36th-parallel

GEOPOLITICS & STRATEGIC ASSESSMENTS

Asia Pacific/Latin America Strategic Architecture Assessment

Part I

Executive Summary

The South Pacific is rapidly becoming an area of economic and political importance. Spanning the waters from the equator to the Southern Ocean between the West Coast of South America and the East Coast of Australia, Papua New Guinea and Indonesia, the region is characterized by great travel distances, a broad range of nation-states, a maritime orientation and previously inaccessible resources. During the last thirty years technological, economic and political change has seen the region emerge as a strategic arena in its own right, with both resident and extra-regional actors now vying for influence and wealth. In this two-part assessment 36th Parallel outlines the major features of the strategic architecture underpinning this evolution.

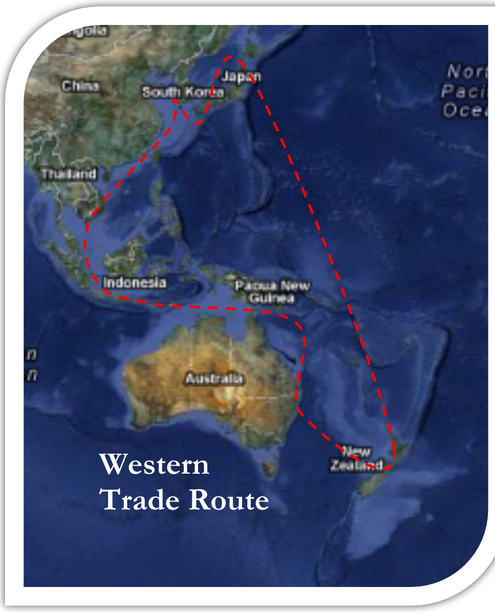
Part One: Introduction and Overview.

Until the late 20th century the strategic importance of the South Pacific was only apparent during wartime. With the revolution in transportation, telecommunication, services, production and exchange that swept the world economy over the last three decades, the South Pacific has increasingly become a region of major economic importance. This includes the sea lines of communication that connect Asia to Australia, New Zealand and the West Coast of South America, as well as the increasingly exploitable natural resources above and below water in Melanesian and Polynesian island states, the open waters between them, as well as along the Eastern and Western South Pacific Rims. With trade and production trend forecasts predicting continued growth in Australasian-South American commerce, the region has assumed previously unknown prominence.

The three main legs of South Pacific strategic architecture are **Trade, Politics/Diplomacy** and **Security**. Although intertwined and overlapped, they can be analytically distinguished from each other. These "pillars" span three distinct sub-regions: the Southeastern Pacific, which extends westwards 2500 kilometers from the South American coast line from the Equator to Chilean Patagonia; the South-central Pacific, which occupies 3000 kilometers of mostly open water between the Equator and the Southern Ocean west of Easter Island to Fiji and Rarotonga; and the Southwestern Pacific, which covers the 2000 kilometers of water and land masses extending from Australia, Indonesia and Papua New Guinea to Fiji and the Cook Islands (distances approximate).

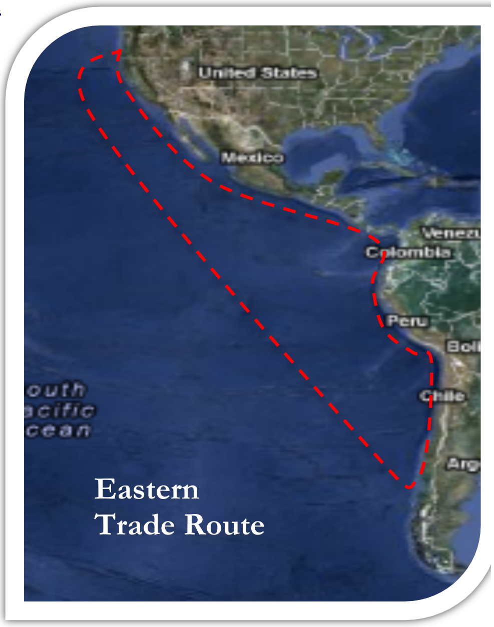
The pillars of the architecture can be respectively sub-divided into **Production**, **Commerce** and **Services**, (with regard to trade), regime type and stability, local political culture and foreign relations (with regards to politics and diplomacy); and enforcement authority and armed force (with regard to security).

There are three major trade routes that cross the region. **The Western** trade route covers the north-south sea and air-lines of communication between Japan, China and South Korea through Singapore, Jakarta, Sydney to Auckland. **The Eastern** trade route extends north-south from Chile to the Panama Canal and west coast of North America and includes the major ports of Valparaiso (Chile), Callao (Peru) and Guayaquil (Ecuador). **The Northwest/Southeast** route traces its course from East Asia to the South American west coast via the South-central and South-eastern Pacific. A fourth budding trade route, the **Southwestern/Southeastern** route from Sydney-Auckland to the South American ports, is expected to increase in importance in the next twenty years.



Western Trade Route

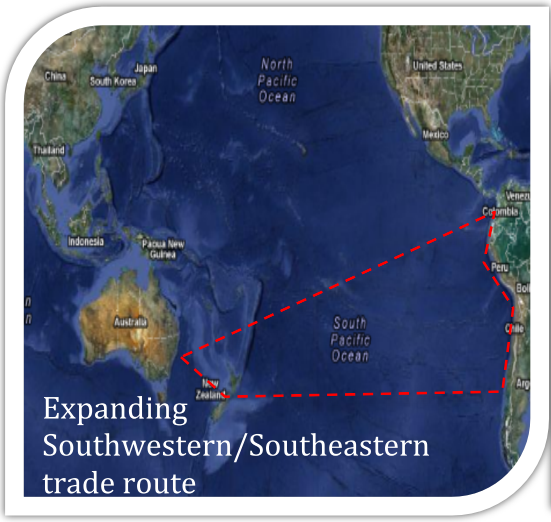
Within each of these trade routes are a number of sub-routes such as those that connect Singapore to Santiago and Auckland to Shanghai. The volume of trade on all of these routes, be it measured in value of goods transported, tonnage displaced, or percentage of imports/exports exchanged, has risen exponentially in the last decade in spite of the 2008-09 recession (with East Asian-South American trade increasing over 100 percent from 2001-2011). Asia-Pacific trade is predicted to continue to grow at sustained rates for the next two decades.



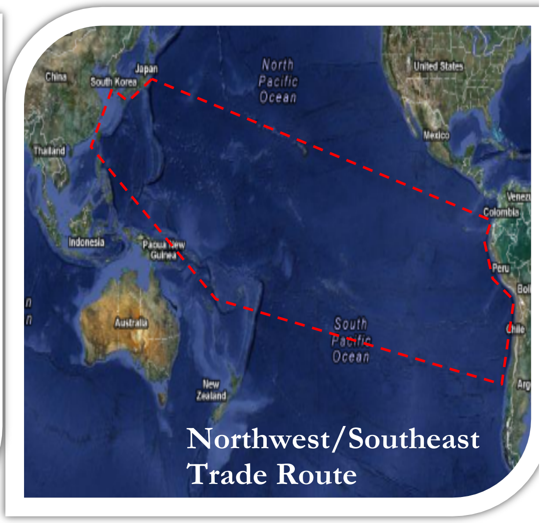
Eastern Trade Route

As of the early 2000s China has replaced Japan as South America's largest Asian trading partner, with South Korea also a significant player in trans-Pacific commerce.
Likewise, China has become the largest trading partner of Australia and New Zealand, and is increasing its commercial and diplomatic presence throughout the South Pacific. South American exports to East Asia rose from 9.7 percent of total exports in 2001 to 23.4 percent in 2011, while imports from East Asia to South America rose from 13.4 to 24.6 percent during that time period. Over those ten years the overall share of world trade between the two regions rose from 11.5 to 24.0 percent (source: Asian Development Bank). Current aggregate trade between Australasia and South America is worth in excess of 500 million US dollars/year.

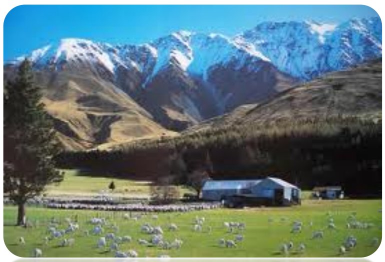
In parallel with the growth in trade has been an increase in Asian foreign direct investment (FDI) in South America and the Antipodes. Most of the increase is the result of Chinese FDI in a range of primary industries, although Korean, Japanese and Singaporean capital is also present in Latin America.



Expanding Southwestern/Southeastern trade route



Northwest/Southeast Trade Route



Although the US continues to be the main trading and investment partner for most Latin American states, China is on its way to overtaking the US in both areas by 2020.

The boom in Australasian-South American commerce is brought about by two factors: the rapid growth of Asian and some Latin American economies, which has led to an expanding middle class hungry for consumer durable and non-durable consumption; and the rise in commodities prices world wide as a result of increased demand brought about by Asian-fueled growth. Australia, New Zealand and South America are commodity exporters, mostly in primary goods and raw materials such as minerals, grains and forestry (with some value-added agricultural products like milk solids and wine in the mix). Asian demand for those commodities continues at a sustained rapid pace, although the aggregate value of commodity exports in the South Pacific exceeds the increase in volume of these goods (again, due to high commodity prices).

Value-added exports from Asia to South America continue to rise, although at levels slightly below those of South American primary good exports to Asia. This has had a negative impact on some South American manufacturing sectors (consumer non-durables in particular). That has led to calls for protectionist measures for these industries as well as a diversification of South American holdings into services as well as value-added agriculture. The importance of the trade imbalance is due not only to the asymmetries involved and the susceptibility of commodity exporters to international price fluctuations, but also to the uncertainties of political competition in some states where nationalist sentiment is very strong. This is particularly true for Ecuador and Peru.

The impact of increased volumes of South Pacific trade has placed strong pressure on infrastructure as well as regulatory and enforcement mechanisms. Capacity limits at ports, poor road and train networks, and lack of skilled labor have contributed to inefficiencies in the commodity chains binding the region's East and West flanks together. The demand for skilled labor in the Antipodes and South America has produced labor market distortions along with a rush of legal and illegal migration to production centers. The absence of infrastructure has created logistical and transportation logjams at the same time that it creates opportunities for investors in those sectors.

The 2008-09 recession alleviated some of the pressure on South Pacific infrastructure, but in the ensuing years of slow rebounding growth the maritime and airfreight over-capacity built up prior to 2008 has had negative consequences on shipping rates and consequently transportation sector profits. Although Trans-Pacific trade volumes have returned to robust positive figures and the value of imports and exports has risen concomitantly, freight rates can be expected to continue to be below their 2007 levels for the next two years. Should the Australasian-South American economic "rebound" continue at a modest rate (two percent per year) with its attendant increase in demand on both commodity and value-added production, then shipping capacity limits can be expected to return to pre-2008 values by 2015 and prices will be adjusted accordingly. However, shipbuilding will lag until the rebound is fully established as a new period of sustained growth. . Air cargo services will extract premium rents until increased maritime capacity becomes operational.

REGULATORY CONTEXT.

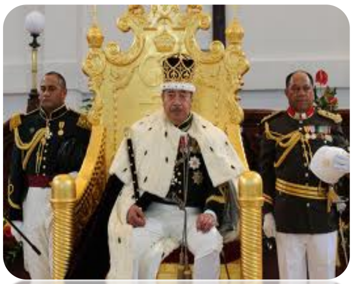
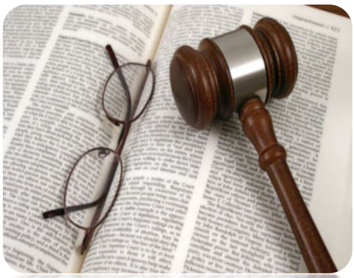
One significant aspect of the South Pacific strategic architecture is the absence of effective regulatory and enforcement mechanisms. Some member states, such as Australia, Chile and New Zealand, have fairly robust regulatory systems, to include taxation, inspection and oversight authority that remain consistent in application in spite of changes in government. Other South Pacific states, however, even when listing consistent regulatory authority on paper, are more susceptible to government variation in interpretation and sometime interference. Nor do many South Pacific states have the enforcement capability to ensure that what is written is followed in practice, This is particularly true for the maritime environment, where small island states as well as Papua New Guinea and New Zealand simply do not have the force projection capability to ensure adherence to national standards within their territorial limits, much less enforcement of international conventions adjacent waters. The problem has been acute in the case of fisheries.

The same is true for regional organizations such as the Pacific Island Forum (PIF) and South Pacific Conference (SPC). Although both organizations have a myriad of by-laws and statutes governing environmental standards, fishery quotas, commercial relations and the like, neither they or most of their member states have the ability to enforce what is written. Moreover, differences between member states have made difficult the promotion of regional security or police entities with multinational or regional jurisdiction. This essentially means that many parts of the South Pacific are *de facto* unregulated. The absence of a regional enforcement capacity, on top of limited national capabilities in that regard, raises the risk profile of the region for legitimate enterprise while creating opportunity for illicit ventures (such as piracy, arms, drug and human trafficking and illegal fishing).

The absence of effective regulatory and security enforcement is of growing importance because of the increased economic utility of South Pacific resources. Coupled with high commodity process, advances in technology have made endeavors such as deep seabed mining and drilling (for natural gas and crude oil) economically feasible.

Likewise, access to forestry and mining in previously remote and inaccessible areas in the region, particularly in Melanesia, have opened avenues of commercial opportunity to private investors. Chinese investment in mining and drilling operations have been a major vehicle for South American growth, and Chinese investors are now competing with US, Australian and Canadian firms in Papua New Guinea and the Solomon Islands for on- and off-shore exploration and extraction concessions.
The resource boom has led to a commercial rush on the part of interested parties, which in the absence of effective regulatory enforcement and oversight has compounded problems of governance in weak states and contributed to a "Wild West" or "cowboy" capitalist culture in some of the newly opened economic sectors. That often involves militarized private security and direct involvement in contentious local community politics.

Although this early phase of resource market opening poses some profit-maximizing opportunities over the short-term, it poses longer-term investment risks as well. That is because the first phase of (resource-exploitation) market opening in unregulated environments allows firms a very wide range of individual latitude in choice when it comes to confronting environmental, labor and governmental demands. Once proprietary territory is carved out the search for uniform standards of operation better allows for secure long-term returns. Otherwise firms are at the mercy of industry-exogenous and often arbitrary factors that, if nothing else, lend to unpredictability in corporate earnings.

GOVERNANCE ISSUES.

The problem is made acute in some areas because of the geography and culture of many South Pacific nations. Most of Polynesia is resource-poor outside of traditional fishing and limited agricultural cultivation, now supplemented by traditional and eco-tourism. Although the countries on the periphery are largely modern in nature, those in the inner South Pacific basin retain a significant number of pre-modern features, to include customs, practices and traditional forms of deference and authority.

These pose risks in two ways. First, the resource-poor nature of many societies leads to economic opportunism on the part of some decision makers, to include governments. The opportunity can be constructed in several ways. For example, the sale of tokens of sovereignty has become a major revenue generator for small island states. Although innocuous when it comes to things such as stamp issuance and retail flag or other symbology sales, traffic in tokens of sovereignty has potentially negative consequences when it comes to passports, off-shore banking and maritime vessel registration. Loose regulatory environments provide incentives for abuse of sovereign tokens in pursuit of profit or as a cloak on legally nebulous activities. Money laundering in national banks, passport fraud, evasion of commercial shipping regulations and violation of international fishing standards are commonplace results of abuses of sovereign tokens.

Corruption is a significant regional problem. In island states, the influx of extra-regional money has compounded traditional cultures of tribute, whereby elites exact treasure from subjects and prospective investors or partners. The traditional practice of "koha," (gift-giving) has eased the way for side-payments and exchanges of favors in pursuit of material and diplomatic gain. A similar situation occurs in Peru and Ecuador, where poor wage conditions for government officials and bureaucrats contributes to "off the books" rent-seeking behavior on their part. Since such people have power of authority, that becomes a price for doing business in some countries. Even the Antipodean neighbors and Chile have had issues with corruption, albeit not on the scale seen in other South Pacific states.

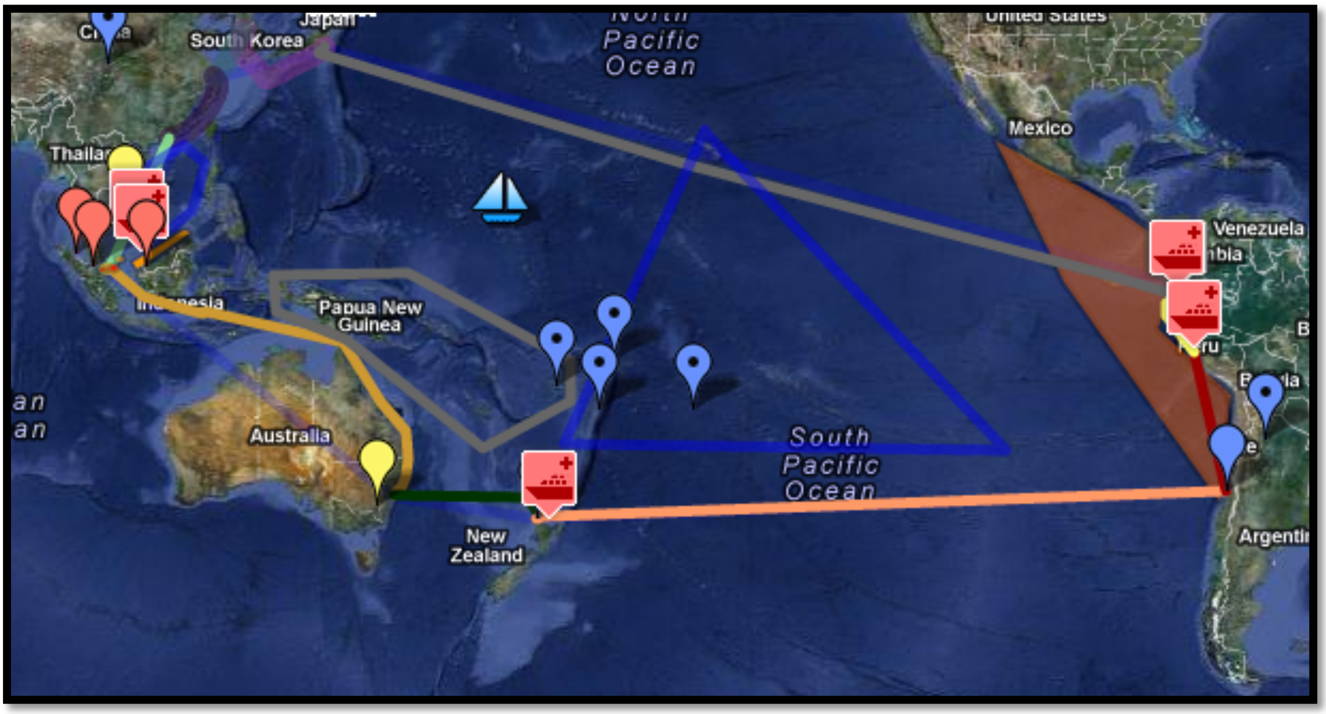
Given the unregulated context and fierce competitive pressures at play, investors need to be aware that such practices are often the norm rather than the exception in South Pacific decision making circles. 36th Parallel Assessments can determine the levels of risk and exposure involved in each case.

Growth of trans-Pacific commerce will inevitably attract the attention of governments situated along trade routes as points of origin, destination and transit. It can be expected that new taxation and levy schemes will be employed by governments seeking to generate revenue off the increase in trade. This will result in a quest for more enforcement capacity on the part of state authorities. Insurance firms as well as investors, shippers and traders need to prepare for that eventuality.

Assessment

The regional investment climate is one of fluidity and uncertainty as well as of potentially strong growth and profitability. Prospective investors and all economic agents need to weigh whether to adopt risk-assuming approaches to inter-regional commerce or to follow risk-avoidance.

If the choice is risk-assumption, it will not insure against catastrophic loss but can maximize short-term opportunities that leave a foundation for long-term returns. Low risk stake holder and start-ups seeking opportunity may consider this route. If the choice is risk-adverse, it can maximize long-term opportunity by avoiding the costs of short-term competition and uncertainty, but in doing so could lose the means for establishing a foundational stake in the long-term governance of the chosen sector. Large firms have already employed risk assuming strategies in important resource-extractive sectors throughout the South Pacific, so any potential short to medium term losses (less than expropriation) are mitigated by the potential for long-term gain. Even so, small and medium business opportunities exist in services throughout the region and will continue to do so for the near future.



*** 36th Parallel's interactive map identifying all major trade routes including the risks, threats and opportunities that lie within them. Go to http://www.36th-parallel.com to access the map and Part II of our analysis.**