwarders and main express carriers) conducted by the World Bank every 2 years. It is based on six core components: efficiency of customs and border management, quality of trade and transport infrastructure, ease of arranging competitively priced shipments, competence and quality of logistics services, ability to track and trace consignments, and frequency with which shipments reach consignees within scheduled times. Respondents rate eight markets on these components on a scale from 1 (worst) to 5 (best). Using principal component analysis, the LPI is constructed from the weighted average of the scores. Only a few Pacific countries have been included in the LPI reports (Fiji, PNG, Solomon Islands, and Timor-Leste).

Liner shipping connectivity index

The liner shipping connectivity index provides an indicator of a country's level of integration into the global shipping networks. It is generated from five components: number of ships, their container-carrying capacity, maximum vessel size, number of services, and number of companies that deploy container ships to and from a country's ports. The index is calculated as follows: For each component, a country's value is divided by the highest value of that component in 2004. For each country, the average of the five components is computed, which is then divided by the maximum average for 2004 and multiplied by 100. The index produces a value of 100 for the country with the highest average index in 2004. The index measures how connected a country is to global shipping networks based on the status of their sea transport sector and two measures of distance.

Table 3 shows the rankings of Pacific countries according to their ease of doing business ranking for the past 2 years. Overall, the best performers among the Pacific countries are Samoa, Fiji, and Tonga. Solomon Islands is ranked in the middle of all countries, followed by the RMI, PNG, and Timor-Leste, which all lag well behind. In the trading across borders criteria, the ranking is pretty much in line with the ease of doing business except for Fiji, which has a low score.

Table 3. Doing Business rankings of selected Pacific DMCs (1=best)

Country	Ease of Doing Business Rank		Trading Across Borders Rank	
	2012	2013	2012	2013
Fiji	54	60	112	111
Kiribati	115	117	89	88
Marshall Islands	103	101	65	65
Micronesia, Fed. States of	146	150	102	100
Palau	109	111	109	108
Papua New Guinea	108	104	117	120
Samoa	55	57	66	66
Solomon Islands	94	92	88	86
Timor-Leste	169	169	82	83
Tonga	61	62	76	77
Vanuatu	78	80	129	132

Note: The 2012 and 2013 Doing Business surveys covered 183 and 185 countries, respectively.
Source: World Bank Doing Business database.

According to the liner shipping connectivity index, Fiji has higher connectivity/low transportation costs, followed distantly by Samoa. Lower in the scale but roughly the same are Solomon Islands, Vanuatu, and Tonga. PNG is ranked 128 out of 155, and this rank was lower than the country's in 2007 (95th).

Table 4. Liner shipping connectivity index—scores of selected Pacific DMCs (Index: Maximum 2004=100)

Country	2009	2010	2011	2012
Fiji	8.74	9.44	9.23	12.39
Kiribati	2.85	2.86	3.11	2.91
Marshall Islands	2.85	2.83	3.08	2.91
Micronesia, Fed. States of	3.85	3.43	3.62	3.58
Palau	3.79	3.43	3.62	3.58
Papua New Guinea	6.58	6.38	8.83	6.86
Samoa	4.62	5.18	4.56	4.39
Solomon Islands	3.96	5.57	5.87	6.07
Tonga	3.99	3.73	3.72	3.37
Vanuatu	4.22	3.75	3.70	3.88

Source: United Nations Conference on Trade and Development UNCTADStat database.

Table 5 shows that their rankings are among the poorest in terms of logistics performance compared with other countries. However, their ranking and score are near to each to other, especially in recent years.

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Table 5. Logistic performance index—scores and ranks of selected Pacific DMCs
(1=worst, 5=best)

Country	2007		2010		2012	
	Rank	Score	Rank	Score	Rank	Score
Fiji			144	2.24	123	2.42
Papua New Guinea	95	2.38	124	2.41	128	2.38
Solomon Islands	138	2.08	135	2.31	126	2.41
Timor-Leste	149	1.71				

Source: Logistics performance index database.

Conclusion

This brief is an exploratory study reporting trade cost ratios for Pacific DMCs using US and New Zealand import data. The ratio provides an easy-to-calculate measure of trade costs available over a longer time period than are generally provided in other trade cost indicators. These may offer Pacific governments a useful tool to monitor their nation's efficiency in trade. The ratio showed that trade costs in the Pacific are generally lower and less volatile in countries with larger export values. In contrast, the ratio appears to be less informative in countries with lower trade values because of its high volatility.

The brief also examined other available trade cost indicators, finding that the trade cost ratio yielded contrasting results. While Fiji and PNG were ranked highly compared with other Pacific DMCs in the ratio, they performed poorly in the Doing Business survey, particularly in terms of trading across borders. Samoa and Tonga had relatively higher trade cost ratios, yet they are ranked better in the Doing Business survey.

Preliminary results show that the value (and volume) of exports has a negative relationship with trade cost ratios. For some Pacific DMCs, the changing composition and volume of exports over time influence trade cost ratios more than distance and economic and historical links. However, caution is warranted in interpreting the results of this study. First, except for a few countries, merchandise exports as a share of economic output is low compared with the Asia and Pacific region. Not only are exports small, but they appear to be concentrated on certain products and, for some countries, exported to one major trading partner. Close to 60% of the Cook Islands' exports, mostly fish, are for the Japanese market. About a quarter of Tonga's exports (e.g., fish, rootcrops, kava, and squash) are shipped to Japan while a fifth goes to the New Zealand market. Solomon Islands' round logs are mostly exported to the PRC and almost all gold exports are sent to Australia, according to the Central Bank of Solomon Islands. Another issue that may arise is what constitutes a merchandise export. As an example, most fish caught in the FSM are through foreign vessels and the licensing fees that shipping companies pay are classified under primary income in the balance of payments. In 2010, FSM exports of fish were valued at $19.3 million while its revenue from licenses fees were $17.7 million. In RMI, exports of fish were valued at $8.8 million while its revenue from license fees were $1.1 million during the same period. Another $3.7 million is described as fish processing and classified under services exports.

Calculating trade cost ratios for selected commodities or goods across countries (using more detailed commodity classifications) appears to be a promising avenue for future research that could address the effect that changes in trade composition have on index values. Expanding the countries covered in the analysis, e.g., extending the analysis to compute the trade cost ratio using Australian trade data, is another direction for future study.

Given the importance of trade costs in shaping the pattern and volume of trade between Pacific DMCs and other economies, and the region's strong dependence on trade, it is useful for Pacific policy makers to have access to a number of trade cost indicators. The trade cost indicator considered in this brief shows promise in providing a timely and easy to generate measure of changes in trading costs over time. Considered alongside other available indicators, this indicator would help policy makers in facilitating trade with the rest of the world, and help boost growth in the region.

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Caribbean integration—lessons for the Pacific?

The Caribbean Community

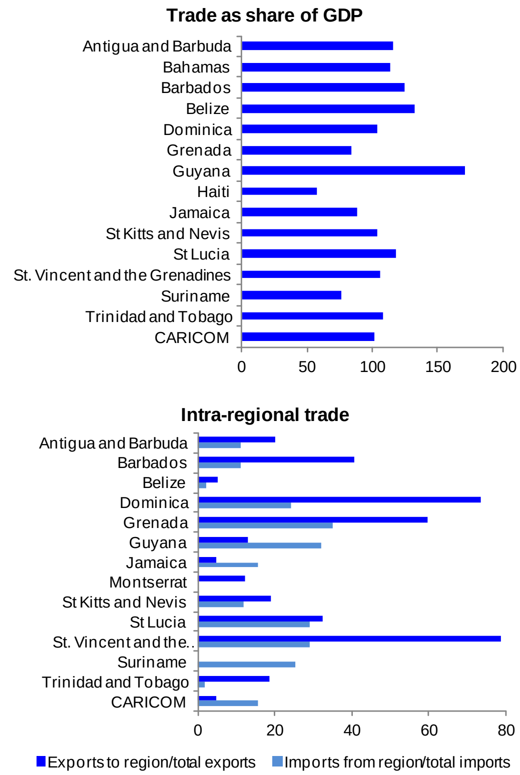
The Caribbean Community (CARICOM) comprises 12 island and three larger coastal states and territories that lie in or border the Caribbean Sea. CARICOM includes high and middle income countries with significant oil, gas, and mineral resources or well-developed offshore banking sectors, as well as some of the poorest countries in the world, largely dependent on subsistence farming (Table 1).

CARICOM's island members face some of the challenges usually associated with smallness and isolation. They are very open to international trade and financial flows, which makes them more exposed to external shocks. Small populations also increase the challenges of building and maintaining institutions, particularly those whose functionality is predicated on independence from political and commercial influence. This is an issue both in terms of the smaller pool of qualified personnel to run the full range of institutions of a modern state, and the greater difficulties encountered in separating political, personal, and institutional interests.

As in the Pacific, trade is very important to CARICOM members, but intraregional trade is typically not. Intraregional commodity trade accounts for a fairly small share of the region's total trade (around 17% of total regional merchandise exports and 13% of imports in 2010), but it is important for some members (Figure 1).

In value terms, regional trade is dominated by petroleum exports from Trinidad and Tobago, which accounted for over 68% of total regional trade in 2008 (CARICOM 2010). North America (Canada and the

Figure 1: Characteristics of CARICOM trade



CARICOM=Caribbean Community, GDP=gross domestic product
Note: Trade share of GDP calculated using imports and exports of goods and factor services as share of GDP for latest available year, intraregional trade ratios calculated using merchandise export and import data for 2010.
Sources: CARICOM website: http://www.caricomstats.org, CIA. 2012. World Factbook, World Bank. 2012. World Development Indicators.

Table 1: CARICOM members–key indicators

	Population (2011)	*Area*	*Population density*	*GDP (2011)* [a]	*Per capita GDP (2011)* [b]
	'000	sq. km	persons/sq. km	$ million	$
Antigua and Barbuda	89	443	201	1,187	18,200
Bahamas	316	13,880	23	8,074	31,400
Barbados	288	430	669	4,478	23,700
Belize	328	22,966	14	1,474	8,400
Dominica	73	751	97	489	14,000
Grenada	109	344	317	822	14,100
Guyana	742	214,969	3	2,480	7,600
Haiti	9,802	27,750	353	7,388	1,300
Jamaica	2,889	10,991	263	14,810	9,100
Montserrat	5	102	51	…	8,500
St Kitts and Nevis	51	261	194	715	15,800
St Lucia	162	616	263	1,239	12,800
St. Vincent and the Grenadines	104	389	266	695	11,600
Suriname	560	163,820	3	3,790	9,600
Trinidad and Tobago	1,226	5,128	239	22,710	20,300

…=data unavailable, sq. km=square kilometer
[a] Using official exchange rates.
[b] In purchasing power parity terms.
Source: CIA 2012, World Development Indicators, 2012.

Caribbean integration—lessons for the Pacific?

United States) and the European Union (EU) are the most important trading partner regions for CARICOM. These regions are also the main destinations for CARICOM members' exports of tourism services, which account for over 20% of GDP for nine of the CARICOM members (Tsikata et al 2009).

As with parts of the Pacific, external migration has long been a feature of Caribbean demographic change. Remittances from the large Caribbean diaspora are significant sources of foreign exchange for some countries (estimated to account for 9% of GDP for Grenada, 14% for Jamaica, 15% for Haiti, and 17% for Guyana (World Bank 2011).

Regional integration

The pursuit of regional integration in the Caribbean predates independence. The short-lived West Indies Federation, promoted by the British authorities, was built on long-standing ideas that the future of the territories depended on forging a political and economic union. The federation was dissolved in 1962, but an interest in economic integration persisted. In the mid-1960s, Caribbean states embarked on a series of integration initiatives of expanding ambition and varying geographic coverage.

These initiatives started with the establishment of the Caribbean Free Trade Association (CARIFTA) in 1965. This was followed by the decision to deepen economic integration by creating a common market as an integral part of the CARICOM, which was established in 1973. In 2002, CARICOM members formally embarked on the creation of an economic union with a commitment to establish the Caribbean Single Market and Economy (CSME) under the Revised Treaty of Chaguaramas, which came into force in 2006. The revised treaty called for a fully market-oriented approach to the regional economy, including free movement of goods, services, investment and labor; deeper macroeconomic policy coordination; increased harmonization of sectoral and microeconomic policy; and eventually a currency union (Table 2).

Within the CARICOM grouping, some countries have taken much deeper steps towards integration. Eight of the nine members of the Organisation of Eastern Caribbean States (OECS) (Anguilla, Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, Montserrat, and St. Vincent and the Grenadines), established in 1981, share a common currency managed by the Eastern Caribbean Central Bank, which also oversees financial and banking integrity for the independent OECS states. Five of the OECS states have ratified a treaty to establish an economic union, providing for free circulation of goods, services, capital, and labor; a regional assembly of parliamentarians; and a common external tariff.

The CARICOM regional integration project has received strong support within the member states. However,

Table 1: Caribbean regional economic integration initiatives

	CARIFTA	*CARICOM*	*CARICOM revised/CSME*
Duration	1968-1973	1973-2006	Post-2006
Membership	12 Anglophone Caribbean countries[a]	13 Anglophone Caribbean countries[b]	CARICOM 15 countries CSME 12 countries[c]
Form	Free Trade Area	Customs Union/Common Market	Economic Union
Scope	Merchandise trade	Merchandise trade Minimal provision for services and capital Incentives policy harmonisation Industrial allocation Joint development of agriculture and natural resources	Merchandise trade Services Capital Skilled labour Macroeconomic policy harmonisation Monetary union Sectoral policy harmonisation
Complementary Pillars	Common services	Functional cooperation (mainly social policy) Foreign policy coordination	Functional cooperation (extended to external trade) Foreign policy coordination

CARICOM=The Caribbean Community, CARIFTA=Caribbean Free Trade Association, CSME=Caribbean Single Market and Economy

[a] Antigua and Barbuda, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, and Trinidad and Tobago.

[b] The Bahamas became a member of the Caribbean Community in 1983 (but not the Common Market)

[c] Suriname joined the Caribbean Community in 1995 and Haiti joined in 2002. The Bahamas, Montserrat, and Haiti do not participate in the CSME.

Source: Girvan, 2010.

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there is growing disenchantment with progress actually made. This comes on top of long-standing doubts about whether models of regional integration that are centered on trade liberalization can deliver much in the way of development outcomes for the Caribbean (Girvan 2010).

A study by the World Bank and the Organization of American States argued that integration had stalled, with the goal of establishing a common market being far from met (Tsikata et al 2009). Another study mandated by CARICOM heads of government observed that CARICOM was in crisis (Stoneman et al 2012). While this was seen as partially due to continuing economic uncertainties in the region caused in part by the 2008 global financial crisis and fallout from problems in Europe, it was also due to long-standing frustration with the slow rate of progress and a serious weakening of the community's structure and operations. In turn, the study linked the frustration to the excessive ambition of the CARICOM agenda in light of constraints including

- binding exogenous constraints due to geography (too many islands), market size, and the inherent complexity (especially of the single market and economy agenda) of the integration project;
- endogenous problems such as the overexpansion of mandates, lack of coherence in the expansion of CARICOM institutions, lack of functionality of many of these institutions, and managerial and administrative weaknesses, including within the secretariat; and
- the perennial problem facing all regional initiatives wherein progress depends on member states' level of implementation and enforcement, and the political, legislative, and administrative challenges of translating community-level decisions into practice.

Hemispheric integration

In parallel with the CSME agenda, CARICOM members have been pursuing integration into the larger regional and hemispheric economy through agreements with other partners. CARICOM has negotiated trade agreements with Colombia, Cuba, Costa Rica, the Dominican Republic, and Venezuela, but the most significant agreements have been with the EU and the US.

Historically, as with the Pacific, Caribbean integration into the global economy has been driven by trade preferences, which have had the effect of shoring up increasingly uncompetitive primary production activities. The US continues to provide unilateral, nonreciprocal, and preferential access through the Caribbean Basin Economic Recovery Act and the Caribbean Trade Partnership Act. However, establishment of an economic partnership agreement between CARICOM, the Dominican Republic, and the EU in 2007 signaled an eventual end to the provision of unilateral preferential access to the EU market (especially significant for the region's sugar and banana industries). A range of new areas including customs and trade facilitation, intellectual property rights, and investment and competition policy were thus brought under the discipline of a binding agreement.

Some proponents of Caribbean integration have argued that the negotiation of the economic partnership agreement (EPA) exposed the lack of a regional governance settlement for the Caribbean, and the failure of leaders and technocrats to secure buy-in to the agreement. Others have pointed out that the discussion within the Caribbean cast the agreement as a largely technocratic issue, when in fact it went to the heart of the political economy of integration for the region. In many areas, the EPA could supersede the CSME as a driver of change for CARICOM members, and the institutional arrangements set up to ensure progress and deal with disputes under the agreement have been seen as supplanting the regional structures that the Caribbean has endeavored to put in place (see Warner 2012).

Lessons for the Pacific?

There are many differences between the members of the CARICOM community and the Pacific. CARICOM members are physically much closer to the large markets with which they have long-standing commercial ties, and none is as geographically fragmented as some Pacific economies. (The whole Caribbean Sea could fit into Kiribati's Exclusive Economic Zone). Most CARICOM members have a more skilled workforce than Pacific economies and a stronger entrepreneurial base. However, countries in both regions face the challenges of size and dependence on air and sea transport for internal links and physical interactions with the rest of the world.

Importantly for the regional integration agenda in the Pacific and the Caribbean, potential gains from regional trade liberalization are not large: prospects for significant, growth-enhancing expansion of intraregional trade are limited (Worrell 2001).

For both regions, a more logical approach is to liberalize trade and investment with the rest of the world, or at the very least with the large markets with which trade in goods and services are, and will be, important for member countries. Further, how this integration is approached is critical. Unfortunately, the dynamic of trade agreements and how they are negotiated typically embody a mercantilist approach to trade and prioritize institutional and policy changes that are not high-order issues for both sides of the table. Caribbean and Pacific economies can

Caribbean integration—lessons for the Pacific?

achieve most of the benefits of trade and investment liberalization through unilateral reforms.

For small states in the Caribbean and the Pacific, there ought to be larger gains from regional institutional integration and development of shared institutions, especially among the countries that share a common legal and institutional colonial legacy.

While this kind of integration has been part of the Caribbean regional agenda in the past, and continues to be pursued in some areas, some governments' reluctance to cede sovereignty to regional institutions has constrained further progress. This also seems to impede the adoption of common sectoral policies and regulatory systems that could lead toward the creation of a single economy. The clear exception to this is the OECS, whose members are part of a monetary union and share a number of institutions.

A key issue seems to be that where an institution directly or indirectly influences a distribution of costs and benefits across participating countries, the parties to the creation of that institution have to be confident that its operation will lead to overall gains for each country. This probably becomes harder to ensure the larger and more disparate the members of that community are, or where culture and behavioral norms differ widely.

Together, these observations suggest that there is value in recalibrating approaches to regional integration. Many regional integration projects around the world have been strongly influenced by the European model, where integration of the regional market was the critical entry point in building confidence that allows progressively deeper integration, including monetary and political union, with a significant allocation of power to central institutions. At the same time, Europe has used trade agreements with other countries and regions to pursue broader commercial interests and ensure market access.

It is not clear that the logic of this approach is very compelling for the Caribbean or the Pacific. For these regions, the gains from regional trade and investment liberalization are small, and regional trade agreements do not deliver enough benefits to build confidence and support for a broader integration agenda. Collectively negotiating agreements with external partners is unlikely to be a good pathway to either strengthening regional coherence or reaping the gains from freer flows of trade and investment.

This suggests that the case for regional policy cooperation and creation of shared institutions has to be sold on its own merits, and pathways must be developed to deal with the sovereignty issues. One lesson from the Caribbean is that subregional groupings with stronger cultural and historic ties can progress where larger pan-regional groupings struggle. For example, eight members of CARICOM that are also members of the Organization of Eastern Caribbean States share a common currency, and five of them have ratified a treaty to establish an economic union.

Another important lesson from the Caribbean lies in the challenge of matching the scope and ambition of the integration agenda to political and capacity realities. CARICOM has been strongly criticized for adopting mandates unmatched by implementation capacity. Leaders of CARICOM countries have also admitted that much of the agenda has been driven in a top-down fashion: despite strong pan-Caribbean sentiment, it has proven hard to convince citizens of member states of the merit of more intensive regionalism. This has made it hard to translate decisions made regionally into national level practice.

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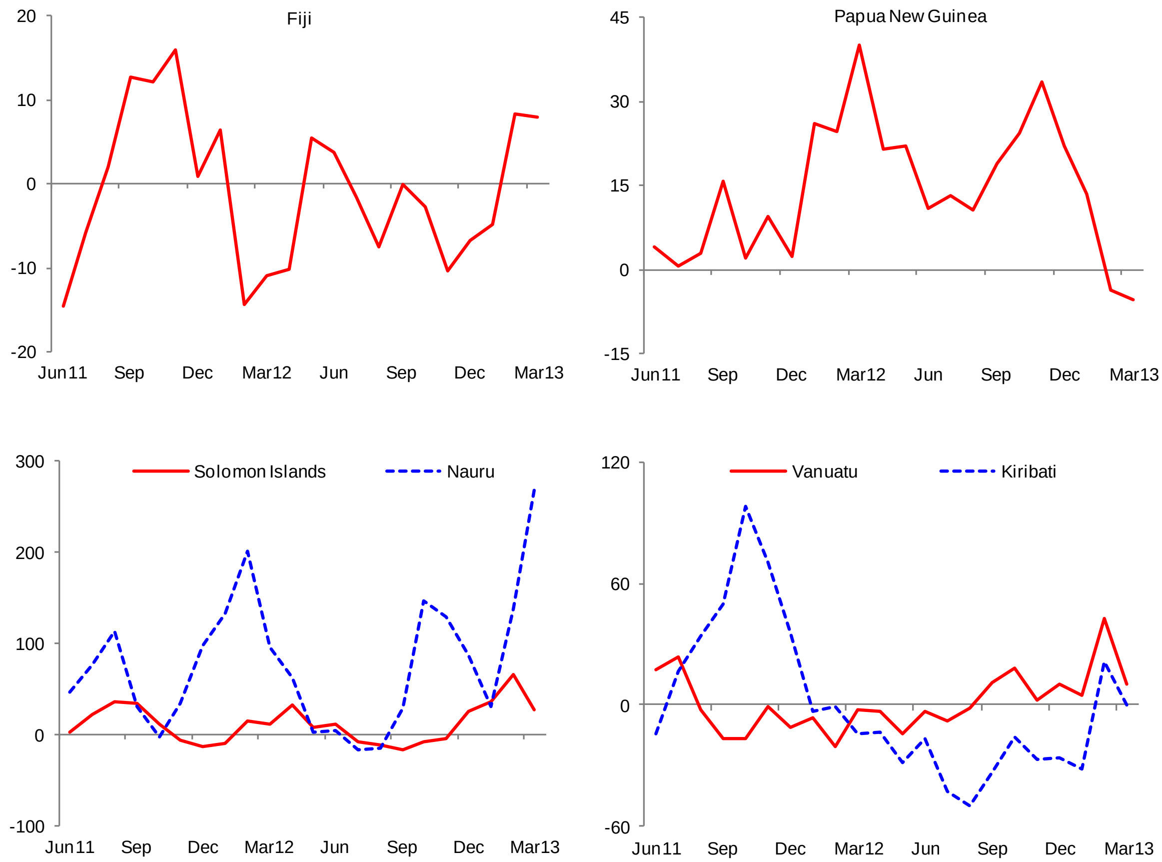
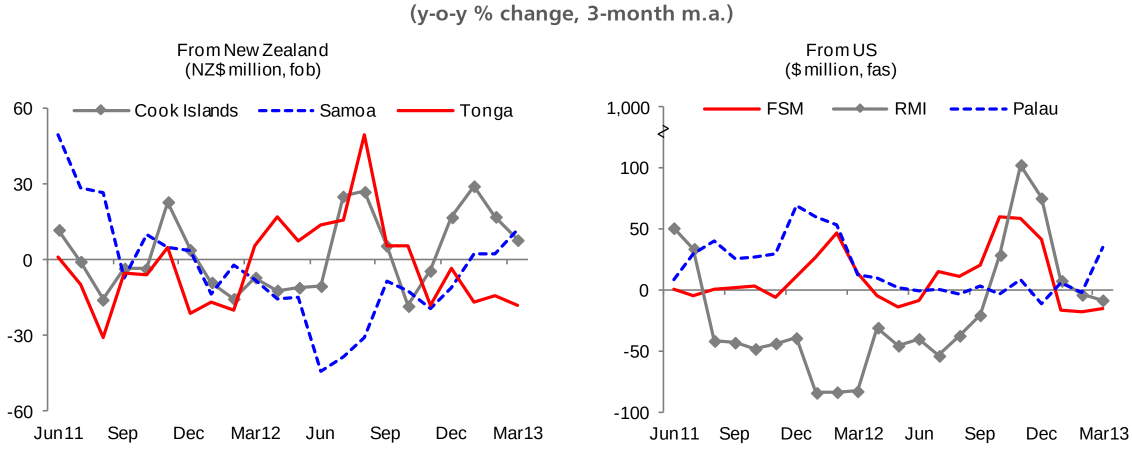
Nonfuel merchandise exports from Australia
(A$; y-o-y % change, 3-month m.a.)



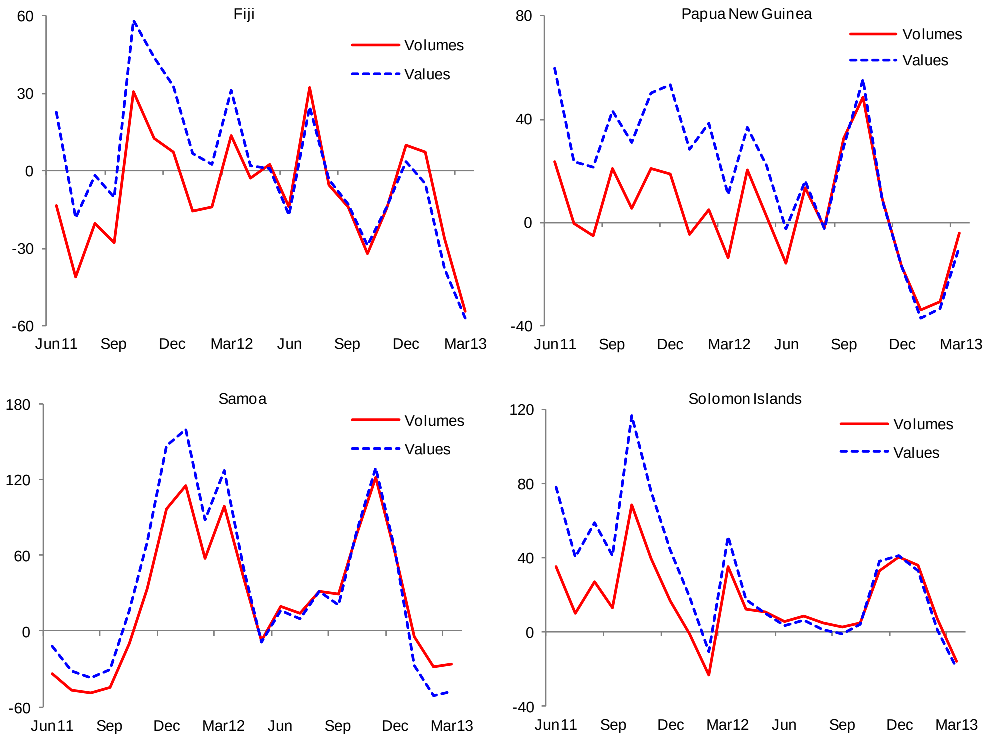
A$=Australian dollars, m.a.=moving average, y-o-y=year on year
Source: Australian Bureau of Statistics.

Nonfuel merchandise exports from New Zealand and the United States
(y-o-y % change, 3-month m.a.)

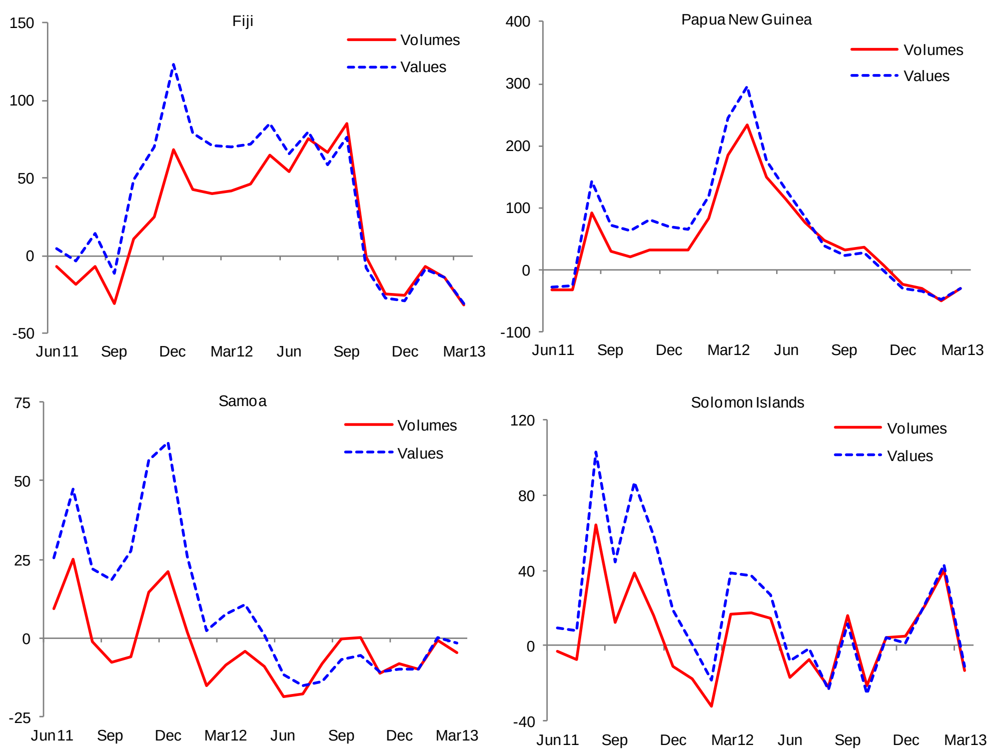


FSM=Federated States of Micronesia, fas=free alongside, fob=free on board, m.a.=moving average, NZ$=New Zealand dollar, RMI=Republic of the Marshall Islands, US=United States, y-o-y=year on year
Sources: Statistics New Zealand and US Census Bureau.

Diesel exports from Singapore
(y-o-y % change, 3-month m.a.)

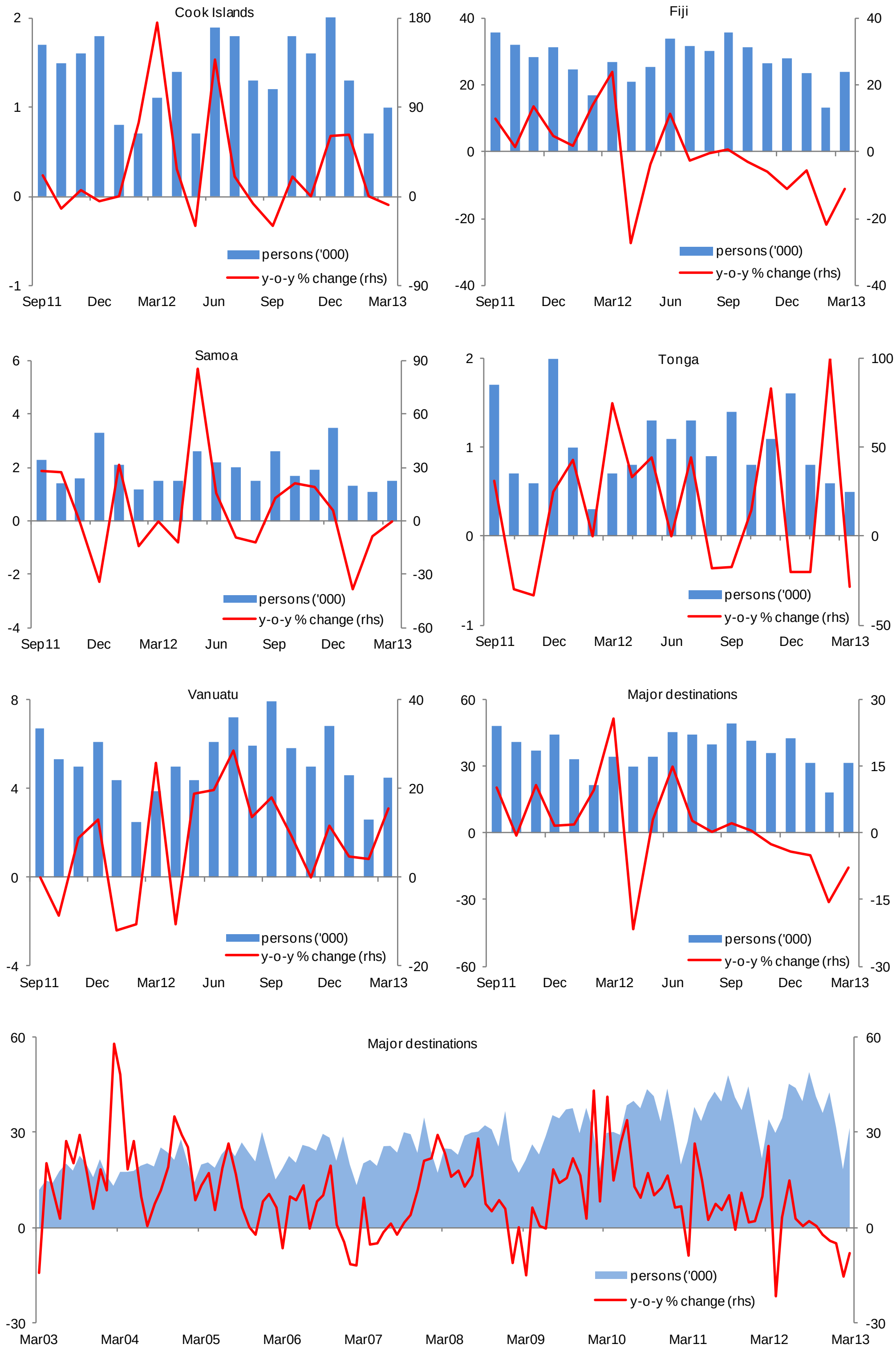


Gasoline exports from Singapore
(y-o-y % change, 3-month m.a.)



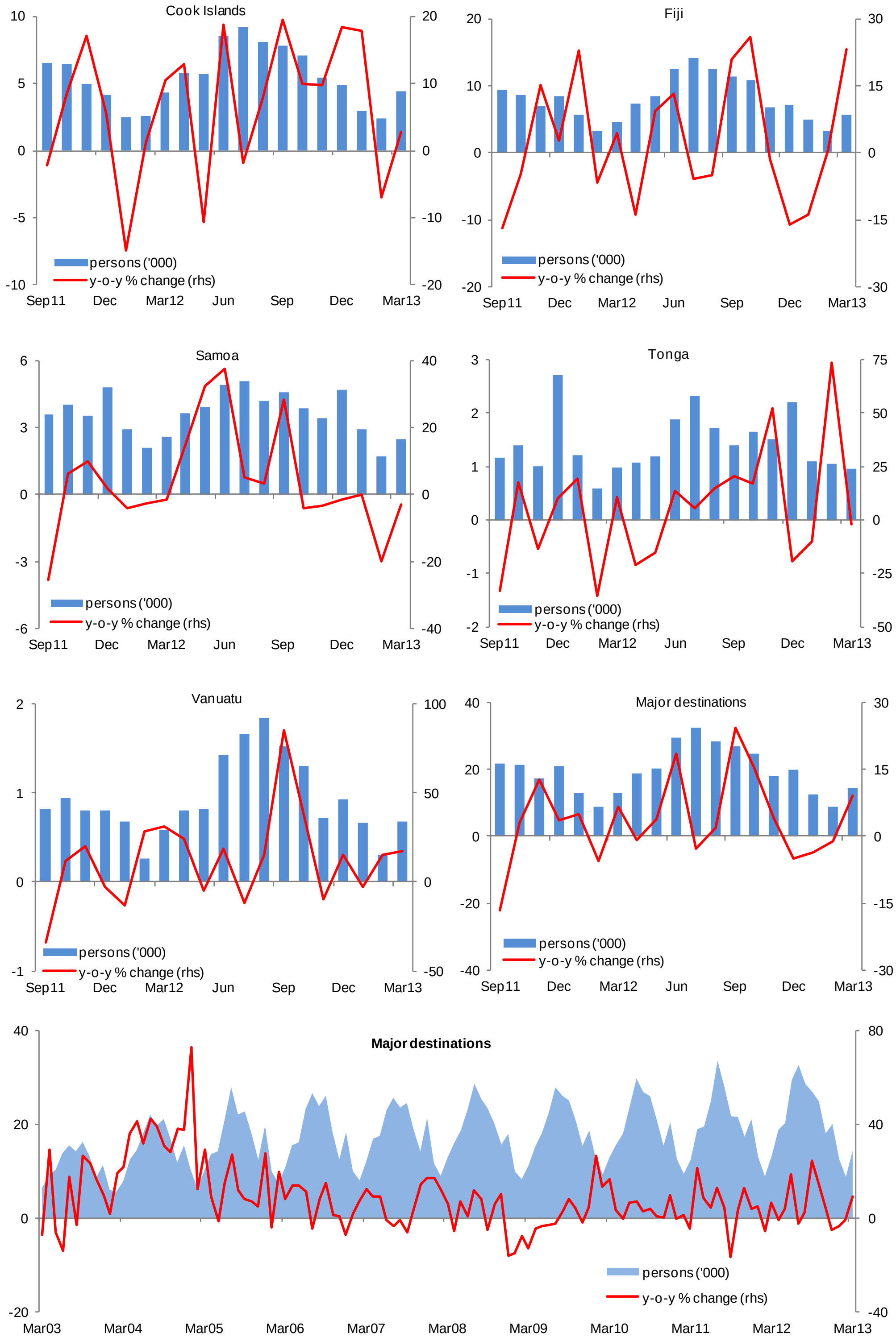
m.a.=moving average, y-o-y=year on year
Source: International Enterprise Singapore.

Departures from Australia to the Pacific (monthly)



rhs=right-hand scale, y-o-y=year on year
Source: Australian Bureau of Statistics.

Departures from New Zealand to the Pacific (monthly)



rhs=right-hand scale, y-o-y=year on year
Source: Statistics New Zealand.

Latest Economic Updates

	GDP Growth	Inflation	Credit Growth[a]	Trade Balance	Import Cover	Fiscal Balance
	(%, 2013p)	(%, 2013p)	(%)	(% of GDP)	(months)	(% of GDP)
Cook Islands	3.2	2.4	–5.2 (Dec-Q 2012)	–46.0 (FY2012e)	—	–1.8 (FY2013e)
Fiji	2.0	2.0	11.3 (Mar 2013)	–26.1 (2011e)	4.6 (May 2013)	–1.6 (2012e)
Kiribati	2.0	1.5	—	–50.5 (2012e)	—	–10.0 (2012e)
Marshall Islands	2.3	4.5	10.4 (FY2011)	–37.7 (FY2012e)	—	–1.1 (FY2012e)
FSM	1.0	4.5	–0.9 (FY2011)	–40.7 (FY2012e)	—	1.2 (FY2012e)
Nauru	4.5	0.5	—	—	—	–1.2 (FY2012e)
Palau	3.0	5.5	—	–50.6 (FY2012e)	—	–3.2 (FY2012e)
PNG	5.5	6.5	12.4 (Dec 2012)	7.1 (2012e)	11.0 (Dec 2012)	–1.2 (2012e)
Samoa	0.9	3.0	–2.1 (Apr 2013)	–18.6 (Jul-Dec 2012)	5.7 (Dec 2012)	0.4 (Jul-Dec 2012)
Solomon Islands	2.5	5.5	5.7 (Dec 2012)	–2.7 (Mar-Q 2013)	11.5 (Apr 2013)	–1.9 (2012e)
Timor-Leste[b]	9.5	9.0	22.5 (Mar 2013)	–50.6 (2012e)	—	136.9 (2012e)
Tonga	0.5	2.7	–7.0 (Feb 2013)	–11.0 (Jul-Dec 2012)	9.1 (Feb 2013)	–0.7 (FY2012e)
Tuvalu	1.3	2.0	—	–50.6 (2012e)	6.7 (2011e)	7.6 (2012e)
Vanuatu	3.2	2.0	4.3 (Mar 2013)	–5.9 (Jan-Feb 2013)	6.7 (Mar 2013)	–1.6 (2012e)

— =not available, e=estimate, GDP=gross domestic product, FSM=Federated States of Micronesia, PNG=Papua New Guinea, p=projection, Q=quarter

[a] Credit growth refers to growth in total loans and advances to the private sector.

[b] Timor-Leste GDP is exclusive of the offshore petroleum industry and the contribution of the United Nations.

Notes: Period of latest data shown in parentheses; import cover for PNG is months of nonmining and oil imports.

Sources: ADB. 2013. *Asian Development Outlook 2013*. Manila; and statistical releases of the region's central banks, finance ministries and treasuries, and statistical bureaus.

Key data sources:

Data used in the *Pacific Economic Monitor* are in the ADB PacMonitor database, which is available in spreadsheet form at www.adb.org/pacmonitor.

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