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# Institutional Quality and Trade in Pacific Island Countries

By

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## *Executive Summary*

This research examines the impact of institutional quality on trade in selected Pacific Island Countries (PICs). Four indicators of institutional quality are chosen: government effectiveness, rule of law, regulatory quality and control of corruption; for six PICs: Fiji, Kiribati, Samoa, Solomon Islands, Tonga and Vanuatu.

Many of the PICs have been characterised with narrow export structures. Other than Fiji, most countries reveal widening long-term balance of trade deficits. PICs export structure is largely based on land and sea resources while machines and transport equipment form the major imports. In terms of markets, USA, Australia, United Kingdom, New Zealand, Germany and Japan are the main export markets while Indonesia, Korea, China and Thailand are some of the newer export markets.

Maintaining strong institutions and achieving continued improvements in institutional quality have become a core area of policy focus for the PICs. A number of key reports prepared for the region specifically maintain the need to strengthen institutions. However, achievements in institutional quality have been disappointing with several PICs revealing low scores for indicators of institutional quality.

The results of our analysis involving the fixed effects model reveal that institutional quality matters. Our results confirm that *government effectiveness* matters more to importers than exporters while an improved *regulatory environment* positively facilitates increased levels of trade. The results of *rule of law* suggest that the deterioration in rule of law seems to be working against improved exports for the PICs. The results of *control of corruption* variable reveal that the presence of corruption tends to reduce imports significantly. Turning to the trade control variables, the level of *income* is not significant while the results of the *real exchange rate* variable do not provide strong confirmation that the appreciation of exporter's currency facilitates trade. The results of the *technology* variable provide strong support that higher levels of technological diffusion are vital for improved trade. The results of the *trade policy* variable confirm that living with the WTO principles of trade liberalization (tariff reduction) strongly facilitates more trade.

Our results support the proposition that institutional quality is an integral part of enhancing trade for PICs. We can conclude that PICs have problems with the institutions that support or facilitate trade. Exports in all the six countries have not been increasing and in some cases the exports have actually declined. Over the last decade PICs have generally pursued an outward-oriented export led growth strategy. There is now increasing realization that institutional factors may be the missing link. This study clearly points out that the institutional quality in PICs is a significant factor in determining the level of trade. From a policy perspective, PICs would need to improve institutional quality so as to facilitate trade.

## *Abstract*

*This paper examines the export, import and total trade determinants using reduced form equations for six Pacific Island countries with an institutional focus. Controlling for common determinants of trade, four indicators of institutional quality: government effectiveness; rule of law; regulatory quality; and control of corruption are chosen. The fixed effects model, controlling for AR(1) errors, indicates that improvements in institutional quality variables matter for improved levels of trade. The results also provide confirmation the appreciation of  currency does not significantly harms trade; higher levels of technological diffusion are vital for improved trade; and that living with the WTO principles of trade liberalization and becoming more outward oriented strongly facilitates more trade. Some policy implications are drawn.*

# *I. Introduction*

This research examines the impact of institutional quality on trade in selected Pacific Island countries (PICs). Many of the PICs have been characterised with narrow export structures, low levels of economic growth and relative poverty resulting largely from low levels of investment. In addition, poor social and economic infrastructure and high production costs have thwarted financial incentives to attract foreign direct investment which has been relatively low. Several countries in the region also reveal low ratios of exports to GDP.

Weak institutions have been identified by many PICs as a key impediment to investment and economic growth. Recent studies indicate that for countries to fully integrate in the world economy and to benefit from outward oriented trade strategies, the functioning and quality of institutions are important. For example, ill functioning institutions can hinder trade (see Anderson, 2001), bad institutions can reduce the volume of trade (see Anderson and Marcouiller, 2002) and openness and quality of institutions are most likely to exhibit bidirectional causality (see Dollar and Kraay, 2002).

Many of the PICs are struggling to improve the institutional infrastructure but are constrained by lack of appropriate levels of public expenditure in this area. The focus of many of the PICs on trade as an engine of growth requires that they pay particular attention to developing the appropriate institutional mechanisms that support both regional and global integration of the economies. The main benefit expected out of this integration is expected to be enhancement of trade. Appropriate and quality institutions would support the PICs endeavour to enhance trade.

In this paper econometric specifications of export, import and total trade determinants are estimated including both commonly used explanatory variables and a set of indicators of institutional quality. Four indicators of institutional quality are chosen: government effectiveness, rule of law, regulatory quality and control of corruption; for six PICs: Fiji, Kiribati, Samoa, Solomon Islands, Tonga and Vanuatu.

The paper is organized as follows. Section two presents an overview of the trade structure and performance of PICs. Section three presents an overview of institutional achievements. Section four discusses the literature linking institutional quality to trade. Section five discusses the analytical model and provides a theoretical justification of chosen variables. Section six discusses the data. Section seven discusses the estimation procedure and presents the empirical results. Section eight presents the conclusion and policy recommendations.

# *II. Pacific Island Countries Trade Structure and Performance*

We analyse PICs trade structure and performance on the basis of core indicators of trade: export and import shares in GDP; exports and imports of main commodities; and the direction of trade.

## II.I Export and Import Share in GDP

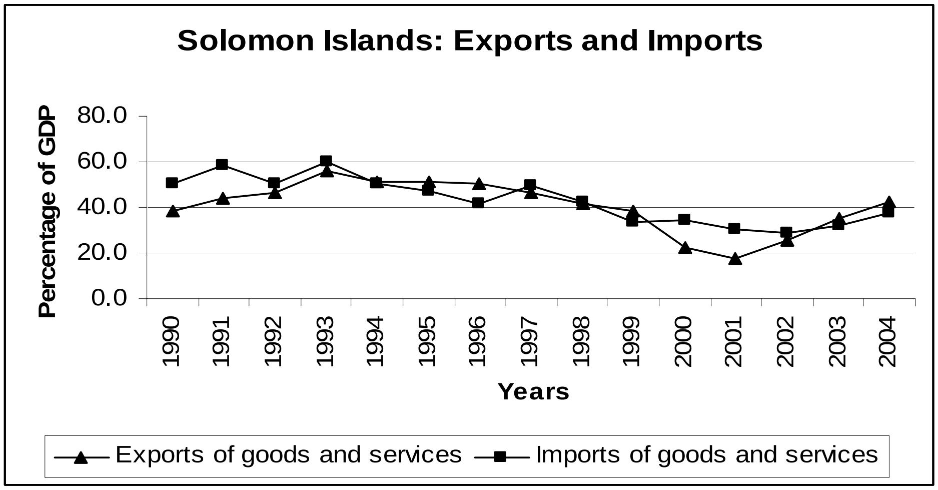
Figures 1 to 6 depict the six PICs exports and imports of goods and services as a percent of GDP for years 1990 to 2004. Over the period, exports of goods and services as a share of GDP were slightly below that of imports of goods and services for Fiji for most of the years between 1990 and 2000. Exports of goods and services surpassed imports of goods and services in the post-2000 period, hence leaving a small trade surplus. On average, exports of goods and services as a percent of GDP for Fiji for the 1990-2004 period was 61 while average imports of goods and services as a share of GDP for the same period were 62. Since 1992, exports as well as import shares in GDP has been on a rising trend.

Figure 1.


Source of data for Figure 1: The World Bank (2006).

Solomon Islands and Vanuatu's exports and imports of goods and services followed a similar pattern to that of Fiji (Figures 2 and 3 respectively). In Vanuatu, exports as a share of GDP averaged 47 percent for the 1990 – 2004 periods while imports as a share of GDP average 59 percent for the same period. A notable feature in Vanuatu is that the country's balance of trade has remained in deficits for the entire period although exports as a share of GDP rose in the post-2000 period.

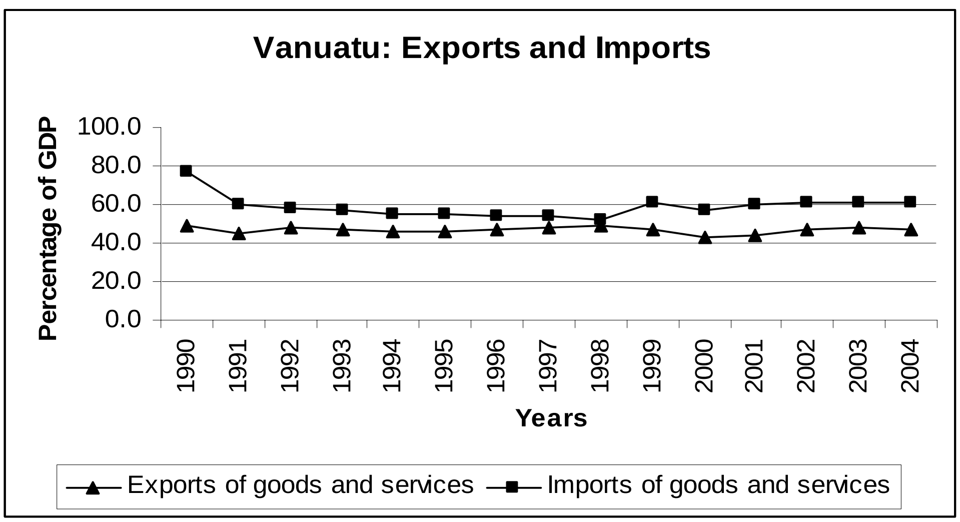
Figure 2.




Source of data for Figure 2: Asian Development Bank (2006).

In the Solomon Islands, exports as a percent of GDP averaged 41 for the 1990-2000 periods while imports as a percent of GDP averaged 43 for the same period. While trade gap has been much narrower than that of Vanuatu, exports and imports as a share of GDP followed a downward trend from 1991-2000. However, the post-2000 period saw an upward trend in exports as a share of GDP as well as imports as a share of GDP.

Figure 3.




Source of data for Figure 3: The World Bank (2006).

Kiribati, Samoa and Tonga reveal huge trade gaps between exports and imports as a percent of GDP for the 1990-2000 periods (Figures 4, 5 and 6). In fact, in Samoa and Tonga, the trade gap has widened in post-2000 period. These three countries have continuously experienced massive trade deficits. Exports as a percentage of GDP averaged 24 in Kiribati; 29 in Samoa; and 19 in Tonga. On the other hand, imports as a percentage of GDP averaged 88 in Kiribati; 61 in Samoa; and 59 in Tonga. Narrow range of export products and rising imports has been the main cause of widening trade gap among these three countries.

Figure 4.


Source of data for Figure 4: The World Bank (2006) and Asian Development Bank (2006).

Figure 5.