An assessment of the proposal for a Pacific Economic and Political Community

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Australia has argued within the Pacific Forum for a regional approach to dealing with the economic and social problems experienced in several of the member states. Australian Prime Minister John Howard, who campaigned strongly for the election of an Australian candidate to the position of Secretary General of the Forum, foreshadowed the main tasks of the new appointee as enhancing greater cooperation and accelerating economic development through better governance in many of the poorly performing member economies. In the final communiqué from the 2003 meeting held in Auckland, the Forum Leaders identified the following three issues for immediate attention:

- greater cooperation between the members in pooling the scarce resources of the region to strengthen national capabilities
- a concerted effort to tackle corruption, and improve governance more generally

The anxieties of the largest and richest member of the Forum, and one under some threat from global insecurity, are understandable: but is such a stance in the interests of the smaller member states? If designed and implemented with adequate care, the proposed Pacific Economic and Political Community (PEPC) could be of mutual benefit to all participants; the risks associated with realising such an outcome are also discussed.

Australia has changed its foreign policy, particularly towards its smaller island neighbours located in the Southwest Pacific, following the wars in Afghanistan and Iraq and terrorist attacks in New York and Bali. It would, however, be wrong to suggest that the push for a PEPC by the Prime Minister was a ‘knee-jerk’ reaction to these recent events. The Australian Government has been increasingly concerned at the poor, and in some cases deteriorating, state of economic development in several of its island neighbours. Many of these same nations have been recipients of large amounts of Australian technical assistance and aid. The poor developmental record, therefore, is at least partially an indictment of this assistance. A Senate Committee charged with reporting on Australia’s relation with the Pacific provided a long-term vision for a ‘Pacific
Economic and Political Community’ as a means of providing ‘meaningful and significant income assistance to PNG and Pacific island countries at the same time being of benefit to the Australian economy’ (Australia, Senate Committee Report 2003:xviii). This indeed was not the first such proposal as several previous studies had argued for deeper integration as a means of accelerating economic development in the island states. The Senate Committee saw the proposed PEPC as a means of raising the pace of economic development, and thus fostering peace and political stability in the immediate neighbourhood.

New Zealand, the other key beneficiary from such an outcome, has remained silent on the proposal other than to reject the use of the Australian dollar as the regional currency. The smaller Pacific nations have remained silent except for the Prime Minister of Fiji who has also snubbed the idea of a regional currency. Opposition to a political unification, of which currency unification would be an integral component, is understandable since it would amount to some loss of sovereignty for individual island nations. However, European countries have been able to balance the loss of sovereignty against the gains they anticipate from integration within the European Union, even to the extent of adopting a common currency. From an economic perspective, the use of the Australian dollar as the regional currency would imply a loss of freedom in economic policy as it would effectively transfer monetary policy to the Reserve Bank of Australia. Again, this loss of monetary (and fiscal) independence should be balanced against the benefits of discipline over fiscal policy that would ensue.

The critical question with respect to the proposed economic unification is whether it would be in the interests of the individual members? If it is in their interests, then how can the community be designed and implemented so as to maximise the developmental benefits while containing the risks?

It is often claimed that the Pacific island economies are disadvantaged because they are small and geographically isolated. On the question of whether the size of an economy is a key determinant of economic viability, the evidence is clear. Given that several small economies (Norfolk Islands as an example) have done exceptionally well in developmental terms, size of an economy cannot be the major determinant of economic viability. Within the Pacific region, Niue and Tuvalu, the smallest of the island economies are not amongst the worst performing states while Papua New Guinea, the largest of these countries, is under severe developmental strain. While geographical isolation from major markets is estimated to have a negative impact on economic growth, it is not a large impact.

Is currency unification for the proposed Pacific Economic and Political Community a necessary and sufficient condition for accelerating development? Again the answer is in the negative. Several countries within the region have adopted the Australian, New Zealand or US dollar and they do not have better performance than those with their own currency. Nauru, Kiribati and Tuvalu use the Australian dollar; Cook Islands and Niue use the New Zealand dollar; while the Federated States of Micronesia, the Marshall Islands, and Palau use the United States dollar.

Given that the small size of the island economies does not point to the need for political unification to ensure economic viability and the fact that currency unification is not sufficient for accelerating development, is the proposed PEPC a futile idea? Again, the answer is in the negative. A community of the nature proposed could accelerate growth if a suite of policies is adopted, with implementation of the key components sequenced to generate maximum benefit. For example, the goods and factor (labour in particular) markets would need to be better
integrated before a single currency was introduced. Such a currency union would only survive if fiscal discipline and price flexibility were already well anchored in the individual members. The proposed PEPC could provide the momentum for freer goods trade and factor mobility in the initial phase. This could then be followed by fiscal responsibility clauses for the individual members if they were to graduate to adopting the common currency. Proposals for political unification should be left to the very end since there are few identifiable developmental benefits from such unification while it has the potential to act as a major stumbling block to deep economic integration.

**Old wine in a new bottle**

The idea of pooling resources, particularly amongst the smaller states, is not new. The several bilateral and multilateral trade agreements that have been established in the region endeavour to achieve the same goal of freer flows of goods and services (World Bank 2003:Chapter 1). However, establishment of regional activities is a somewhat different matter. The leaders at the most recent Forum endorsed scoping studies (to be funded by Australia) on ways of sharing airline and shipping services. Both Air Pacific and the Forum Shipping Line were created on these very considerations. Both have had very limited success in meeting the aspirations of their creators; while Air Pacific gravitated towards becoming a Fiji airline, the Forum Shipping Line remains a regional activity but has as yet to return a dividend to the owners.

The reasons for the gulf between reality and intent in relation to Air Pacific and the Forum Shipping Line must be investigated prior to embarking on yet another regional airline or shipping service. Even if the resources to start a regional airline could be raised, there is a strong likelihood of opposition from existing airlines. Why would profitable national carriers such as Air Pacific, Air Vanuatu and Polynesian Airlines give up their privileged positions for a new regional carrier? Why would their governments, as the largest shareholders, support a proposal that erodes the position of the national flag carrier? It has been difficult enough to privatise loss-making airlines such as Air Niugini; the suggestion to amalgamate national flag carriers into a single regional carrier is tantamount to political unification, a task not to be taken on lightly. Even in the unlikely case of the creation of a regional carrier, would it offer the benefits of economies of scale as purported?

The contrasting performance of Air Pacific and the Forum Shipping Line provide many lessons for the proposal for regional enterprises to serve shipping and aviation services. One of the major challenges facing a communally owned service provider is to balance considerations of minimum service obligations with returning profits to the shareholders: this is trying to meet two, and often-competing objectives, with the one instrument—a contravention of Tinbergen’s principle of good public policy of ‘one instrument for each policy objective’. Both Air Pacific and the Forum Shipping Line were caught in this bind: while Air Pacific took the path to commercial viability, the Forum Shipping Line held on to serving its members. Not surprisingly, the latter has continued to make losses while keeping the equity partners together while the opposite happened to Air Pacific. What guarantee is there that a regional airline or shipping company will not follow one of the above mentioned trajectories? Let’s consider some other cooperative initiatives by the members of the Pacific Forum.

Several regional organisations have been created over the past three decades. The relatively successful ones include the Forum Secretariat (formerly the South Pacific Economic Cooperation Bureau), the South Pacific Commission (now known as the
Secretariat of the Pacific Community) and the University of the South Pacific (USP). Of these, USP is perhaps the best demonstration of successful regional cooperation, but it is far from being a commercial enterprise. Even in this case, small island nations such as Samoa and Tonga have created or maintained their own universities, with many fewer resources than the regional university. Much akin to the experiences of Air Pacific and the Forum Shipping Line, there is benefit in scrutinising the reasons for the large diversity in performance of regional bodies in relation to the original intent for their creation. Such considerations are essential for two reasons: first, to avoid repeating mistakes, and second, to avoid the need to dismantle such bodies, as experience has proved this to be a very difficult task.

Australian concerns relating to regional security, particularly in the aftermath of the terrorist attacks on New York and Bali, may indeed be new and deserve detailed consideration. The region does not have formal arrangements for defence cooperation, thus a case may now exist for such an arrangement. The Biketawa Accord did consider proposals for a regional peacekeeping force; this could be expanded to cater for the new demands relating to maintaining regional security. With the benefit of hindsight, such a force could have served as a deterrent to the military coups and the ensuing political instabilities leading to economic paralysis in Fiji and Solomon Islands. Or better still, their presence could have deterred the usurping of legal authority. The recent meeting of the Forum endorsed the Australian-led military and police intervention in Solomon Islands, but a credible force able to deal with such instabilities may have at best prevented the crisis and at worst contained it at a much earlier stage and well short of the damage done to date, and of the resources needed to rescue the situation. The Biketawa Accord could be expanded to incorporate a proposal for a rapid deployment capacity stationed with the member defence forces. The proposed revamping of the Fiji Police College, with funding from Australia of A$17 million to be spread over five years, to meet the training demands of the smaller island nations, could also act as the hub for a regional police force. The College could provide the virtual linking of the forces stationed in member countries; indeed, there is no better way than for college alumni to continue to work together in a regional capacity. In summary, regional security concerns are new but could be accommodated within the context of the Biketawa Accord: that is, this new consideration could be effectively packaged within an existing regional arrangement.

**Smallness and economic viability**

Smallness does not necessarily imply non-viability of an economy as there are several small economies that have done exceptionally well in terms of economic development. There is cross-country evidence that well-managed, small economies have outperformed both their poorly managed cousins as well as their much larger counterparts. While size does create particular problems, smallness does not constitute an insurmountable development hazard. The challenge for policymakers is to draw lessons from the successes and emulate these within the less successful economies.

Many of the factors important to development are identical for both large and small countries. For example, the critical ingredients for development such as clear and enforceable property rights, good public infrastructure, an open trading environment, and an accommodating international trading environment are common to both small and large open economies.

Small economies are more open than large countries in terms of the share of trade.
in GDP. The narrow resource base of small economies prevents them from satisfying the diverse demands of domestic consumers. Hence, these economies are more reliant on international trade than their larger counterparts. The reliance on a narrow range of export commodities to earn foreign exchange exposes the economies to greater volatility in such earnings due to reduced opportunities for income diversification. Hence, supply shocks at home or price shocks from abroad lead to greater volatility in income and demand in small vis-à-vis large economies. Small economies, by definition, lack market power in the global market place; this is as much a strength as a handicap. While small economies are at the mercy of global commodity prices, they face infinitely elastic demand for their commodity exports.

The thinness of foreign exchange markets in small economies is one of the factors that has dissuaded them from adopting freely-floating exchange rate regimes. Given their greater openness, larger exposure than large countries to external shocks, and thin foreign exchange markets; small countries often adopt fixed exchange rate regimes and/or their central banks intervene heavily in order to maintain exchange rate stability. Such actions limit the ability to use monetary policy for macroeconomic stabilisation. The small size also limits the ability to use discretionary (strategic) trade policy for improvements in domestic welfare. Exchange rate policy is used sparingly and only in extreme situations, given the need to maintain credibility of the domestic currency. Consequently, fiscal policy is used as the major tool for economic management (Chand 2002).

Small isolated states face several problems that have the potential to constrain economic activity. Most of these disadvantages emanate from lack of economies of scale, often implying the lack of a sufficiently large population and domestic resource base to allow production of goods and services at the minimum efficient scale. Geographical isolation raises transportation costs, imposing a competitive disadvantage on high bulk-to-value exports such as primary commodities. A higher degree of specialisation follows from efforts to secure economies of scale in production, marketing, transportation, and distribution. The industries that are established tend to be those requiring minimal economies of scale such as small-scale agriculture, boutique tourism, and assembly activity such as clothing. Some import-competing industries survive due to a combination of high levels of natural and/or regulatory protection, public sector subsidies, and the presence of large resource rents that fund downstream processing.

Lack of scale economies could be a serious handicap to growth since recent developments in endogenous growth theory suggest that scale is necessary for growth-enhancing activities, including research and development and learning-by-doing (see Arrow 1962; Romer, 1986; Lucas 1988; Barro and Sala-I-Martin 1995; and Aghion and Howitt 1998). But greater specialisation increases exposure to movements in international prices and quantity shocks such as those arising from adverse natural consequences that in turn are manifested as output and export instability. Examples of the latter include the recent taro blight in Samoa that nearly decimated the industry, and a severe downturn in tourist arrivals in Vanuatu in 1998 due to hail damage to its lone jet-aircraft.

The jury is still out on the extent to which the factors listed above have constrained growth in small economies. After extensive empirical testing, Easterly and Kraay (2000) came to the conclusion that smallness is not a disadvantage to development, arguing that on average small states have higher incomes than their larger counterparts. This claim has not gone unchallenged as noted in Blake (2001), but what is clear from several
similar analyses is that the constraints to growth of output faced by small states can be overcome; but doing so demands good economic management. Easterly and Kraay also claim that the ingredients and recipe for growth of production is the same for all countries and suggest that unwarranted attention has been paid to the problems of small states. I have argued elsewhere (Chand 2002) that there is considerable, albeit not total, overlap in development problems faced by small and large economies; four issues peculiar to small states and relevant for the discussion here are enumerated next.

First, their small markets are often able to sustain only a few and sometimes only a single supplier. This thinness of the market can confer market power on the incumbent(s), thereby constraining competition—a necessity for achieving efficient allocation of resources. However, if there are no barriers to imports of competing goods or services, the ensuing contestability will place a limit on the ability of the monopolist to extract abnormal profits. Second, an absence of scale economies reduces the range of non-traded services produced by the private sector. This often provides the rationale for public sector participation in commerce. National airlines and state-run utility companies in small states are created and often supported with taxpayer funds on the premise that it fills the void left by the private sector; but this very support also acts as a barrier to private sector participation. Developing country experience with state-owned enterprises in terms of their profitability, sustainability, and efficiency of resource use, has been poor. In some cases, problems of small markets may be overcome by changes in technology. The telecommunications industry is a good example. In this case wireless technology has meant that the earlier need for large-scale markets to support the building of fixed-line facilities is no longer important.

Third, the small population of small states limits the pool of available skills including those for economic management. Furthermore, the small size of the population means an even smaller group of elite, which hampers ‘arms-length’ governance, and therefore creates the conditions for nepotism and corruption; this is what Harberger (1988) calls the ‘tyranny of demography’. Poor governance leading to poor economic management penalises development. Fourth, and as explained earlier, small, open economies tend to peg their domestic currency to the currencies of their major trading partners as a means of minimising exchange rate volatility. When the capital account is open, this policy imposes a cost to economic management by limiting the effectiveness of monetary policy in demand management. Furthermore, adverse terms of trade shocks with downward rigidity in domestic prices lead to an appreciation of the real exchange rate, to the detriment of domestic competitiveness, thus exacerbating the recessionary impact of the initial shock.

In summary, small states have more volatile income and have limited capacity to mitigate the effects of international shocks on domestic production, employment, and prices. The best that these states can do is to learn to cope with and be prepared for such volatility; the international community can facilitate but not initiate such a process. Small states face problems that are due to their size, but these are surmountable challenges requiring commensurate capacity in economic management. Thus, smallness on its own cannot be a sufficient reason for the Pacific island states to enter into an economic and political community, but doing so may make good economic management easier whilst not alleviating the need for the same. However, there are prerequisites for the proposed PEPC to deliver a higher and more sustained rate of growth of income for the communities of the region.
Prerequisites for the proposed PEPC to deliver

In deciding to adopt a common currency such as the Australian dollar (or a 'Pacific' dollar as suggested by the Governor of New Zealand’s central bank), the members of the proposed Pacific Economic and Political Community would need to weigh up the benefits against the costs of such a proposal. It is critically important to note that a package of policies must be adopted if the proposed PEPC is to deliver a higher rate of economic development while at the same time underpinning long-term regional security. Such a package will, inevitably, constrain policy choices within individual countries and as such incur costs.

The members of the proposed community would first need to be convinced that each would gain individually from joining; otherwise side-payments may be required to induce those that otherwise pay a price for the benefit of the group collectively. The most likely candidate to satisfy the requirement of collective benefit without needing side-payments is freer movements in goods, services, capital, and labour—such deep integration would need to be accompanied by unification of codes and standards. The benefits from deep integration may induce the members to pursue fiscal and financial integration; fiscal integration is necessary condition if a common currency is to be adopted. Political unification may follow implementation of free mobility of goods, services, and factors of production within the region, accompanied by common codes and standards including the use of a single currency. The benefits from each of the above three steps will, in all likelihood fall as unification is deepened; it may very well be that the case for political unification may not arise for a considerable while yet.

Conclusion

The Australian Prime Minister, at the 2003 Forum Leaders meeting in Auckland, made a strong case for greater pooling of the region’s resources to strengthen regional capacity while inducing greater peer pressure, particularly amongst the leaders, for better governance. There is little debate on the legitimacy of this position. Within this context, the case for a collective initiative on regional security threats is also sensible. But extending the concept of regionalisation to a Pacific Economic and Political Community, on the premise that the small island states individually are not economically viable, has little basis. Niue and Tuvalu, the smallest of Pacific island states, are in far better shape than their much larger and more resource-abundant neighbours in Melanesia. Moreover, the suggestions for a regional airline, shipping service and single currency may be both overly ambitious and politically naive.

One sensible way to proceed to greater unification within the region but with an open trade regime is to embark on deep integration involving freeing up of restrictions on movements of goods, services, capital, and labour in the region. Locking in with the trade liberalisation agenda of Australia may assist the members to resist domestic lobbies opposed to such reform. Freer movement of labour may allow several of the island states to complete major downsizing exercises within their public service and the disciplinary forces, as it would provide an exit for workers made redundant in the process. These steps could lead to the unification of the region’s financial markets; a natural outcome of such a process may well be demands for a single regional currency from within the membership. Demands for political unification, in all likelihood, would come last given that benefits from unification are likely to be a lot smaller than those from
the preceding steps. The suggestion for political and economic unification in the same breath thus could have been counterproductive.

The proposal for a Pacific Economic and Political Community, if it is to materialise, must be pushed in three distinct stages, with an option for the members to opt out from the unification process at any stage of the game. The first stage would entail deep trade integration involving removal of all regulatory impediments to trade in goods, services, and factors of production. Such a process will necessarily involve unification of codes and standards. The second step would entail setting of fiscal standards and unification of the financial sector; a single regional currency may follow as a consequence. Only after completing these latter two stages should political unification be given any thought. The gains from each of the above steps will be positive but of smaller magnitude than the previous step while costs, particularly in political terms, could rise with each step. Continued participation with an option to opt out will be evidence of net positive benefits from being part of the process. From the regional perspective, the resulting position may be improved by allowing side-payments; but even thinking about this possibility is a risk given the existing problems of poor governance.

Notes

1 Note that in the case of perfect capital mobility with a fixed exchange rate, monetary policy is ineffective in demand management.
2 Previous attempts to downsize the armed forces in all of Melanesia have failed due to tough resistance from those affected—the simple lesson for the reformers being that you do not ‘fire’ those with ‘fire arms’.

References