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**THE PERFORMANCE AND
PROSPECTS OF THE PACIFIC
ISLAND ECONOMIES IN THE
WORLD ECONOMY**

by
A. P. Thirlwall



EAST-WEST CENTER

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1991

A report for the Pacific Islands Development Program,
as a contribution to its research project on
The Role of the Private Sector in
Pacific Islands Development

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Biodata

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INTRODUCTION

Every country is concerned with its level of economic and social development, and with its economic performance, both absolutely and relative to other countries in the world economy. The Pacific Island Economies (hereafter, PIEs) are no exception.¹ How have the PIEs fared in the turbulent years of the 1970s and 1980s, and what are their prospects for growth and development in the 1990s? The analysis to follow will address these issues, as far as the data will allow. Three themes will run through the report:

1. the comparative performance of the PIEs themselves;
2. the performance of the PIEs relative to other developing economies, and particularly relative to other small low income countries. (Small economies measured in terms of population size and purchasing power have problems peculiar to themselves.)
3. the relationship, or link, if any, between the performance of the PIEs and trends in the world economy relating to such factors as world output growth, world trade growth, and commodity price trends and fluctuations.

The study will be divided into seven parts:

Part I will give a statistical picture of gross domestic product (GDP), and per capita income, of the PIEs relative to other developing economies, including small economies with a population size of less than one million.

Part II will contain a brief overview of the performance of the world economy in the 1970s and 1980s as a background to Part III.

Part III will be concerned with the performance of the PIEs in the 1970s and 1980s in terms of a variety of macroeconomic indicators including: the growth of output; investment (including direct investment from overseas); exports and imports; the balance of payments; the terms of trade; and inflation. Particular attention will be focused on whether any discernable relationship exists between investment and growth, and between export per-

formance and growth. Economic theory suggests that there should be such a relationship. On the other hand, these island economies, dominated by the production and export of primary commodities (and sometimes affected by political upheaval), may be subject to such supply shocks that no statistical relation is observable. This is a matter for inquiry.

Part IV will attempt to examine the extent to which the functioning of the PIEs appears to be affected by the performance of the world economy. In other words, are the cycles observable in the world economy mirrored in the performance of the PIEs, or do the PIEs function largely independently of trends in the world economy? It is well established, for example, that world trade growth and the growth performance of developed, industrialized countries are closely linked. Is there a similar link between world trade growth and the growth of the PIEs?

Answers to these questions will also be important in helping to answer the question posed in Part III of whether growth is demand-led by investment and/or exports or determined primarily by erratic shocks in supply.

Part V will look at the structure and direction of Pacific Island trade, with particular emphasis on the changing direction of trade in the 1980s. This type of information is important for knowing what is happening to the magnitude of intra-Pacific Island trade; whether Pacific Island exports are being directed to the fastest growing markets, and whether trade agreements such as SPARTECA are having any noticeable effect on the pattern of trade. In this section, we shall have things to say about the future prospects for exports; about the importance for economic development of countries moving out of the production and export of basic raw materials into the processing of manufactured goods, and about the wisdom of free trade for structural change particularly in small economies without a large domestic market to reap economies of large scale production. Economic theory indicates several legitimate (economic) arguments for protection for the maximization of social welfare.

Part VI will examine more closely the export and balance of payments performance of the PIEs in relation to movements in commodity prices, and the extent to which changes in export earnings have been dominated by price or volume changes. The perni-

cious and wasteful effects of violent swings in primary product prices will be highlighted, and the ways in which these may be compensated for either at the national or international level. The use made by the PIEs of the IMF's Compensatory Financing Facility and the EEC Stabex Scheme under the Lomé convention will be looked at.

Part VII will give some forecasts for the world economy in the 1990s, made by the National Institute of Economic and Social Research (London), the IMF, UNCTAD and the World Bank, and attempt to assess the prospects of the PIEs in the light of these forecasts, drawing where possible on the statistical analysis of the previous sections.

I

COMPARATIVE INCOME LEVELS IN THE PACIFIC ISLAND ECONOMIES

For data on gross domestic product and income per head, we rely primarily on figures collected and published by the World Bank.² The statistics for 1987 (together with estimates of the population) are given in Table 1 (measured in \$US at current prices).

In terms of the value of output produced, by far the largest economy is Papua New Guinea, followed by Fiji, the Solomon Islands, and Vanuatu. In terms of income per head, however, the positions of Fiji and Papua New Guinea are reversed, with Fiji registering a level of living standards more than double that of Papua New Guinea. Income statistics for developing economies with a large subsistence or non-monetized sector must, of course, be treated with caution, but the relative ranking of countries indicated in Table 1 is probably broadly correct. Aggregate figures for per capita income also say nothing about the distribution of income between households or classes of people in different sectors of an economy, which is also important as a determinant of welfare. In the case of the PIEs, it is difficult to make any judgment in this regard since little, if any, information exists on the distribution of income. This may be a major topic for future research.

The average per capita income for the PIEs as a whole is approximately \$US 800. This puts the PIEs somewhere between the 42

Table 1: GDP and Income Per Head for the Pacific Island Economies, 1987 (\$US)

	GDP (\$US million)	Income Per Head	Population
Fiji	1,139.04	1,570	725,500
Papua New Guinea	2,424.31	700	3,463,300
Solomon Islands	122.64	420	292,000
Vanuatu	122.52	845	145,000
Western Samoa	89.10	550	162,000
Kiribati	32.50	480	67,700
Tonga	68.26	720	94,800
Cook Islands	34.44	2,014	17,100

low income countries identified by the World Bank with an average per capita income of \$290 per annum and the 34 lower middle income countries with an average per capita income of \$1,200 per annum. The World Bank data also allows a comparison between the PIEs and other economies with populations of less than one million. The data for some of these countries are given in Table 2.

There are other small islands for which data are not available or published, but they are estimated by the World Bank to have per capita incomes in the lower-to-upper middle income range. The data suggests, therefore, that apart from Fiji, the average living standards in the other PIEs are relatively low compared with many other small economies.

If we look at the list of countries in Table 2, however, one obvious explanation for this is that most of the richer countries with income per capita in excess of \$1,000 are basically tourist resorts in close proximity to the large markets of the United States and

Table 2: Per Capita Income and Population for Countries with Less Than One Million People, 1987

	Per Capita Income (\$US)	Population
Guinea-Bissau	160	922,000
Gambia	220	797,000
Sao Tomé and Príncipe	280	115,000
Maldives	300	192,000
Comoros	370	426,000
Guyana	390	797,000
Cape Verde	500	344,000
Swaziland	700	712,000
St. Vincent and Grenadines	1,000	120,000
Belize	1,240	176,000
Grenada	1,340	100,000
St. Lucia	1,400	142,000
Dominica	1,440	80,000
St. Kitts and Nevis	1,700	44,000
Suriname	2,270	420,000
Antigua and Barbuda	2,540	83,000
Seychelles	3,120	67,000
Malta	4,190	345,000
Cyprus	5,200	680,000
Barbados	5,350	254,000

Source: World Development Report, 1989.

Europe. Without tourism, many of these countries would be extremely poor.

This raises the general issue of the obstacles faced by small countries in the growth and development process, compared to countries of larger size. Firstly, there is a general tendency for small countries to be more highly specialized and less diversified than larger countries which makes them more vulnerable to both internal and external shocks and outside influences. Specialization may be partly the result of natural factors (god-given comparative advantage) relating to a narrow range of natural resource endowments, and partly a function of production disadvantages in other activities associated with the small size of market when production is subject to economies of scale. This leads on to the second major reason why small countries may suffer a development disadvantage. In many activities, particularly infrastructure projects and manufacturing, production is subject to scale economies which means that profitable and competitive production depends on the scale of population or the size of market. Because of indivisibilities in the use of capital, for example, there are large economies of scale involved in the provision of infrastructure—such as roads, public utilities, public health facilities, etc.—which only become “economical” to provide when population has reached a certain size, yet many of these types of infrastructure are vital to the development process and the productivity of other activities depends on them. In the case of most manufactured goods, costs per unit of output fall as output increases because of the ability to reap technical, financial, and risk-bearing economies. In the development history of the now industrialized countries, the export of goods was invariably based on a large home market which enabled the goods to be marketed competitively. Without a large home market base, it is always going to be extremely difficult for the PIEs to market abroad a large range of processed goods, at least in competition with larger economies, except in the field of highly specialized or “niche” products. Thirdly, to the extent that small economies are island economies and geographically remote, which many are including the PIEs, transport and communications can present formidable obstacles to the competitive production and export of goods, not the least by raising the transport costs of inputs and outputs. All these obstacles must be borne in

Table 3: Gross Domestic Product by Economic Sector (%)

	Primary Production	Manufacturing	Transport, Utilities, Construction	Services (including retailing)	% GDP Exported
Fiji	25.0	11.0	32.5	31.5	40
Papua New Guinea	43.5	9.1	9.3	38.1	49
Solomon Islands	47.9	4.7	12.2	35.2	83
Vanuatu	23.0	4.7	14.1	58.2	66
Western Samoa	34.2	13.0	6.4	46.4	62
Kiribati	17.9	2.1	23.1	56.9	102
Tonga	22.9	9.2	16.1	51.8	78
Cook Islands	12.8	5.1	17.0	65.1	n.a.

Source: South Pacific Commission, *South Pacific Economies: Statistical Summary*
No. 11, 1987.

mind in considering the development potential and prospects of small (island) economies in general, and the PIEs in particular.

We conclude this section with a brief summary of the structure of production in the PIEs. Table 3 shows the distribution of the GDP between the production of primary commodities, services, and manufactured goods, plus the proportion of GDP exported.

Two things stand out from Table 3. The first is the very low proportion of total output contributed by the manufacturing sector (although this is growing quickly in some of the islands, such as Fiji and Tonga). The second is the high proportion of GDP exported, which is indicative of the level of specialization in production. Moreover, over 90 percent of the value of exports comes from the primary sector. While agriculture and primary exports are important in the early stages of development (for the purpose of what Marx once called "primitive accumulation"), primary production alone cannot provide the basis for sustainable long-run development. Only three countries in the world have ever become "rich" based on the development of primary products alone—namely, Australia, New Zealand, and Canada—but they were blessed with exceptional natural resource endowments and a very low population to resource ratio giving the potential for scale economies through extensive "cultivation," (countries "born free" as Rostow once described them³). If history has any lessons to teach, it is that there must be structural change in favor of a higher proportion of output and exports coming from the non-primary

sector if countries are to achieve high levels of per capita income without unemployment. The crucial question is how to bring about this structural change as expeditiously and as efficiently as possible. Structural change can be highly disruptive for a small island economy with its narrow economic base. What is required is a balanced growth strategy which consolidates the traditional commodity base but at the same time encourages new areas of activity such as high value niche products. We will return to this question in Section V when the issue of trade strategy is discussed.

II

THE PERFORMANCE OF THE WORLD ECONOMY IN THE 1970s AND 1980s

The decades of the 1970s and 1980s were punctuated by three major shocks to the world economy, the effects of which still linger and which continue to affect adversely the functioning of the world economy and the development process in many developing countries, particularly in Africa and Latin America. The first two shocks were the explosion of oil prices in 1973 and 1979; the third, and related, shock was the debt crisis which was building up in the late 1970s and which came to a head in the summer of 1982 when Mexico announced the suspension of debt repayments of dollar denominated loans to the private banking system and sovereign lenders. The effect of the first oil shock in December 1973, when OPEC raised the price of oil by 400 percent, was a massive transfer of purchasing power away from the oil consuming countries in favor of the oil producing countries. This directly and automatically reduced the demand for domestically produced goods in the oil consuming countries, initiating deflationary tendencies throughout the world economic system since the oil producing countries were unable, largely through a lack of absorptive capacity, to use their surpluses to buy an equivalent amount of industrial goods. At the same time, governments of the oil consuming countries introduced deflationary policies both to cut imports to protect their balance of payments and to contain the rate of inflation. The end result was a marked slowdown in the growth of world trade and output. In the ten years prior to 1973 world output grew on average at 5 percent per annum, and expanded by 5.9 percent in 1973. In 1974, growth slowed to 1.9 percent, and in 1975 to a mere 0.5 percent. There was some recovery between 1976 and 1978 before the second oil price rise in 1979.

The surpluses accumulated by the oil producing countries were largely deposited in the western banking system through the Euro-dollar market. The banks, flushed with liquidity, were anxious to on-lend and did so with alacrity to the developing countries with minimal risk analysis and often with each bank not knowing what others were doing in the same country. The developing countries