Trade, regionalism and economic sustainability: how to pay for import needs

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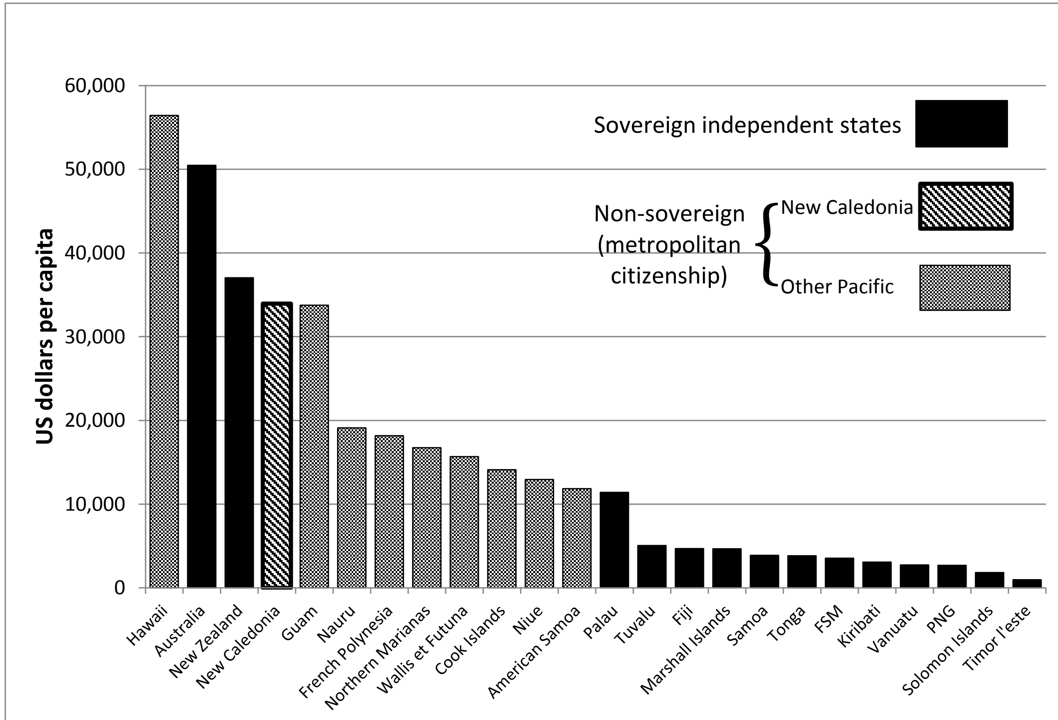
Geoff Bertram
Institute for Governance and Policy Studies
Victoria University of Wellington

1. Introduction

New Caledonia is one of very few successful mineral export economies across the small-island world. (Svalbard no longer exports coal, the Pacific phosphate deposits of Angauar, Banaba, Nauru and Makatea have been exhausted, and the Panguna mine in Bourgainville remains closed). New Caledonia’s chief export, nickel, accounts for 90% of the countrry’s total export earnings. It is exported out of the Pacific region to large metropolitan economies with heavy metallurgical industries; there is no market for nickel within the small-island Pacific region. In common with other Pacific island economies, New Caledonia faces outward from the region both economically and politically, and is drawn into convergence with its metropolitan patron rather than with the other small islands of the region (Bertram 2004).

Also in common with many of the other small islands, New Caledonia has become increasingly reliant on financial transfers from its metropolitan patron to maintain its level of income – transfers that are determined by the closeness of the political ties between centre and periphery. The combination of a successful leading export sector and political integration with the French metropole accounts for New Caledonia’s high ranking in terms of income per capita relative to other small island economies – see Figure 1. (As Poirine’s paper for this conference shows (Poirine 2017), the divergence of French Polynesia from New Caledonia in the past two decades is attributable largely to New Caledonia’s having two major sources of external resources – export earnings as well as official transfers – in contrast to French Polynesia which has lacked a major export sector since the end of nuclear testing.)

Figure 1: GNI (or GDP) per capita in 24 Pacific economies



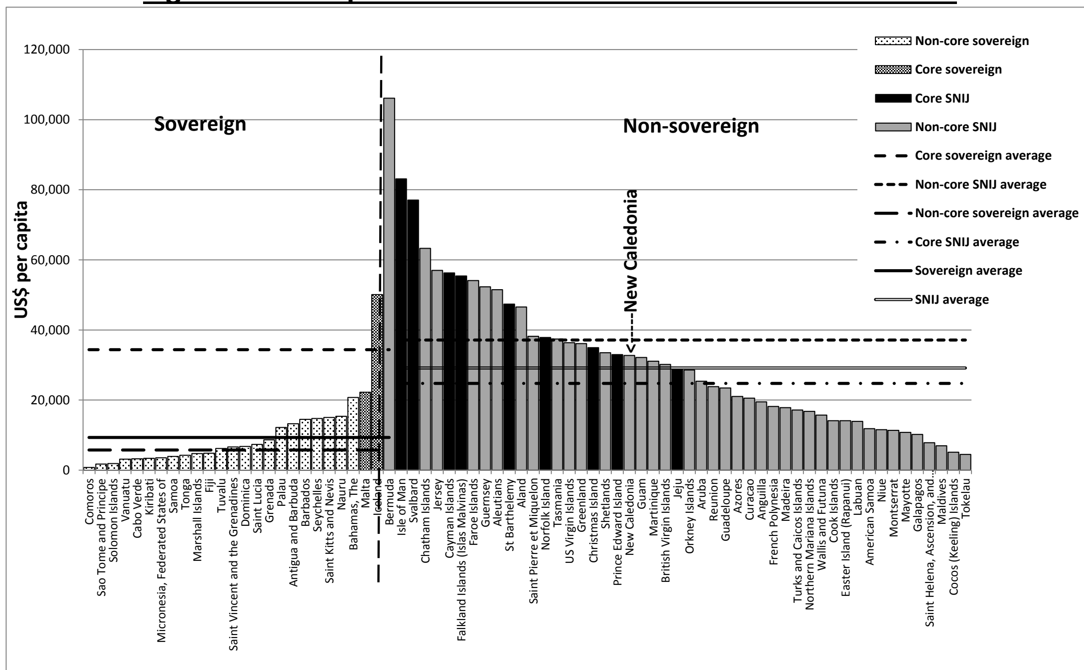
Sources: All sovereign economies, plus French Polynesia, New Caledonia, and Cook Islands, from https://unstats.un.org/unsd/snaama/resQuery.asp accessed 25 August 2017, accessed 25 August 2017. All figures are for 2015.

American Samoa, Guam, Hawaii and Northern Marianas from US Bureau of Economic Analysis website www.bea.gov accessedv25 August 2017.

Wallis et Futuna calculated from “TABLEAU DE BORD FEDOM PM, Mis à jour, 15 Janvier 2016”, www.fedom.org/wp-content/uploads/2-15/06/TdB-15-Janv-2016.pdf , Tables 7a and 7b converted to USD.

Niue from https://dfat.gov.au/trade/resources/Documents/niue.pdf , figure for 2012.

Figure 2: Per capita GNI or GDP for 74 small island economies

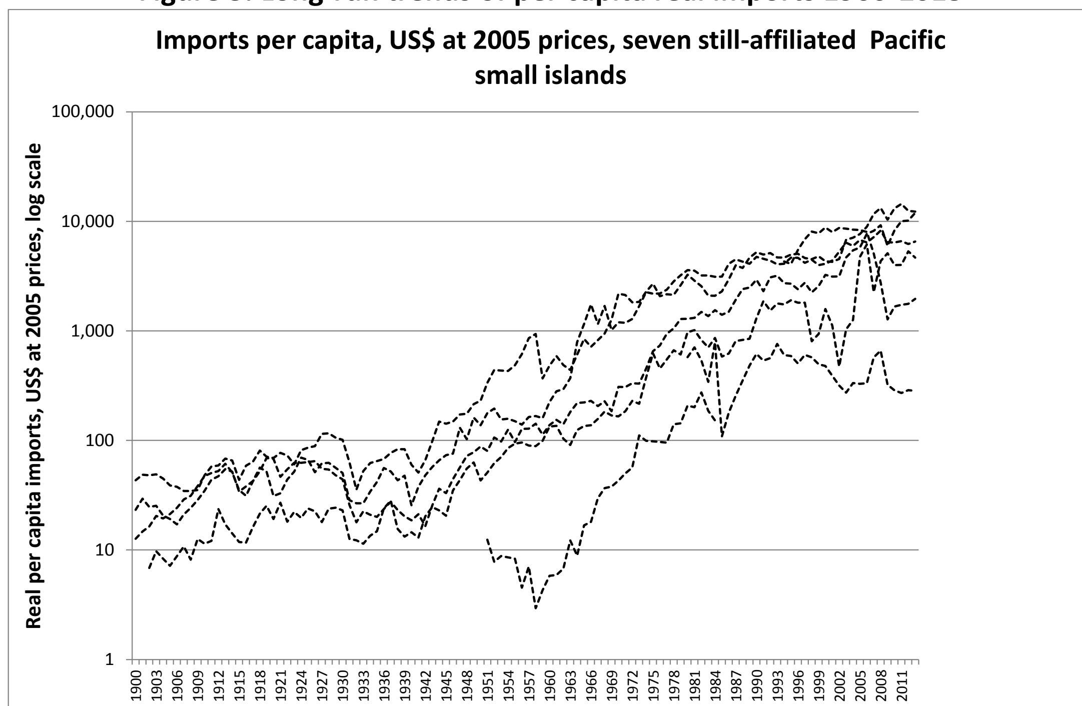


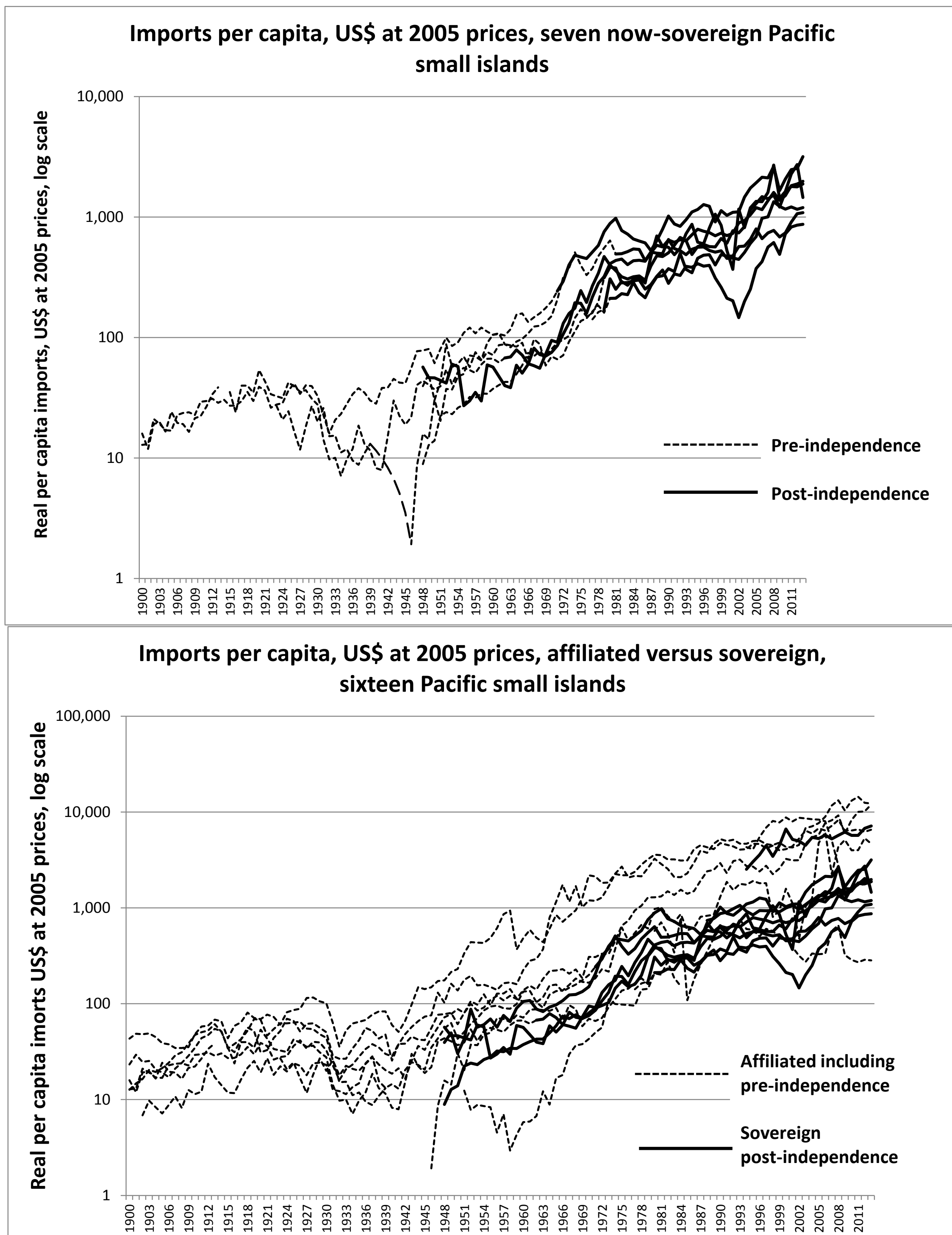
Source: Bertram and Poirine forthcoming, Figure 2.

It is clear from Figure 1 that across the Pacific region, small island states that are fully independent tend to have lower incomes than those which retain associations with metropolitan patrons and share the citizenship of those patrons. This pattern is not restricted to the Pacific. As Figure 2 shows, across the wider global economy the same pattern holds true. Small islands that are still part of, or closely linked with, larger metropolitan states, tend to have higher per capita incomes than small islands that have become or remained independent sovereign states. This is by now a well-established stylised fact (Armstrong and Read 2000, 2002; Bertram 2015, 2016; Feyrer and Sacerdote 2009; McElroy and Parry 2012). However, it is not at all clear which way causality runs. Looking at a global data set, the gap between the two sets of small islands developed before political status was assigned and has persisted since at least the mid-twentieth century at a fairly constant relativity (Bertram 2015, 2016).

In the Pacific, long-run import data extending back before decolonisation is available for thirteen small island economies – seven that have become independent, and six that remain affiliated to metropolitan states. Figure 3 shows the long-run growth paths of per capita real imports for the two groups of economies separately, then combines them, providing a comparative story from 1900 to 2013.

Figure 3: Long-run trends of per capita real imports 1900-2013

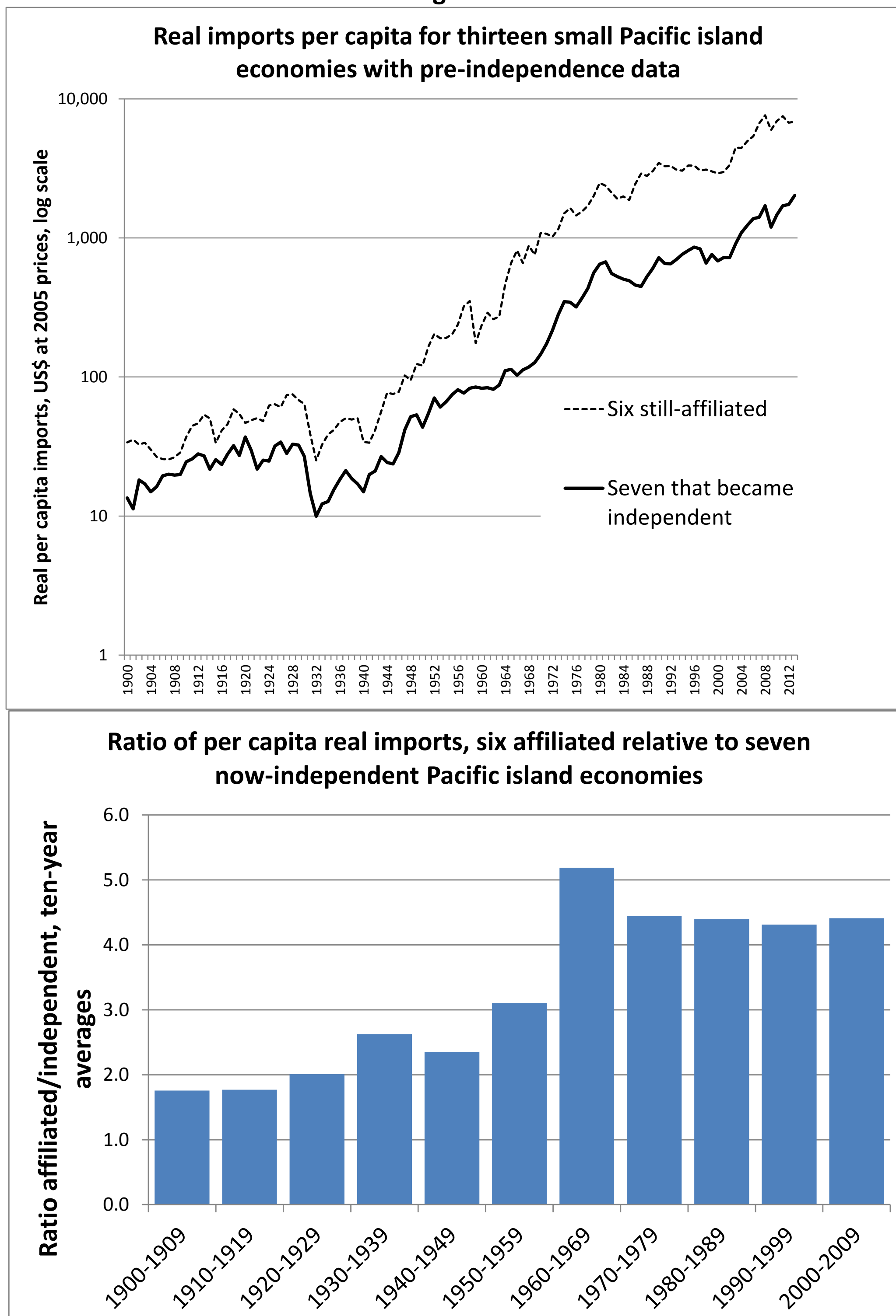




The outstanding feature of Figure 3 is that the income gap, between islands that are today sovereign and those that are not, was already established by 1950 and that the two groups of islands have grown parallel ever since. The gap, in other words, opened up before decolonisation, and becoming independent made no difference, either positive or negative, to the growth paths. Figure 4 shows the population-weighted per capita real imports of the two sets of island economies, and the ratio of those still affiliated to those which became independent. The ratio was already nearly 2 at 1900, rose to 3 by the 1950s, and has been

constant at 4.4 for four decades since 1970. The dates of independence of the seven now-independent countries in Figure 4 were pre-1900 for Tonga, 1962 for Samoa, 1970 for Fiji, 1978 for Tuvalu and Solomon Islands, 1979 for Kiribati, and 1980 for Vanuatu. The big shifts in the import ratio took place in the decades before independence – not afterwards.

Figure 4



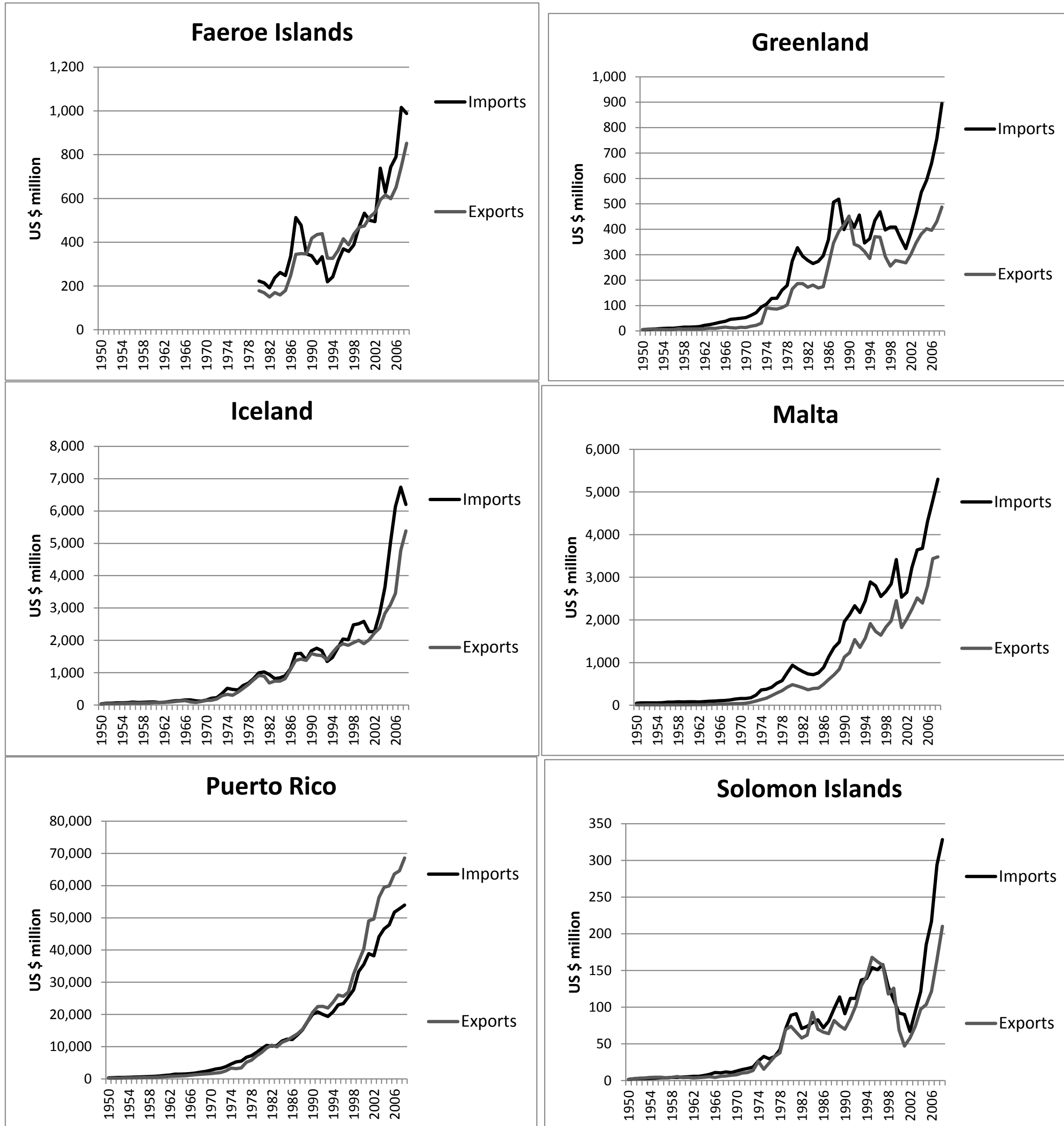
There is, therefore, nothing in the historical record to suggest that moving from non-sovereign to sovereign status necessarily means a reduction in income, or vice versa – at least so far as can be told from the import data. Nevertheless each small island economy has followed its own particular historical trajectory, and its modern situation is path-dependent. The policy options for each must, therefore, be assessed in the particular historical context.

In the remainder of this paper I first look at long-run historical patterns of trade and development to illustrate the issue of how funding is secured to pay for the imports which sustain, and largely determine, the level of income and development in a small island economy. I then distinguish between two different types of region and show why regional trade integration has little to offer the small-island Pacific. This means that although integration has a role as a political and cultural project, it does not have a clear economic side to it.

2. How to pay for imports: the "Jaws Effect"

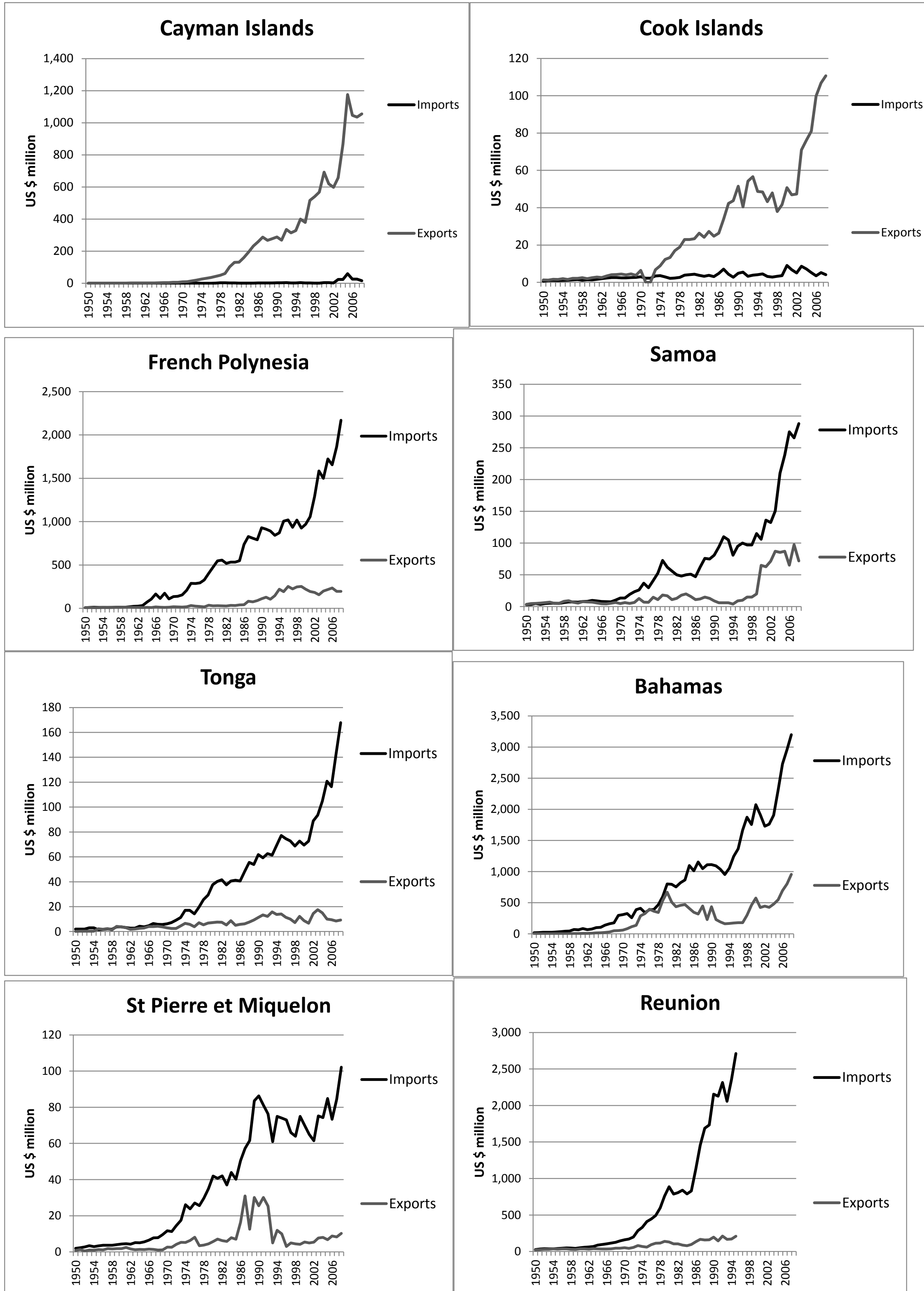
Trade is a two-way process, and it is common in the literature to think of economic development in an open economy as a process in which trade is balanced: export earnings grow, and pull imports up with them via some sort of Keynesian multiplier process. Some small island economies do exhibit this sort of balanced-trade growth – see Figure 5. These are, however, exceptions that prove a very different general rule.

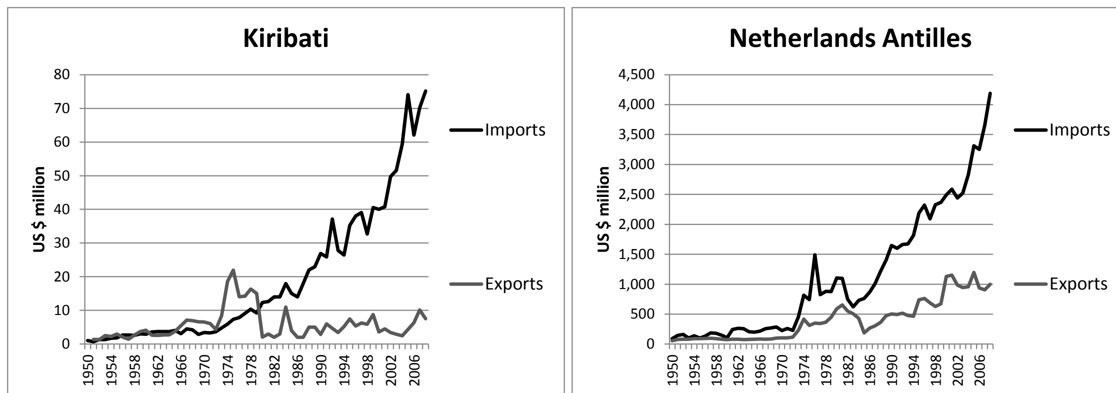
Figure 5: Small island economies with (roughly) balanced trade



In strong contrast to the economies shown in Figure 5, the trade statistics of the great majority of small island economies since the Second World War exhibit a "jaws effect": imports have raced away relative to exports, creating spectacular gaps between the two. Some examples are in Figure 6.

Figure 6 The jaws effect





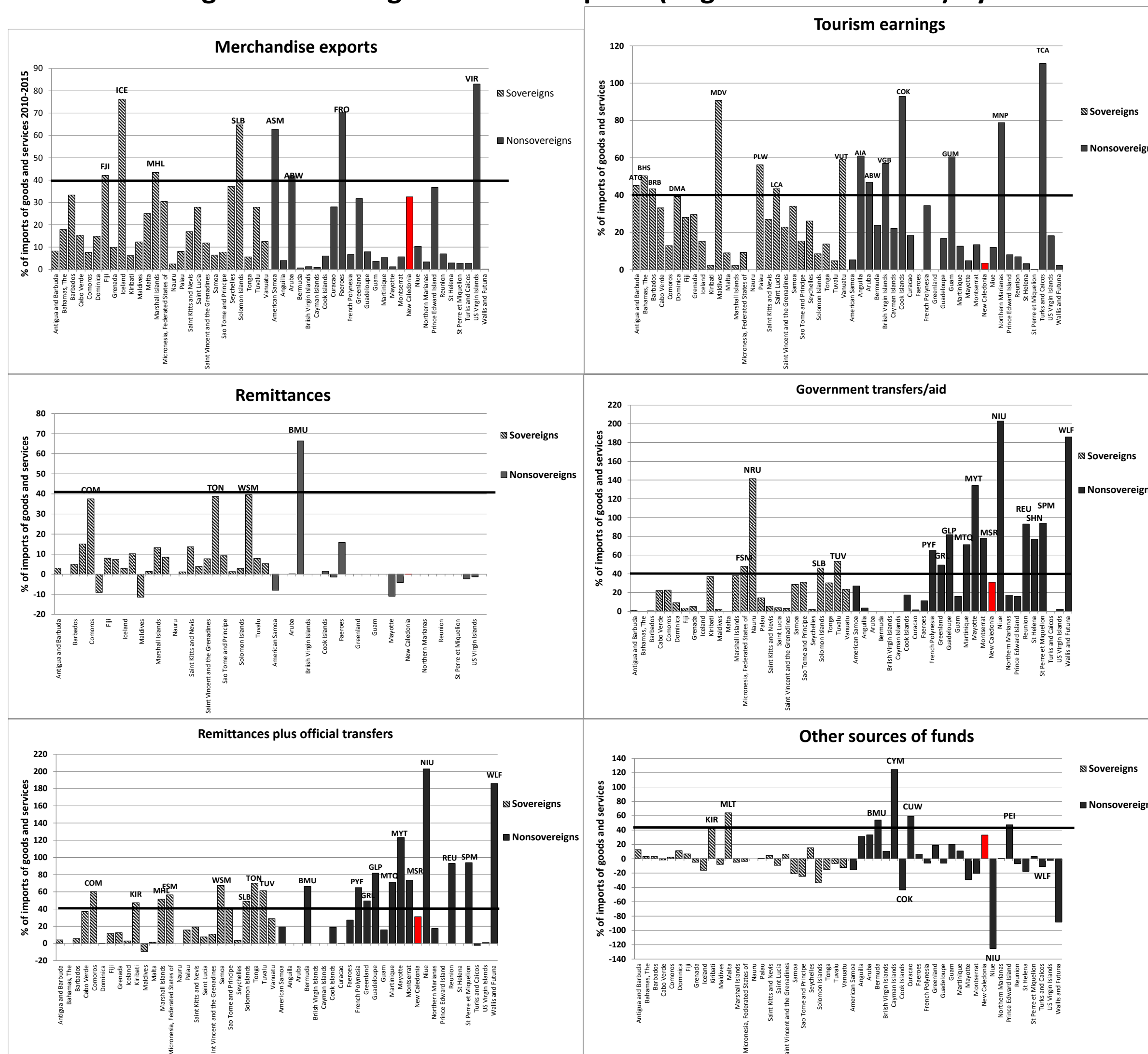
In small island economies such as these, the leading sector has been imports rather than merchandise exports. To maintain balance of payments equilibrium in the absence of massive borrowing, these economies have secured large flows of external resources from some other source or sources (Baldacchino 2006; McElroy 2006; Bertram 2006; Baldacchino and Bertram 2009). The literature on island economies has highlighted the importance of several of these:

- Migrant remittances (important in Samoa and Tonga)
- Official transfers (important in French Polynesia and Reunion)
- Tourism earnings (important in the Cook Islands and Bahamas)
- Licence fees from fisheries, ship registries, tax havens (important in Cayman Islands)
- Income from sovereign wealth funds (important in Kiribati)

The resource requirements and specialised skills required for success in these non-trade activities are quite different from those needed to operate an export economy. Generally speaking, many small islands pay for their imports out of rents that flow from particular endowments they possess or have acquired. Tourism requires landscapes and climate; remittances require migration outlets and human capital suitable for external labour markets; tax havens and offshore financial centres require specialised jurisdictional and institutional arrangements; official transfers require strong political connections with metropolitan funders.

In Bertram and Poirine (2018 forthcoming) we consider various ways to cover the cost of imports of goods and services across the world's small island economies. Figure 7 reproduces our findings for our global set of 74 economies. In each chart a horizontal line shows the 40% threshold beyond which, we argue, an economy can be considered "dominated" by a particular source of external purchasing power. Data are averages over the period 2010-2015. In each chart, the position of New Caledonia is highlighted for comparison. Sovereign independent small islands are cross-hatched on the left of each chart; non-sovereign small islands are in solid fill on the right.

Figure 7: Coverage of cost of imports (of goods and services) by:

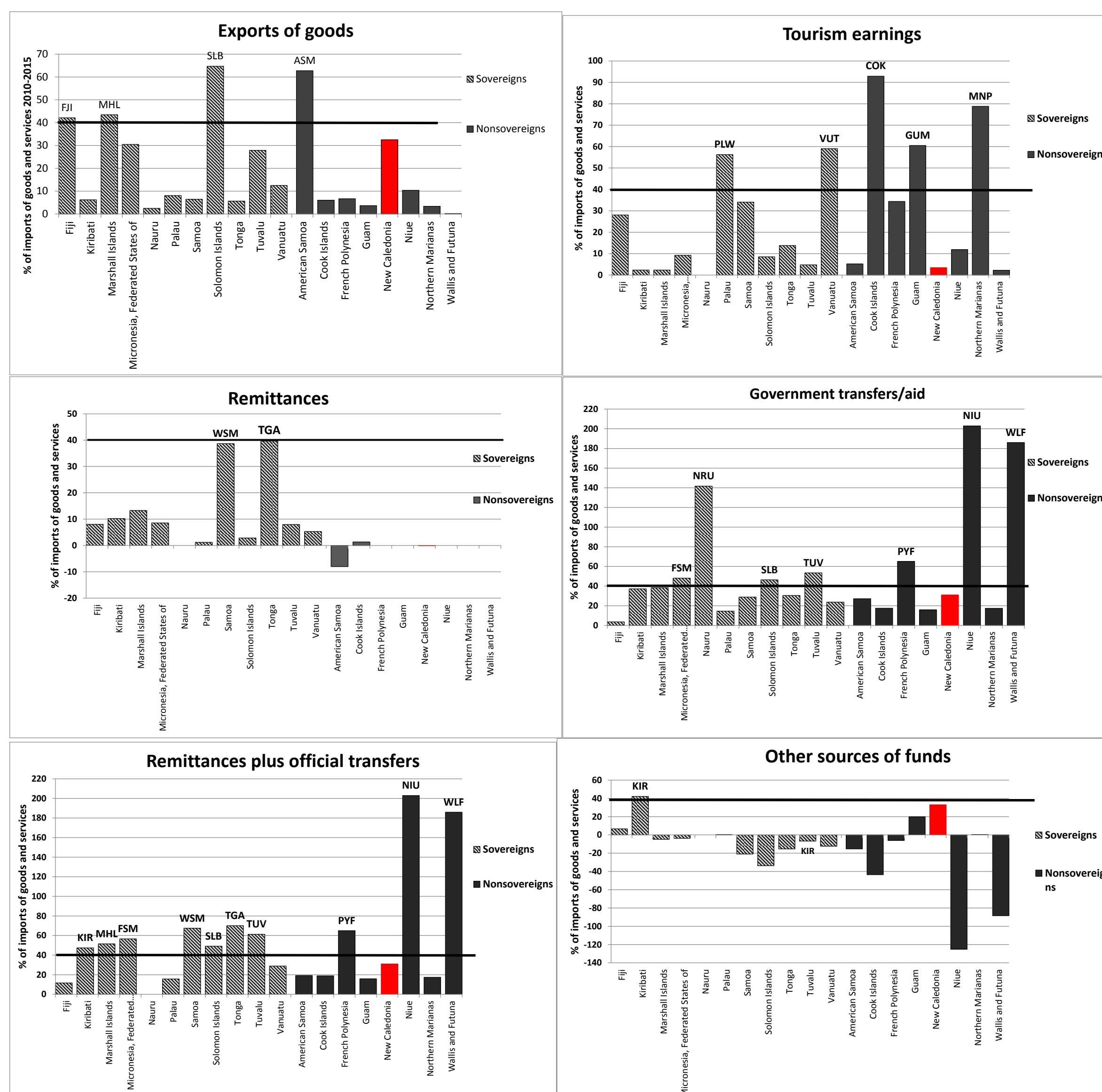


Merchandise exports play a leading role in only a few small islands world wide. In the Pacific, only American Samoa, Fiji, Marshall Islands and Solomon Islands fund more than 40% of their import requirements from this source. New Caledonia follows them, with a coverage ratio of one-third. Of the 74 economies plotted in Figure 7, only eight paid for more than 40% of their 2010-2015 import requirements out of merchandise export earnings, and those eight have been reduced to six following closure of large oil refineries in Aruba and the US Virgin Islands. Thirteen of the 74 were tourism-led; four had remittances around or over the 40% threshold (though the remittances flowing into Bermuda's tax haven are not the sort usually discussed in the small-island literature); fifteen relied on official transfers of funds (aid or budget support); and six (including Bermuda again) were funded from other sources: non-tourism services exports, private capital inflow, and the returns on Kiribati's sovereign wealth fund. The remaining small island economies had more diversified sources of funding with none reaching the 40% threshold.

New Caledonia is one of those diversified cases, with 33% coverage from goods exports, 31% from official transfers, and 34% from "other", which in New Caledonia's case is foreign direct investment flowing into the economy. Tourism (under 4%) and remittances (marginally negative) do not play any major role.

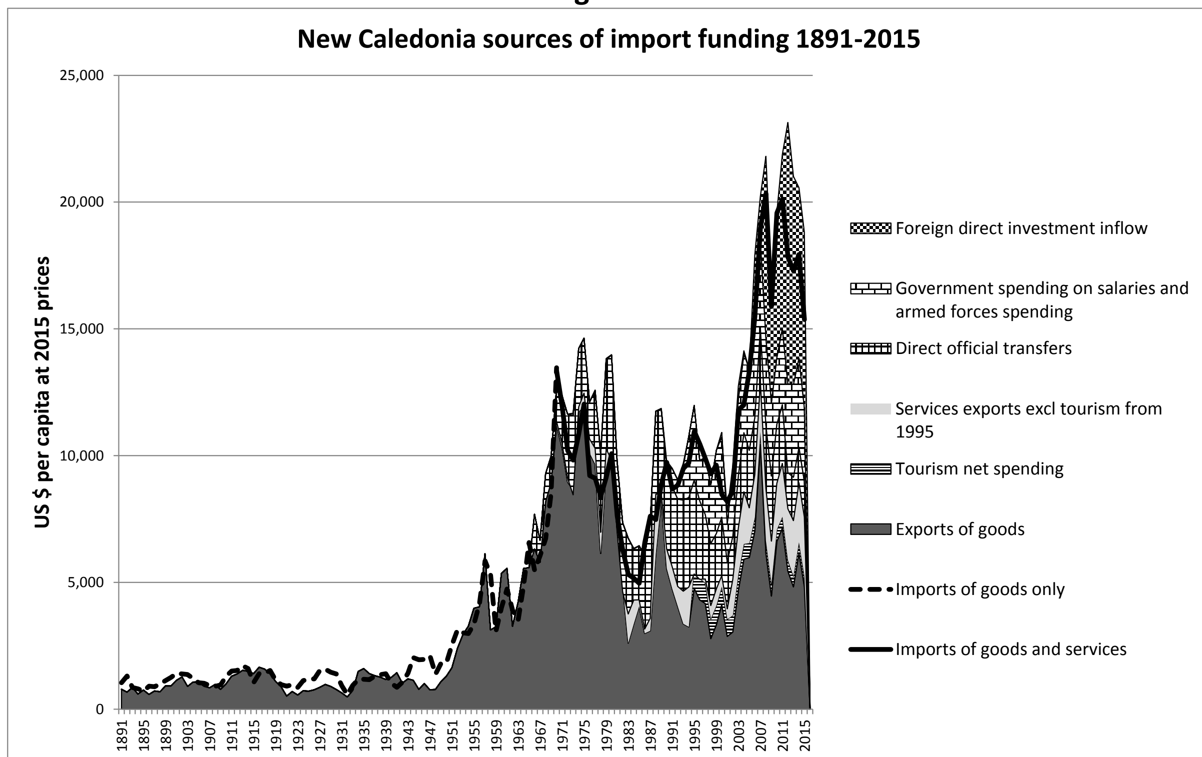
Figure 8 repeats the calculation shown in Figure 7, but this time including only the nineteen Pacific Island economies in our dataset. The importance of aid and remittances combined, especially for the sovereign independent island states of the Pacific, stands out, accounting for over 40% of import funding in ten of the nineteen Pacific island economies in Figure 6, which is why the "MIRAB" model emerged in this region (Bertram and Watters 1985).

Figure 8: Coverage ratios for 19 small Pacific island economies, 2010-2015 average



To trace the long-term historical roots of New Caledonia's current profile of import funding, Figure 9 reconstructs the balance of payments since 1891. The structure of the chart starts from the "jaws effect" gap between imports and merchandise exports, and shows how the gap between the two has been filled by official transfers from France, tourism earnings, and capital inflow.

Figure 9:



Source: figures assembled by the author from multiple sources.

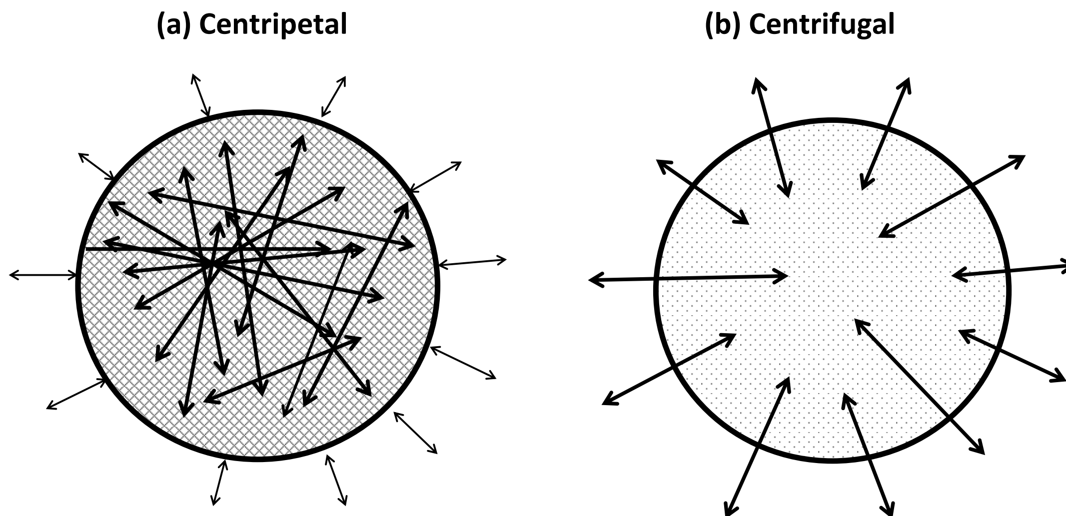
From Figure 9 it is clear that a structural transformation of the New Caledonia balance of payments occurred in the early 1980s, in the context of a sharp downturn in export earnings from nickel. From that point on, official transfers to the New Caledonia government, together with government spending directly funded from Paris, quickly moved to equal export earnings. Apart from the short-lived export booms of 1988 and 2006, this French Government funding of the local economy has remained a mainstay of its import capacity for nearly thirty years. (In the past decade, foreign direct investment in major new smelters and mine development has both caused and funded a steep increase in total imports, but as investment projects are completed, this component of total imports is likely to come down again, leaving per capita imports between $10,000 and $15,000.)

3. What sort of region is the Pacific?

A region is generally defined as a set of geographically-contiguous territorial units bound together by some common characteristics. Figure 10 contrasts two ways in which the economic dynamics within a region can operate, on the basis of whether the biggest

gravitational attraction for trading and policy interactions lies within the region (a "centripetal" dynamic) or outside it (a "centrifugal" dynamic.

Figure 10: Two patterns of economic and political gravitation

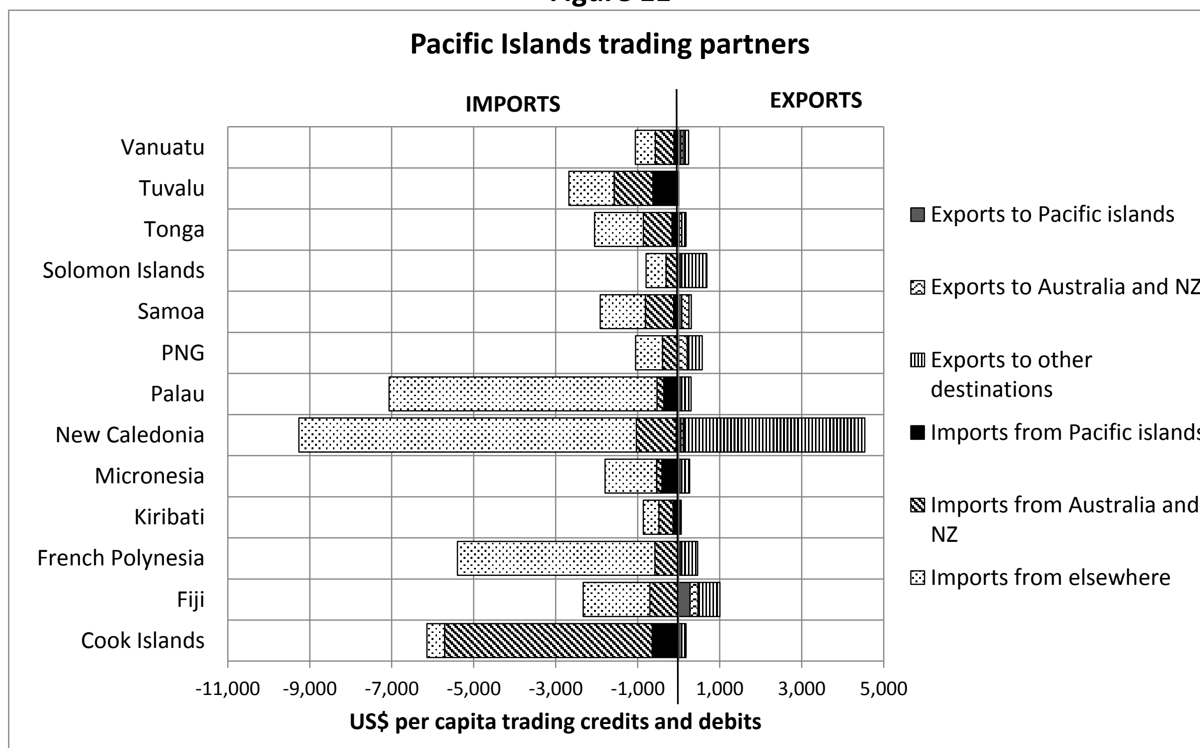


Centripetal regions such as the United States and the EU have dense networks of within-region economic interaction, shared history and culture, and success with consolidation of central governing arrangements to pursue a common purpose. Regional integration makes obvious sense in that setting because resource endowments, trading opportunities, and common infrastructure needs in a setting of large populations, all point to an inward-focused entity. External transactions with the outside world are secondary, not the prime driving force for the units within the region.

In a centrifugal region, each entity within the region relates more directly with countries outside the region than with its neighbours within the region. Regional dynamics are dominated by the trading and political relations of individual units with powerful patrons and partners in the outside world. The island regions of the Pacific, Caribbean and Indian Ocean all exhibit this centrifugal pattern, especially in regard to their trading relations. These collections of small entities scattered across oceans form "regions" only in the weak geographical sense of shared space, combined in the Pacific and Caribbean with strong ethnic and cultural affinities. What is ;lacking is the strong internal gravitational forces that pull continental regions with large populations together and deliver large gains from freer trade.

As Figure 11 shows, not only do Pacific island countries run large trade deficits (the "jaws effect"), but virtually all their exports go to destinations outside the Pacific island region, mostly further afield than Australia and New Zealand. Although Australia and New Zealand loom larger as suppliers of imports to the Cook islands and Tuvalu, most of the countries in Figure 9 draw their imports from further afield.

Figure 11



Note: Imports are shown here as negative exports to make the trade balance easier to see.
Source: Data from the World Bank's 'World Integrated Trade Solution' website at http://wits.worldbank.org/countrystats.aspx?lang=en accessed 25 August 2017.

Figures 12 and 13 show import and export data separately, reinforcing the point that regional trade integration among the Pacific islands has made effectively no headway to date. Aggregating the 13 economies into Table 1 shows that only 4-11% of their exports go to other Pacific islands, and only 2-4% of imports are sourced from other islands in the region (the higher figures result if PNG is excluded from the calculation).

Table 1: Destinations of exports and sources of imports for 13 Pacific Island economies, %

	Exports to Pacific islands	Exports to Australia and NZ	Exports to other destinations	Imports from Pacific islands	Imports from Australia and NZ	Imports from elsewhere
All 13 economies in Figure 5	4%	26%	70%	2%	29%	69%
Region excluding PNG	11%	9%	80%	3%	21%	76%

Source: as for Figure 5.

Figure 12

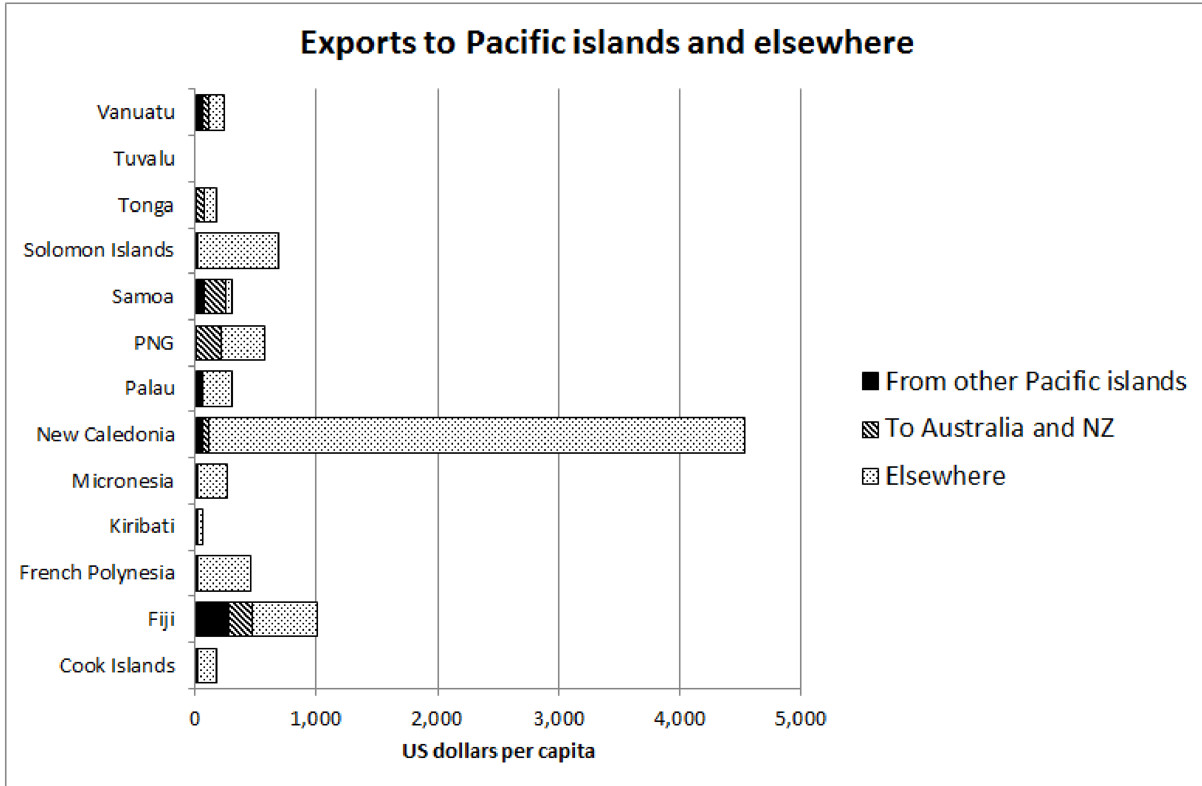
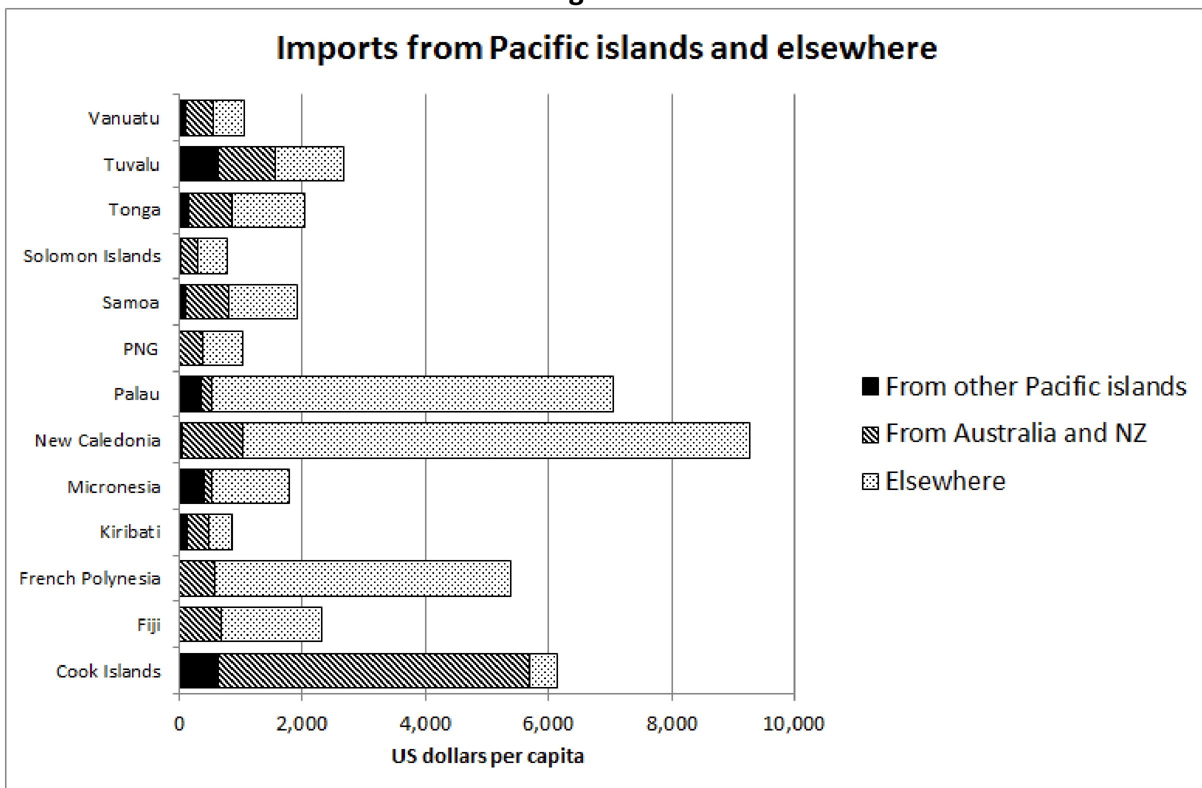


Figure 13



It is because of the lack of centripetal economic and political opportunities that efforts at regional integration have not borne fruit in the Caribbean and the Pacific, despite half a century of attempts since decolonisation began. Rather than drawing together as unified

wholes, these island regions have remained fragmented amongst different externally-linked spheres of metropolitan influence, exercised from outside the island space. In the Pacific France, Australia, New Zealand, the United States, Japan and China provide the key reference points for both trade and political linkages. From these metropolitan economies come financial transfers, direct investment, technical assistance, migrant remittances and political leadership, as well as demand for the export commodities of New Caledonia, Solomon Islands, Marshall Islands and American Samoa. It is to the metropolitan states that most islander migrants go. The resulting constellations of economic transactions emerge from straightforward mutual interests mediated through global markets and institutions, within long-standing spheres of influence laid down in the nineteenth and early twentieth centuries.

There is therefore serious doubt about the effectiveness and underlying purpose of the much-hyped so-called "free trade agreements" such as PACER-plus – not simply the fact that they have been driven by Australia and New Zealand as a means to consolidate their regional power and influence, but more generally the lack of obvious economic (as distinct from political) payoffs for the region's small island economies.

There is no realistic prospect of island states in the Pacific replacing their historically-grounded external linkages with a dense regional network of interconnections among complementary economies. The island economies are too similar in their resource endowments to get big gains from trade amongst themselves; the gains from trade and other economic interactions require exchange with larger outside units. Changing patrons is always a possibility, but doing without bilateral external links is not.

Crocombe (2007), documenting the recently rising power and influence of China and Japan in the Pacific islands, commented that a primary role for regionally-integrated institutional organizations of Pacific island governments is not so much to build within-region economic interaction, as to mediate in bilateral exchanges with outside powers, in the attempt to add at least a little more strength to the island nations' inherently weak bargaining positions:

> A concern for the Islands is which activities will be best dealt with bilaterally with Asian nations, which through regional organizations, and which through or in association with thirds parties: at present mainly Australia and New Zealand in the South Pacific and the USA north of the equator. Most governments prefer to deal directly but few are equipped to do so. The rhetoric of working regionally is stronger than the reality, and some who agree to work regionally work bilaterally behind the scenes….. So small countries often seek the help of larger partners who are prepared to help, or see it as in their long-term interest to do so. (Crocombe 2007 p.469).

The admission of New Caledonia and French Polynesia to full membership of the Pacific Islands Forum in September 2016 brought the Forum up to eighteen full member states, six observer states, one associate member, five observer institutions, and eighteen "dialogue partners" including France. The issue of whether French entry to the Forum would make

any difference to the lack of results over half a century of attempts to promote regional economic integration drew the following comment from the Fijian economist Kaliopate Tavola (Pareti 2017):

> [R]egional cooperation has been undermined by high costs, lack of benefits to members due to regionalism being voluntary and due as well to members' great diversity of interests, in resources, economic strengths and degree of integration into the global economy…
>
> …[R]egional market integration has not been successful – see e.g. … SPARTECA, PARTA, PICTA, PACER and PACER-Plus…. [T]he pooling of resources for regional service has floundered in a number of high-profile regional projects, e.g. Air Pacific, the Forum Shipping Line etc;
>
> [D]eepened regional integration has not taken root at all. Will the incorporation of France in Pacific Regionalism mark the death of decolonization efforts? Or will it signify an historic change in the approach to decolonisation?

For New Caledonia, moving to a fully-autonomous, prosperous existence within a self-sufficient regional economy is not an option. Relationships with the outside world beyond the Pacific will remain dominant, and policy options will involve balancing alternative external patrons. Neither Australia nor China has obvious advantages over France as patron, so the first step must surely be to get the best possible results out of the relationship with metropolitan France.

Economic history suggests that no significant economic gains would follow independence from France, though there may well be political and cultural gains for the Kanak people. Whether there would be economic <u>losses</u> from independence is less clear, because of uncertainty about whether France would continue to provide financial support and whether an alternative patron might emerge. The choice is really about which patron to prefer – not about escaping altogether from any patron – and how to identify the institutional arrangements that gain for New Caledonia's population the greatest possible gains from the patronage relationship.

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