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NEW DEVELOPMENTS IN TRADE AND ECONOMIC COOPERATION AMONG PACIFIC ISLANDS FORUM MEMBERS

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Prepared for ***Pacific Update 2001***
Brisbane, 18 July 2001

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At their meeting on 27-28 June 2001 in Apia, Samoa, trade ministers from the 16-member Pacific Islands Forum endorsed two trade and economic cooperation agreements: a Pacific Agreement on Closer Economic Relations (PACER) applying to all 16 Forum members, and a Pacific Island Countries Trade Agreement (PICTA) between the 14 Forum Island Countries (FICs).[1] These two agreements will now be forwarded to Forum Leaders' meeting in Nauru in August 2001, with the Ministers' recommendation that they be formally approved and signed.

The purpose of this paper is to briefly summarise the process which has led to the finalisation of these agreements and to outline their main provisions.

I.

The concept of trade integration in the Forum region was first raised at the inaugural South Pacific Forum in August 1971. After a number of false starts, the process leading to the negotiation of the PACER and PICTA agreements was launched in 1998 with the commissioning of a report on free trade options for the FICs. This followed a mandate provided at the Forum Economic Ministers' meeting in Cairns in 1997.

The resulting report (Scollay 1998) considered the proposal for a free trade area among the FICs in the context of a commitment already made by the FICs to the gradual liberalisation of their trade policies, as part of their response to the emerging trend of globalisation. It noted the obvious facts of the small size and limited production base of the FIC economies, the low level of existing trade among the FICs, and the limited potential for increase in that trade. These observations led inevitably to the conclusion that the economic effects of a free trade agreement among the FICs are likely to be very small. This conclusion was supported by rudimentary quantitative analysis based on available data, which also indicated that while these economic effects are likely to be positive for the majority of FICs, they could actually be negative in some cases. It was further shown however that in these cases the combination of a free trade area among the FICs with ongoing reduction of external (MFN) tariffs would ensure a positive impact on economic welfare.

The projection of a very small economic benefit to the FICs from a free trade area among themselves reflected both the limited potential for increased trade between the FICs, and the likelihood that a significant part of this increased trade could represent trade diversion rather than trade creation.[2] Not unexpectedly a separate analysis (Stoeckel et al. 1998) showed that the FICs might derive larger economic benefits from a free trade arrangement linking them with Australia and New Zealand. Since Australia and New Zealand account for a significant share of the trade of most FICs the potential for trade diversion would be correspondingly reduced. As a logical extension of this analysis a further report (Scollay and Gilbert 1998) indicated still larger benefits to the FICs could be anticipated from non-discriminatory or MFN liberalisation of their trade barriers.

More comprehensive liberalisation would however impose much larger short-term adjustment costs on the FICs. In addition to the adjustments arising from the exposure of FIC producers to sharply increased competition, loss of tariff revenue was a serious concern for a number of FICs for whom tariffs

[1] The 14 FICs are Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Nauru, Niue, Palau, Papua New Guinea, Republic of the Marshall Islands, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu. The remaining two Forum members are of course Australia and New Zealand.

[2] Trade diversion occurs when purchases of imports are diverted from more efficient non-partner countries to less efficient partner countries, purely because of the preferences available to the latter under the trade agreement.

represented a substantial proportion of government revenue. Scollay (1998) for example reported that tariffs represented 64% of total tax revenue in Kiribati, 57% in Vanuatu, and 46% in Tuvalu. Dependence on tariff revenue is clearly a major constraint on trade liberalisation, since no government can contemplate a sudden collapse of its revenue. One solution of course is to restructure tax systems so as develop alternative sources of revenue and thus reduce the dependence on tariffs for revenue purposes. Most FICs have either already moved or are considering moves in this direction. Several have introduced a value-added tax as a means to broaden their revenue base, and others are also contemplating the introduction of either a value-added tax or some other broad-based consumption tax. In addition, improvements in tariff administration and modernisation of customs procedures can be and are being made to improve the revenue flow derived from any given tariff structure, for example by reducing the extent of under-collection of tariffs. Nevertheless it will take some years for the restructuring of FIC tax systems to reach the stage where all FICs will be ready to consider removing tariffs on a substantial part of their trade. In the meantime a free trade agreement among the FICs, precisely because the affected trade flows are expected to remain so small, has much less significant implications for government revenue, and is correspondingly more manageable.[3]

Based on these considerations, the conclusion reached in Scollay (1998a) was that, whereas a FIC free trade area could not be justified as an ultimate objective of trade policy, it could nevertheless be useful as a feasible initial step in a longer-term strategy of trade liberalisation, allowing the FICs time to prepare for more comprehensive trade liberalisation. This notion of a FIC-only free trade area as "stepping stone" to wider trade liberalisation was quickly incorporated as an integral element of the FIC approach in subsequent negotiations.

A further conclusion in Scollay (1998a) is that if a decision were to be made to proceed with a FIC FTA, it should be designed so as to minimise negotiating and administration costs. Otherwise these costs will be very likely to outweigh the relatively minor economic benefits likely to come from the arrangement. Scollay (1998) strongly recommends a "negative list" approach whereby trade is liberalised in all products except for a (preferably short) list of exclusions. This is contrasted with the "positive list" or "product-by-product" approach often used in the negotiation of FTAs between developing countries, which tends to be very intensive in the use of negotiating and administrative resources, especially relative to the share of trade covered by the arrangements. Under the "positive list" approach, furthermore, experience shows that progress in removing trade barriers often slows down quite rapidly as the negotiations widen to take in increasingly sensitive products.

Another strong recommendation was that any FIC free trade agreement should be supported by a strong programme of trade and investment facilitation measures, especially in the quarantine and customs areas. The gains from this may be as or more significant than the gains from removing tariffs between members.

At 1998 meetings of Forum Economic Ministers and Forum leaders, it was agreed that the Forum Secretariat would continue to assist members to develop a framework for achieving a free trade agreement among Forum members. The communiqué of the 1998 Forum meeting noted the agreement of Leaders that "when work on the free trade area framework was sufficiently advanced, a meeting of Forum Trade Ministers be convened to make recommendations to the next Forum".

A draft negotiating text was prepared (Myburgh 1999), based closely on the recommendations in Scollay (1998a). Its principal features were:

[3] Even a FIC-only free trade agreement will cause a significant loss of tariff revenue for some FICs, notably for Kiribati and Tuvalu.

- Tariffs to be phased out over ten years on an automatic timetabled basis, with a slightly longer period to be allowed for small island states (SIS) and least developed states (LDCs).[4]
- Non-tariff barriers to be eliminated as and when they are identified, if necessary through tariffication. This approach was considered preferable to spending resources on developing and negotiating detailed rules to address a problem which is believed to be minor.
- A "negative list" approach to be adopted, with provisions to limit the size of negative lists and gradually phase them out.
- Rules of origin designed to facilitate rather than to restrict trade.
- "Emergency Actions" (antidumping and countervailing measures, safeguard and balance of payment measures) allowed under strict conditions
- An "infant industry" provision included to allow suspension of the agreement for nominated products to allow "infant industries" to develop, again under strict conditions, including an automatic lapsing of the suspension if the development does not proceed within a stated timeframe.
- Principles for conduct of government procurement to be included, although their implementation would be non-binding and on a "best efforts" basis.
- A three-stage dispute settlement process, progressing from consultation to mediation to arbitration.
- The operation of the agreement to be reviewed after five years, and at regular intervals thereafter.

The key considerations in these design features were first, to minimise negotiating and administrative costs so that these offset any positive economic effects as little as possible, as explained above. This was reflected in the automaticity built in to the tariff reduction schedules and especially in the adoption of a "negative list" approach. Second, the provisions on emergency actions and infant industries reflected the vulnerability of the FICs and the need to provide for the possible future evolution of their development strategies. The provisions were intended to ensure that the FICs have sufficient flexibility to deal with unusually severe economic disturbances and to implement fresh development initiatives that may be proposed in future, while at the same time providing sufficient disciplines to ensure that this flexibility is not used to undermine the agreement by re-introducing unjustified protection on a discretionary basis. Third, it was intended that the agreement be compatible with the WTO obligations of FIC WTO members. Fourth, and relatedly, the agreement was designed as a genuine trade liberalisation initiative, and this was reflected in its wide coverage, the relatively liberal rules of origin, and the automaticity of its provisions.

The economic arguments in favour of this last point are not necessarily clear-cut. Laird (1999) points out that in the case of a trade-diverting agreement it might be preferable to keep the coverage of the agreement as narrow as possible, to minimise the economic damage caused by trade diversion - and there are some grounds to be concerned about possible trade diversion in a regional trade agreement comprising the FICs, as noted earlier. However since such a regional trade agreement is regarded as no more than a step in what is intended to be a more comprehensive liberalisation process, it was felt that the arguments in favour of wide coverage should prevail. It was also considered that this should not be regarded as a threat to the development process in the FICs, in view of their very narrow production base, which means that there are relatively few industries or potential industries which will be placed under pressure by the dismantling of protection. These relatively few cases can be readily accommodated under the "negative list" provisions. Future development of new industries was addressed in the "infant industry" provision.

[4] FICs designated as small island states (SIS) are Cook Islands, Kiribati, Nauru, Niue, Republic of Marshall Islands, and Tuvalu. FICs designated by the United Nations as least developed countries are Kiribati, Samoa, Solomon Islands, Tuvalu and Vanuatu

Following completion of the negotiations for establishment of the free trade area, it was envisaged that detailed proposals would be developed and implemented for trade facilitation measures to accompany the FTA, particularly in the quarantine and customs areas.

Forum Trade Ministers met in June 1999, and agreed to recommend to Forum that "Leaders endorse in principle a free trade area among Forum members based upon the draft framework agreement". Possible later extension of the agreement to cover services, and to include the French and United States Pacific territories[5], was also mooted. The Leaders in turn "endorsed in principle a free trade area among Forum members noting that this would be implemented in stages over a period of up to 2009 for developing Forum Island countries (FICs) and 2011 for the Smaller Island States and Least Developed Countries." The 1999 Forum "tasked the Officials to negotiate the details of the draft Agreement, including negative lists and measures to provide for the application of the arrangements to Australia and New Zealand."

II.

The requirement for "measures to provide for the application of the arrangements to Australia and New Zealand" obviously reflected a concern for Forum unity, and a corresponding desire for an arrangement which included all Forum members. At the same time it introduced an additional layer of complexity into the situation.

In the first place, the FICs were clearly not ready to enter immediately into a free trade agreement with Australia and New Zealand. Since the FICs already have duty free access to the Australian and New Zealand markets under SPARTECA, this would have meant reciprocal extension to Australia and New Zealand of duty free access to FIC markets. Under the "stepping stone" approach adopted by the FICs, this would be a subsequent step, to be taken at some time after the establishment of free trade among the FICs. "Application of the arrangements to Australia and New Zealand" would therefore have to be on a deferred basis. This of course is not in principle an insuperable obstacle, and various formulations could be proposed to cover the situation, although it would not necessarily be easy to reach agreement on a preferred approach.

However a further set of issues is raised by the need for the "arrangements" to comply with WTO provisions governing regional trading arrangements. Since three FICs are WTO members, the need for consistency with WTO obligations already applies to an FIC free trade area. However, since all FICs are developing countries, a FIC-only free trade area could be notified to the WTO under the so-called Enabling Clause of 1979, which allows free trade areas among developing countries to be formed under somewhat less rigorous conditions than those laid down in GATT Article XXIV, which sets out the general rules for WTO-consistent regional trading agreements covering trade in goods.[6] On the other hand, since Australia and New Zealand are developed countries, any free trade agreement in which they are involved must meet the standards of GATT Article XXIV. Thus an agreement designed to meet the needs of the FICs, and capable of being notified to the WTO under the Enabling Clause, would not necessarily be acceptable to Australia and New Zealand, since it might fail to satisfy Article XXIV.

There is also a thorny set of issues relating to the Article XXIV requirement that free trade agreements involving WTO members must cover "substantially all trade" between the participants in the agreement.

[5] The French Pacific territories are French Polynesia, New Caledonia, and Wallis and Futuna. U.S. Pacific territories are American Samoa, Commonwealth of the Northern Mariana Islands, and Guam.

[6] Regional trading agreements covering trade in services are correspondingly subject to Article V of the GATS (General Agreement on Trade in Services)

In trade among Australia, New Zealand and the FICs, by far the largest trade flow is the bilateral trade between Australia and New Zealand. Thus, although WTO members continue to argue over the precise meaning of "substantially all trade" (see for example WTO Secretariat 2000), it is clear that a Forum-wide free trade agreement could not satisfy any reasonable definition of "substantially all trade" unless the trade between Australia and New Zealand is covered. Yet this trade is already covered by the ANZCERTA agreement, and presumably Australia and New Zealand would not contemplate including this trade within the scope of a new Forum-wide free trade agreement. While it is possible to suggest ways in which the potential overlap between ANZCERTA and a Forum-wide free trade area might be addressed in the WTO context, the lack of consensus among WTO members on the interpretation of Article XXIV (WTO Secretariat 2000) means that it is difficult to make a definitive assessment of the likely acceptability to the WTO membership of any of the possible formulations. At best, it could be anticipated that this overlap would create difficulties in the WTO.

The complications for Forum free trade arrangements posed by FIC trade relations with developed countries are not confined to those involving Australia and New Zealand. While discussions of a Forum free trade arrangement were proceeding, FIC members of the African Caribbean and Pacific (ACP) group of states (the so-called Pacific ACP states, or PACPs)[7], were also facing a demand from the European Union that their existing non-reciprocal preferential trading arrangements with the European Union under the Lomè Convention be converted into reciprocal free trade arrangements, to be incorporated in Regional Economic Partnership Agreements (REPAs). The purpose behind this request by the European Union was to bring its trade arrangements with the ACP states into conformity with WTO rules on RTAs, so that they would no longer require a WTO waiver as in the past.[8]

With the signing of the Cotonou Agreement in 2000 as the successor agreement to the Lomè Convention between the European Union and the ACP states, membership of the ACP group was extended to the six FICs that had not previously been members of that group. Thus all 14 FICs are now also PACPs, and signatories to the Cotonou Agreement. The trade provisions of the Cotonou Agreement[9] provide for negotiation of reciprocal free trade arrangements between ACP states to commence in 2002 and to be concluded by 2007[10], with the existing non-reciprocal arrangements to continue to apply in the meantime.[11] The Cotonou Agreement also provides that where ACP states extend preferences to other developed countries which are more favourable than those they apply to the European Union, those preferences must then also be extended to the European Union.

An implication of the Cotonou Agreement is thus that conclusion by the FICs of a reciprocal free trade agreement with Australia and New Zealand would require them to enter into a similar arrangement with

[7] The original eight PACPs were Fiji, Kiribati, Papua New Guinea, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu

[8] Countries applying for a WTO waiver expose themselves to demands for concessions which other countries will try to extract as the "price" of the waiver. The European Union's application for a temporary waiver for the trade provisions of the Cotonou Agreement, for example, has led to demands for concessions on banana trade issues.

[9] The Cotonou Agreement, like the Lomè Convention before it, also contains extensive provisions on economic and technical assistance.

[10] The European Union has suggested that REPAs should be negotiated with separate sub-groups of ACP states, such as the PACPs. It does not follow that all ACP states will enter into such agreements. The Cotonou Agreement provides for alternative arrangements to be negotiated with ACP states unable to accept European Union's proposed model. Least developed ACPs (including least developed PACPs) can expect to obtain duty-free access to the European Union for virtually all products under the latter's "Everything But Arms" (EBA) initiative, and may accordingly see no need to enter into reciprocal free trade arrangements in order to preserve their market access.

[11] The EU has undertaken to seek a temporary WTO waiver for the Cotonou Agreement to cover the transitional period. This waiver is proving difficult to secure (see footnote 7)

the European Union, if they had not already done so in the meantime. Conversely, although the FICs had no corresponding legal obligation to Australia and New Zealand, it seemed clearly unrealistic to expect that those two countries, as members of and major donors to the Forum, would a tolerate a situation where the European Union received trade preferences over them from their fellow Forum members. It was thus reasonable to anticipate that conclusion by the FICs of a reciprocal free trade agreement with the European Union as envisaged in the Cotonou Agreement would lead inexorably to the need to negotiate a similar agreement with Australia and New Zealand. The latter possibility was the more significant one for the FICs in terms of the adjustment costs they would be likely to face, since the European Union is a relatively minor source of FIC imports[12] whereas Australia and New Zealand account for a major share of the imports of most FICs[13].

The three former United States trust territories – Federated States of Micronesia, Republic of the Marshall Islands, and Palau – also have an MFN provision in their Compact of Free Association (CFA) with the United States, whereby they must not give more favourable tariff treatment to other countries than they give to the United States. Unlike the corresponding provision in the Cotonou Agreement, this provision does not differentiate between developed and developing country trading partners, so that it would be applicable to a free trade arrangements with the FICs as well as to a free trade arrangement involving Australia and New Zealand. The "freely associated states" appear to have some grounds for believing that the United States would be willing to waive its rights under this provision to allow them to enter a free trade agreement solely among FICs, but equally that such a waiver would not be available for a free trade arrangement involving Australia and New Zealand. In any event it is clear that the economic assistance received under the Compacts is of such overwhelming importance to the economies of the "freely associated states" that they would not contemplate entering any arrangement which might jeopardise that assistance.

III.

The two agreements endorsed by the Forum Trade Ministers in Apia in June 2001 provide a structure designed to address the issues and concerns identified in the preceding sections.

The PACER covers the Forum as a whole, and is a framework agreement providing for the gradual and evolutionary development of trade and economic cooperation arrangements among the Forum members. It envisages that this development will proceed at different paces between different members or groups of members of the Forum, depending on the development needs on the members concerned. Although it deals with trade issues, it is explicitly designed not to be a trade agreement in the sense of a preferential arrangement requiring notification to the WTO. It thus does not establish any trade preferences between its members.

Preferential trade arrangements will be covered by separate free trade agreements under the "umbrella" of the PACER. The PICTA will be the first free trade agreement to be established on this basis. As an agreement between developing countries the PICTA may be notified to the WTO under the Enabling Clause. Free trade agreements between Australia, New Zealand and the FICs may be established under the "umbrella" of the PACER at a later date, although the PACER does not contain any stipulation as to the form that such agreements should take, beyond stating that they must be WTO-consistent and conform to the other objectives and guiding principles of the PACER. The PACER is a forward-looking

[12] The European is of course much more important as an export market for FIC producers of certain products, especially sugar, tuna, vegetable oils, and garments

[13] The exceptions to this statement are Federated States of Micronesia, Republic of the Marshall Islands, and Palau

agreement, and as such contemplates that trade and economic cooperation arrangements among the Forum members may eventually be extended to cover services, investment, and other aspects of a single regional market – but only when the members are ready to do so.

The PACER does contain provisions as to the timing of negotiations for Forum-wide free trade arrangements, including Australia and New Zealand. These negotiations are required to commence no later than eight years after the PICTA enters into force[14]. They may however have to commence earlier. If FICs enter into negotiations for free trade arrangements with other developed countries[15] they are then required to provide the opportunity for negotiations of free trade arrangements[16] with Australia and New Zealand. Thus if FICs enter into negotiations for reciprocal free trade arrangements with the European Union, as contemplated in the Cotonou Agreement, this will trigger a requirement for the opportunity to negotiate free trade arrangements to be provided to Australia and New Zealand. Negotiation by the FICs of free trade arrangements with developing countries will not trigger a similar obligation, although the FICs are obliged under the PACER to "consult" with Australia and New Zealand once any such arrangements with developing countries have been concluded.

By way of reciprocal obligation, the PACER requires consultations aimed at improved market access for the FICs if Australia and New Zealand commence negotiations on free trade arrangements with non-Forum countries. Although the FICs already have duty-free access to the Australian and New Zealand markets under SPARTECA, this provision may nevertheless be of some value to them. Improved market access could for example take the form of a relaxation of rules of origin applying to imports from the FICs.[17]

The principal benefit of the PACER to the FICs however is likely to flow from the provisions relating to trade facilitation and financial and technical assistance. The PACER requires the establishment of detailed work programmes on trade facilitation, designed primarily to improve the trading capabilities and opportunities of the FICs. The content of these trade facilitation programmes is to be determined through regular consultations between the parties, based on periodic identification of the FICs' needs. Issues covered by trade facilitation programmes are to include, but need not be limited to quarantine, customs and standards and conformance. Australia and New Zealand are to provide financial and technical assistance for trade facilitation programmes, as well as for capacity building and structural adjustment including fiscal reform measures.

The PICTA broadly follows the outline of the original draft negotiating text described earlier, but with some modifications. Tariffs are to be progressively and automatically reduced according to graduated schedules contained in the agreement. The schedules vary according to the initial level of tariffs, but provide for tariffs to be reduced to zero by developing FICs no later than 2010, and by the small island states and least developed countries among the FICs no later than 2012. Specific and fixed tariffs may be converted to ad valorem tariffs and then reduced according to the relevant schedule, or alternatively

[14] The negotiations may of course commence earlier if the parties so agree.

[15] This provision applies to OECD members. An almost identical provision applies in the case of free trade arrangements countries with a per capita income higher than that of the developed Forum member with the lowest per capita income (i.e. New Zealand). This would include for example Singapore and Hong Kong. The provision does not apply to agreements with non-Forum Pacific Islands (i.e. the French and U.S. Pacific territories.

[16] "Free trade arrangements" here means agreements falling within the definition covered by GATT Article XXIV.

[17] For example, the recent Closer Economic Partnership agreement between New Zealand and Singapore contains more favourable rules of origin than those in SPARTECA. If other trading partners of Australia and New Zealand are able to gain access to those markets on terms more favourable than those available to the FICs (including in terms of rules of origin), this will erode the FICs' benefits under SPARTECA.

reduced in accordance with a separate schedule for such tariffs. Each member may have a "negative list" of "sensitive products" for which protection may be maintained over a longer period. Tariffs on goods on these "negative lists" are to be phased out by 2016. The negative lists are to be finalised prior to the Forum meeting in August 2001 and will be contained in an annex forming part of the legal text. It is anticipated that these "negative lists" will be relatively short. Alcohol and tobacco products are exempted from liberalisation in the first two years of the agreement's operation. This exemption reflects the importance of these products as sources of tariff revenue, and also issues relating to the ownership of the producers of these products in some FICs. A study is being undertaken on the possible integration of these products into the PICTA. Based on the results of this study, a decision will be made at the end of the two-year period as to how and when these products should be included in the PICTA.

Rules of origin under the PICTA will based on a 40% value added criterion, with provision for cumulation of value added between PICTA members. Thus the required 40% value added could be the total of value added in two or more PICTA members. Provision is also made for derogation from the rules where good cause can be shown and where no member is adversely affected. A Rules of Origin Committee will be set up to administer and review application of the rules of origin, and to consider requests for derogation. The Rules of Origin Committee may also propose changes in the Rules, for example if experience shows that the percentage used in the value-added criterion needs to be modified. Satisfactory implementation of the rules of origin will be important to the success of PICTA, and the role of the Rules of Origin Committee will therefore also be important, especially in the early phase of the agreement. Although the Rules necessarily contain considerable detail, it is anticipated that they will be simpler to use and administer than the SPARTECA rules. Exporters familiar with the SPARTECA Rules are not expected to experience difficulty with the PICTA Rules.

In relation to Emergency Action, infant industry protection and dispute settlement, the provisions of the original draft legal text, outlined above, remain essentially intact. The PICTA expressly does not affect rights and obligation under other agreements. Thus for example, a FIC WTO member subject to countervailing duty or antidumping action by another FIC WTO member could insist that WTO procedures be followed rather than those set out in PICTA. Existing preferential agreements between FICs, such as the Melanesian Spearhead Group (MSG) Trade Agreement, may continue to operate if their members so wish. The members of the MSG Trade Agreement could for example decide to liberalise among themselves at a faster pace than provided under the PICTA, or to establish a higher degree of integration among themselves, for example by forming themselves into a customs union.

The PICTA enters into force once it has been ratified by six countries. Once the period allowed for signature of the agreement has expired, FICs who wish to join later will have to apply for accession as new members. The Compact countries are given an additional three years to sign the agreement, in consideration of the special circumstances relating to their arrangements with the United States.

The negotiation of the content of the PICTA, and the administration of the agreement, are entirely in the hands of the FICs, subject only to a general requirement that the PICTA should be consistent with the objectives and guiding principles of the PACER. This points to an often unnoticed benefit of the PICTA to the FICs. The PICTA is providing the FICs with valuable "hands-on" experience in the negotiation and implementation of trade agreements. This experience is likely to serve them well in subsequent negotiations with Australia, New Zealand, the European Union, and possibly other trading partners.

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