

# Swimming with the Tide: Path Dependence and Private Sector Development in the Pacific Islands

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At a luncheon in Honolulu, a representative of the Bank of Hawaii told the story of the development of the Nikko Hotel on Saipan. Money was provided by a group of Japanese investors who dealt directly with a real estate firm on Saipan to purchase a site for the hotel. After the hotel was built, the original landowners went to court to contest the purchase of the land. They argued the land was still theirs because the real estate firm was a sham corporation set up to allow a foreign investor to circumvent the law preventing foreign ownership of land in the Northern Marianas. According to the speaker, the court ruled in favor of the original landowners and voided the sale of the land. The hotel developers, however, refused to deal with the original landowners, who demanded a much higher price for their land. The speaker closed by noting that since the Nikko trial there had not been another major hotel project on Saipan financed by Japanese investment. At the same luncheon, a representative of the Outrigger Hotel chain that owns and manages hotels throughout the Pacific, described how Outrigger goes into a location to develop a hotel. Before Outrigger initiates a project on a Pacific island, he said, Outrigger takes the time to get to know the local business community to find out who is reliable and will be a dependable partner. Outrigger then works with its local partner to secure the necessary agreements to obtain the land for its hotel. The representative of Outrigger concluded by saying that Outrigger has never had any problems with landowners or traditional land tenure laws in any of its Pacific island hotel projects.

## Introduction

The Asian Development Bank has funded the publication of several reports calling for a program of reforms to create a more secure investment environment in Pacific Island Countries.<sup>1</sup> Like the representative from the Bank of Hawaii above, these publications have argued that unless there are institutions in the Pacific Islands such as clear, enforceable land tenure laws, consistent enforcement of contracts by the courts and secured lending, the region will not be able to attract the investment needed to develop its private sector. But, as the comment from the representative of Outrigger Hotels also demonstrates, successful investments are being made in the region despite its weak

institutions. In fact, as the history of development in the Pacific makes clear, since foreign trade was introduced into the Pacific Islands in the eighteenth century, there has never been a time when the Pacific Islands have been unable to attract foreign investment. The same institutions that are being used by companies like Outrigger were used more than two hundred years ago as part of a development strategy that has succeeded despite the inherent difficulties of working in a region where costs and risks are high and the formal institutions (banks, courts, government agencies) needed to support economic development are inefficient and unreliable. All of this suggests that we need to look beyond a particular set of policies and formal institutions and examine more closely the investments that have occurred in the region to understand what has caused these investments and what role formal as well as informal institutions have played in supporting as well as preventing them.<sup>2</sup>

### Path Dependence in Pacific Island Country

#### Economic Development

The most comprehensive critique of economic institutions in the Pacific Islands to date is *Swimming Against the Tide?: An Assessment of the Private Sector in the Pacific*. (Holden et al.) It concludes by calling on Pacific Island governments to support private sector development by:

- Fostering financial sector development so that credit is more available for business development;
- Clarifying land rights and modifying them with respect to cultural preservation and the development of land markets;
- Reducing the role of the state in the economies of the region;
- Revamping the regulatory regimes so that business development is less constrained and monopolies are prudently regulated;
- Providing assistance to small-scale rural enterprises.

This emphasis on the reform of formal institutions follows Nobel laureate Douglass North, who has argued that getting the formal institutions right is crucial because some institutions create incentives that produce economic development while others undermine and prevent it. (1990, 3) North observes that undeveloped as well as developing countries like the island states in the Pacific tend to foster institutions that promote “re-distributive rather than productive activity.” (*ibid.* 9) In a re-distributive economy maintaining a positive relationship with those who control the sources of wealth takes priority over insuring that the institutions that support economic development function fairly and efficiently. This is particularly true in some of the states in the Pacific where status and connections are important and where commercial opportunities are distributed within family/political networks.<sup>3</sup> Many of the business leaders in the Pacific, for example, owe their success to appointments to positions in parastatal organizations, income generating ventures that are owned and subsidized by the state. (Reddy & Duncan, 12) An analysis of the public institutions in the Republic of the Marshall Islands shows that the RMI government supports nineteen state owned enterprises (SOEs) where

many of the contracts to operate these SOEs were non-competitive and many of these SOEs are, “completely dependent on the government, not only for capital funding but for operating funds as well.” (ERI 2003, 32) But, what is most ‘re-distributive’ about Pacific Island governments is that government employment, which is often an extension of the island patronage system, accounts for a disproportionate percentage of economic activity. Reports have been written highlighting this imbalance and calling for fewer government employees and smaller state budgets, nevertheless island governments have persisted in maintaining high levels of public employment. (Knapman & Saldanha; Duncan et al.) One of the glaring deficiencies in Holden et al.’s *Swimming Against the Tide* is that it does not acknowledge this history of resistance to institutional reform on the part of island governments and consequently it does not adequately explain why island political leaders will break with their past practice and embrace Holden et al.’s list of recommended reforms.

Contrary to the program of top-down reforms outlined in *Swimming Against the Tide*, historically, it has been the private sector in the Pacific, not elected officials, that has led the way in demanding institutions that support private sector development. In Hawaii, the call for land reforms in the early 1850s came from foreigners who hoped to profit from land speculation. (Daws, 171 ff.) In Fiji, the merchants supported Fiji’s first constitution as a tool to collect outstanding debts from white planters. (Legge, 74 ff.) Throughout the twentieth century, the Indo-Fijian sugar farmers have consistently and effectively pressed for land reforms. (Lal, 99 ff.) During the last twenty-five years, though, examples of

private sector led reform in Pacific Island states have been the exception rather than the rule. Part of the reason for this is that the private sector in the Pacific is a relatively small part of island economies. As a result, island governments are not dependent on the tax revenues that come from the private sector to fund their operations. Development grants and low interest loans from development organizations as well as other external funds such as fishing licenses, have been available to cover shortfalls in government operating budgets. Consequently, the private sector in these Pacific Island states, rather than being in a position to insist on pro-business institutions, must court the favor of the government to secure contracts for development projects and obtain various perks such as approval of loans from state owned development banks. (Lucas et al., 28-9)

North has argued that economic reform is less likely to come from officials tasked to administer top-down reform programs (because the benefits that come from maintaining the status quo give these same officials a compelling incentive to frustrate change) than it is from the gradual evolution of local, informal institutions. (North 2005, 62) When we look, though, at the various bottom-up, grassroots strategies that have been introduced to develop Pacific island private sector economies – such as rural participatory programs to develop island products and entrepreneurship programs designed to create small businesses – we are confronted with competing incentives here as well. For instance, despite repeatedly asking for programs and projects designed to provide them with private sector job opportunities, Pacific islanders consistently have chosen to pursue other sources of income such as local government jobs and out-migration. Along with

remittances, these alternative sources of income have undercut the need for Pacific islanders to find or create jobs in their local private sector. (Bertram & Watters)

Nevertheless, remittances and government payrolls have produced a relatively high level of consumption in the Pacific that has in turn created opportunities to develop new island businesses. As a result, island governments were persuaded to use their aid funds to develop entrepreneurship programs to create privately owned businesses that could recycle some of this income in the local economy. (Hailey; Fairbairn) Island leaders were encouraged by the advocates for these small business development programs to see small business development as the engine that would turn Pacific islanders into small business owners who would create a vibrant private sector. Surveys showed, though, that before this could happen island entrepreneurs needed small business loans, management training and market information. (*ibid.*) To make up for the lack of capital, island development banks were funded to provide highly leveraged small business loans (85% financing at 9% annual interest), but these loans only succeeded in saddling the entrepreneur with a burdensome and often unmanageable debt. To address the apparent lack of management skills, island governments funded training programs, but training alone could not address the problems inherent in doing business on a small island where local markets are quickly saturated and off-island markets are often inaccessible due to the lack of affordable transportation. The only successful island businessmen noted by Fairbairn and others in their survey of six island countries in the late 1980s were the Gorokans of Papua New Guinea. Ironically, the Gorokan businessmen did not need or use government subsidized loans and business training programs to be successful. Instead,

they pooled the money they made from the coffee they grew on their land to build small stores, to purchase trucks to haul passengers and freight, and to develop cattle projects and other ventures. (Finney, 65 ff.)

In summary, whether the programs and initiatives have been “top down” or “bottom up,” efforts to stimulate private sector development in the Pacific Islands have been a general failure due to “path dependence,” the persistence of existing institutions to preserve the status quo.

### Private Sector Development in the Pacific

In contrast to this current lack of private sector development in the Pacific, many of the Pacific Island states over the last two hundred years have dramatically transformed their economies so that they bear little resemblance to the communal, stone-age subsistence economies that met the first European explorers. They possess jet airports, modern communications, ports and harbors, electrical grids, paved roads, modern hotels and local manufacturers who export their products all over the world. Two hundred years is a relatively short period of time compared to the time it took the European states and their colonies to bring about similar changes. How did this all happen and how did it happen so quickly? Two recent histories of the rise of the global economy highlight the role of long-distance trade in the economic development of the Pacific. (Chanda; Fernandez-

Armesto) In these accounts, the Pacific Islands are the last link in a chain that finally connected Europe with China and the Americas in a truly global economy. One can follow the development of Pacific Island trade from sandalwood, and beche-de-mer, through whale oil and copra, to sugar and coffee and finally to tuna, Tahitian pearls and tourism with a few minor products along the way such as pumpkins and fresh ginger, vanilla and black pepper as well as giant clams and live coral. The market opportunity for each of these products attracted traders from America, Europe and Russia who invested in those islands where these products could be obtained. This trade also attracted the interests of the traders' respective governments that made investments to secure the trade for their nationals as part of their global economic strategy.

### **Long-distance Trade**

The institutions that were critical for long-distance trade were different from those that supported the development of local commerce in Europe and the land-based economies of their colonies in the Americas.<sup>4</sup> For long-distance traders, land was not essential. It was more often a liability than an asset since it was difficult to secure and easy to lose. The trader needed only a relatively small site – space at the dock or along the road or a booth in the market. In the beginning of Pacific Island trade, the deck and hold of a ship were more than enough space for trading if the islands possessed a navigable harbor and an accommodating trading partner. A trader could become a major land owner, but the trader's working capital was not his land but his stock which was not fixed but was as

“liquid” as possible, able to flow wherever there was a profit. The trader placed a premium on having the flexibility to shift from one trade good and one market to another as demand changed. Profits that did not go into the purchase of more trade goods were loaned at interest or used to enter into partnerships with other traders. For the trader, money was just another commodity to be turned over for a profit as often and as rapidly as possible.

Labor was also a commodity. Labor contracts and slaves were a part of the traders’ stock and trade. The trader himself employed relatively few people, only those needed to complete the trading transaction. In most cases, though, a trader did not deal directly with production labor. He left that to those from whom he obtained his trade goods. This production partner was expected to know the most effective ‘currency’ to motivate the local workforce. In the Pacific Islands this was land, food and status, all of which were controlled by the local elites. By controlling the natural resources, the local elites not only controlled the manpower needed to make trade possible, they also controlled sufficient manpower to disrupt the trade. As a result, the trader had to rely on his trading partner to provide both security as well as workers. This limited the choice of production partner to those elites who controlled the most manpower. From the perspective of the trader, the labor market could be reduced to one person. This was the case in Hawaii where Kamehameha, for a time, controlled all of the sandalwood trade. (Kirch et al.) In Fiji and Tahiti there was more competition among the elites for control of the trade. (Campbell, 63ff.)

The competition among island elites was mirrored by the traders themselves who were in an ongoing competition with each other for exclusive access to island resources. The early traders in the Pacific were not reluctant to call upon their governments to take their side when there were disputes over access to trading areas, but Western governments had to balance the benefits of securing exclusive access for their nationals against the cost of establishing and administering a remote, foreign outpost. In Indonesia, the enormous returns from the spice trade more than compensated the Dutch for the cost of establishing colonies and garrisons. In the Pacific, this cost was hard to justify. Consequently, traders in the Pacific could not rely on their governments to intervene on their behalf to secure their trade.<sup>5</sup> Instead, they had to be prepared to provide their own security.

Just as the trader had to work through the local elites on the production/supply side of the trade, he also had to work through the elites on the market/distribution end of the trade as well. The market in which the long-distance trader sold his goods bears little resemblance to the classical economist's ideal market where products are sold to all comers at prices that are set by those in the market who are able to compare products as well as prices.<sup>6</sup> The elites in foreign markets controlled the distribution of goods, local as well as foreign. The long-distance trader had to work through a local agent who worked through a local distribution network. These distribution networks, like the local production networks back in the Pacific islands, were a reflection of the local society, comprised of alliances that were economically, socially and culturally determined. They had grown up over

many decades and in some cases centuries. Each network amounted to an enormous sunken cost in time as well as expense that no outsider could easily match, much less improve upon. As a result, because the costs almost always far exceeded the benefits, there was little justification or incentive for the trader to create a local distribution network of his own but every reason to work through the much better informed and connected local distributors.

### **Self-enforced contracts**

Given the importance of forming partnerships between the traders and their production agents and their distributors, it is not surprising that the institution on which long-distance trade was built was the self-enforced contract, also known as private ordering.<sup>7</sup> The trader's agreement with his suppliers and distributors had to be self-enforced because he was almost completely on his own. He was beyond the protection of the legal system of his home country and not always recognized legally in the countries where he traded. For the trader's agreements to be self-enforced, they had to meet the following five conditions.

- The participants must gain each other's trust.
- The participants must have an incentive to trade.
- The participants must be able to meet their commitments as well as protect the trade from theft or attack;
- The projected benefits from future transactions must exceed the gain from cheating in any single transaction;
- The penalties for cheating or failing to meet a commitment must be severe such as termination of the contract or exclusion from future trade.

The incentives as well as the contributions of the participants in the trade agreement may be completely different. And each party can be operating in a different value system and may employ skills, experience and assets that are foreign to the other party. As long as everyone involved can see a benefit from the contract, though, the complications that often occurred as a result of cultural differences could be addressed and overcome. They could also outweigh the incentive to cheat. As the game theorists have shown, cheating is rational only when one of the parties to the contract determines that cheating will produce a greater return than any gains that might result from future transactions. (Dixit, 27) For the early traders in the Pacific, there was a built in incentive to return for future trade because their ships could only hold so much sandalwood or beche de mer. For island chiefs, future deliveries of ships and guns made trade a valuable asset in the ever present competition for status and control of island resources.

To identify who was a potential trading partner, Western traders and Pacific islanders had to rely upon intermediaries to act as “the liaison between the masters and supercargoes of visiting ships and the chief or people of the area where they lived,” and serve as the “interpreter of one culture to another.” (Maude 1964, 268) The traders looked to the chiefs to secure the trade from attacks from their rivals. They also depended upon the chiefs to oversee the harvesting and processing of island products which included ‘motivating’ the natives. Once the initial demand for Western trade goods was satisfied among the locals, the traders had relatively few things with which to motivate island labor over an extended period of time. Some of the German traders in the mid-nineteenth

century had to resort to passing out pipes and introducing tobacco to give islanders, “who had no needs,” a reason to trade. (Firth, 6) Tobacco could be an effective currency, but in the end, the traders had to rely on the hierarchical structure of island society that insured a high degree of deference and obedience to the will of the chiefs who held the power of life and death over their subjects. When the chiefs put their retainers at the disposal of the traders these island laborers were quick to meet the technical standards set by the traders for products like beche de mer that had to be processed before being shipped.

Early island trade was, by many standards, successful because it was able to address and overcome what today are perceived to be the major barriers to private sector development – the lack of secure contracts and the prevalence of cheating; difficulty motivating and retaining island labor; the lack of Western production technology; the inability to penetrate and compete in foreign markets. Moreover, the early traders overcame these barriers in an environment in which the formal institutions that we rely upon today to support and protect commerce – commercial laws, courts, third party enforcement – were not only weak, but in most cases were non-existent. Island trade relied on partnerships based on a set of incentives that were sufficiently advantageous to the traders, who had access to a global distribution system, and the island elites, who controlled the local natural and human resources.

The idea that markets had to be legally open and market opportunities equally available to everyone was totally foreign to early island trade. In fact, early island trade succeeded because it was a reflection of the inequalities and the authority structure in island hierarchies. Only the chiefs and chief system were able to secure the trade locally and to deliver the natural and human resources that were required. The chiefs as well as their Western trading partners quickly overcame the information gaps on both sides of the trade through collaboration and a pooling of technology, experience, skills and knowledge. As a result, the chiefs never had to become international traders with agents in markets throughout the world and the traders never had to become island chiefs with traditional authority over island resources and island labor. The traders provided the product specifications and the techniques for processing island resources. The chiefs and island elites insured the participation and cooperation of island laborers who mastered the techniques they were taught and successfully produced products for markets about which they had no knowledge.

### **Island Trading Houses**

In addition to the self-enforced contract which provided the framework for the earliest island trade, the other institution that has played a significant role in the development of Pacific island economies has been the island trading house which grew directly out of the

early trade. As the supply of sandalwood and beche de mer dwindled to a trickle the traders left agents in the islands so they could trade year round for the small lots of sandalwood and beche de mer as they came in. Some of these agents formed island trading houses replicating the trading houses in America, Australia and Europe that had sent them out to the Pacific. The trading houses in Honolulu became “the entrepot of the Pacific sector of the World System . . . . the crossroads of the Pacific” and were supplied by regular visits from trading ships from all over the world. (Kirch et al., 4) The Honolulu trading houses took delivery of furs and lumber from the Pacific Northwest, cloth and manufactured goods from London and Boston and traded with the chiefs for sandalwood and local produce. These trading houses used the same trade goods used by the earliest traders: guns, powder, tools, nails and cloth. They also stocked spices and lumber and “Yankee notions of all sorts” for the growing community of colonists and missionaries who had taken up residence in the islands. (Sullivan et al., 21)

With the advent of whaling in the Pacific in the 1820s, the trading houses expanded to address the needs of the whaling fleet. They not only supplied the whaling fleet with equipment and produce, they also provided storage and shipping services so that the whalers could off-load their oil and ship it home without having to return to their home port. The model for these full-service operations, or factors as they were known in Hawaii, came from the Hanseatic town of Bremen by way of Heinrich Hackfeld who settled in Hawaii in 1849. (Simpich, 1-7) Bremen was dominated by burgher families with strong commercial ties to each other. Its trading houses were self financing and

vertically integrated. They made their profit from: mark-up on their own merchandise; freight on shipping other merchants' goods; insuring the goods they shipped; commissions from negotiating the sale of the goods and the purchase and shipping of goods in return if the client was another merchant; and interest collected on advances against purchase price. Samuel Castle and Amos Cooke, who took over the missionary commissary in Honolulu as a private business in 1851 when the American Board of Commissioners for Foreign Mission withdrew from Hawaii, followed Hackfeld's example. (Taylor et al., 73-74). They were soon joined by Theo Davies, originally an agent for the Manchester trading house Janion & Co. (Hoyt) and the American trading company, C. Brewer & Co. Charles Brewer was an associate of Henry Pierce and James Hunnewell, traders from Boston. (Sullivan et al.)

## Sugar

Hawaii's trading houses were instrumental in transforming Hawaii's bankrupt sugar plantations into a multi-million dollar industry. In the 1820s and 1830s, the potential for sugar in Hawaii was believed to be enormous. Sugar already grew in the islands and there was a market for it on the West Coast. But four decades passed from the opening of the first sugar plantation in 1825 before sugar began to show any signs of becoming a profitable industry. During this period, Hawaii's sugar growers experienced numerous problems. There was a shortage of tools; their mills were crude and unreliable; the quality of the first sugar was too poor to sell outside of Hawaii; and local labor was scarce and

unaffordable.<sup>8</sup> The chiefs were able to deliver some laborers to work on the sugar plantations for short periods of time but the plantation owners could not provide sufficient incentives to induce Hawaiian workers to make the commitment required to clear the land and plant, harvest and transport the sugarcane to the mill where it could be processed into raw sugar. The sugar growers were only successful in retaining island labor when they were able to use the debt laws to bind their Hawaiian workers to the plantation. By encouraging island workers to run up large debts at the plantation store, they could then threaten them with incarceration if they did not work until they had paid back what they owed. (MacLennan 1997, 108-18)

Some plantations suffered from drought and required expensive irrigation, while others received too much rain and had to be drained. But the overriding problem was that no one knew how long it would take for sugar to produce a profit. Lured into becoming plantation owners by periodic high sugar prices, the early sugar growers in Hawaii invested heavily in land. These land purchases were facilitated and encouraged by a government policy that made both land and loans available to sugar growers even though, as one member of the Royal Hawaiian Agricultural Society described them in 1850, they were: “persons possessing neither experience in the business they were undertaking, nor the requisite capital and knowledge of the soil, to carry through to a successful result.” (Sullivan et al., 105) ‘Knowledge of the soil’ would not have been much help, though, when the weather was bad or the mills broke down. And even the most knowledgeable and experienced sugar grower could not predict that it would take forty

years for the sugar industry in Hawaii to become profitable. If they had, they would not have been able to afford the financing required to keep their plantations operating: money was lent to the early sugar growers in Hawaii at the rate of 12% to 18% interest. (MacLennan 1995, 49-53)

Initially, the trading houses in Hawaii were interested in the sugar industry only as agents or factors (importing supplies and transporting and marketing sugar), but they were inextricably drawn into becoming equity stakeholders because they needed the planters' agency contracts: investing in a sugar plantation was one way to become the plantation's agent. Trading houses also raised capital for the sugar growers through stock sales to other merchants and by securing bank financing in San Francisco, Boston and London, places the trading houses had credit and could guarantee a loan for a sugar grower with the income from the trading house's other businesses. Going into debt on behalf of a sugar grower, though, was a high risk proposition even with other sources of income. In 1866 when the sugar market in Hawaii crashed, some of the factors went into bankruptcy with them. (Hoyt, 57) But, when whaling came to an abrupt end in 1860, the trading houses' primary source of income became the factoring services they provided to the sugar plantations. Whether they liked the risks or not, the future of the trading houses in Honolulu depended upon the survival of the sugar industry. (Taylor et al., 85)

As a result of their mutual dependence, the trading houses gradually began to provide an array of assistance to the sugar growers that extended well beyond financing and credit. Hackfeld recruited an agriculture expert in Bremen, who developed the irrigation system

begun at Lihue in 1860. (Simpich, 31-57) Henry Pierce, an associate of Charles Brewer of C. Brewer & Company, sent out from Boston D.M. Watson, a mechanic who introduced the centrifugal separator – a major improvement in the extraction of sugar from the cane. C. Brewer & Company provided financing to Watson to start the Honolulu Iron Works which allowed the sugar growers to have their mills fabricated in Hawaii rather than order them from Europe where the manufacturers required cash in advance. (Sullivan et al., 109) Castle & Cooke, the factors for Alexander & Baldwin, acted as financial advisors advising them on the purchase and sale of land and equipment. (Taylor et al. 89-90) Hawaii's trading houses were also responsible for recruiting labor from China and Japan to work on Hawaii's sugar plantations. Where the factors provided the most important service to the planters, however, was in securing buyers for their sugar on the West Coast:

“It was a hazardous business to sell little-known Hawaiian sugar in competition with Caribbean production, the historic source of American needs. The task of doing a better selling job fell to the Honolulu agents, who, with their banking connections and suppliers, knew their way around the major markets of the United States. Marketing raw sugar at the best price the U.S. refineries would pay became the most important duty of the agents in Honolulu.” (*ibid.*, 74-5)

Samuel Castle's “negotiated quota on high grade sugar in exchange for a higher quota and a 15% premium for low grade sugar from San Francisco & Pacific Refineries” in the late 1860s is considered by one historian as the turning point and the beginning of profitability for Hawaii's sugar industry. (Daws, 175-77)

In Fiji, the local trading houses, like their counterparts in Hawaii, supplied the Fijian sugar growers and advanced them credit. They acted as agents overseeing the sale of Fijian sugar in Australia. And some became plantation owners themselves. Some of these merchants were able to make a profit during the early years of the Fiji sugar industry by limiting the issuance of credit to the sugar growers and by controlling the mark-up on the goods they sold to them, but the merchants like William Hennings, who extended too much credit to the sugar growers, followed them into bankruptcy. ((Knapman, 87 ff.; Scarr, 1972, 106 ff.) Almost all of the early sugar growers in Fiji, even with the credit extended to them by the merchants, lacked the resources to weather the unprofitable years that plagued the Fiji sugar industry throughout its first three decades. (Knapman, 48-64)

The Sydney-based Colonial Sugar Refining Company (CSR), which was ultimately successful in its effort to grow and refine Fiji sugar, could extract only a 5.2% profit from 1887 to 1898, far below the 8%-12% interest that sugar growers had to pay to borrow money from the banks when the banks were willing to lend. CSR, however, was not financed with debt. It avoided the cost of debt financing through the sale of stock and by reinvesting its profits back into the company. CSR's access to equity capital allowed it to provide all of the services provided by the trading houses in Hawaii: credit and loans to its sugar growers; advanced technology, low cost labor, and access to profitable markets.

Copra

Unlike sugar, coconut oil was produced by Pacific islanders long before the beginning of Western trade, but the whaler/traders did not begin to trade for coconut oil until the 1850s. It was a natural complement to the whale oil they were already collecting. They already carried the barrels to store it and like whale oil, it was very lucrative. One could trade \$.17 worth of tobacco for 3.5 gallons of coconut oil worth \$3.50. (Maude 1968, 244) Maude, who provides the only detailed account of the early coconut oil trade in the Pacific, suggests that it developed on lines similar to the earlier sandalwood and beche de mer trade. Beachcombers and castaways acted as mediators between the whaling ships and the island chiefs who oversaw the production of the oil by island labor. As the trade developed, resident agents remained in the islands to trade, collect and store coconut oil year round. These agents were dependent on the whaling ships to return and transport the oil to market. (*ibid.*)

Like the trading houses in Hawaii, the early coconut oil traders had to take the next step and create their own link to the market. Richard Randell in the *Gilberts* sailed to Sydney to arrange to have his oil picked up. When he arrived in Sydney, Randell had to solicit the support of the local merchant Charles Smith who “was well connected.” Randell and Smith formed a partnership. Smith agreed to provide trade goods, pick up Randell’s oil and sell it. (*ibid.*, 247) Randell was responsible for the organization and management of the trade in the *Gilberts* which included “the recruitment, employment and posting of staff and oil agents throughout the Group.” (*ibid.*, 248) Randell had to rely upon the authority of the High Chief Baitke to secure his trade. (*ibid.*, 251) In return for the chief’s

support, Randell, “gave his full support to the reigning family and acted as interpreter in their dealings with other Europeans.” (*ibid.*, 257) This relationship continued for fourteen years. During which time “the trader and his trade were inviolate.” (*ibid.*, 257)

In 1857, with the arrival in the Pacific of the large Hamburg trading house, Godeffroy und Sohn, the coconut oil trade in the Pacific changed from oil to copra.<sup>9</sup> Godeffroy und Sohn established its headquarters in Apia in Samoa and began experimenting with various local products as potential exports. The process of drying coconut meat into chunks of copra was introduced by Godeffroy’s agent, Theodor Weber. Copra took less time and labor to produce than coconut oil and could be shipped to Europe for processing into coconut oil with less spoilage. As a large trading house, Godeffroy und Sohn had the means to accomplish throughout the Western and Central Pacific what Randell and Smith had only been able to do in the Gilberts. Independent island traders quickly saw the advantage of partnering with this large German trading house. After only a year operating as an independent coconut oil trader, Adolph Capelle in the Marshalls went to work for Godeffroy und Sohn. Through this partnership Capelle obtained trading goods from Godeffroy und Sohn and gained a reliable buyer with access to markets throughout Europe. Like Randell, Capelle used the authority of the local chiefs to harvest and process the copra. The laborers who dried the copra handed it over to the chiefs and were “rewarded or not rewarded with a share of the trade goods as the chiefs saw fit.” In this way the chiefs served as “economic brokers” for the traders. (Hezel 1983, 216)

The structure of the copra trade in Fiji was equally hierarchical comprised of a system of trading partnerships in which trade goods were advanced to rural small scale store keepers who collected the copra which was passed on to larger intermediaries in the port towns from where it was consolidated, put on ships arranged by the merchants who sold the copra abroad. (Knapman, 85 ff.) Trading companies in Fiji that dealt primarily in copra were forced to extend credit to smaller, remote stores who in turn extended credit to the copra producers. There was always some risk for the trading companies of paying too much for the copra, but this was unavoidable due to the competition among the traders to secure as much copra as possible. Successful traders balanced “the (eventual market) price of copra against the cost of shipping, trade goods and debt or credit to customers.” (Knapman, 85) When the markets for copra fell in the 1880s a large copra trader like Hennings could lose a considerable sum of money if he had extended too much credit to acquire his copra. Because of these risks, the banks preferred to avoid financing the copra trade. (*ibid.*) The traders, though, believed that the risks could be managed by manipulating the margin on their trade goods and by limiting or extending credit based on their knowledge of the market. Another way they could reduce risks was by eliminating competition for the copra and the labor required to harvest it. They accomplished this by developing copra plantations where they paid their workers by the day. Plantation copra was four times more profitable than copra obtained through trade. (Firth, 20)

The island trading houses in the Pacific in the nineteenth century provided several critical services that made the sugar and copra industries in the Pacific possible. First, they were a source of capital. By financing the sugar industry, the trading houses gave the sugar industry the time it needed to mature. Equity financing gave the sugar growers an alternative to debt at 8% to 12% which the plantations by themselves were not able to support. Second, the trading houses were a source of technical expertise that figured significantly in the development of both sugar and copra. Through their links to the larger global market, the trading houses had access to technical information that was either not available in the islands or could not be obtained except at a cost the growers could not afford. Godeffroy und Sohn, could afford to support their agents while they looked for and developed new island products such as copra because they had an income from their other businesses. Finally, the trading houses provided island producers with a link to the market. The trading houses possessed a network of associates and agents in markets where the trading houses were well known. These relationships proved invaluable when the trading houses made sugar and copra part of their business. The inherent weakness of a small producer trying to sell his product in a market far from his island plantation made it virtually impossible for an island sugar grower to operate successfully without the support of a trading house. When we look at Hawaii and Fiji, we cannot find an example of a sugar or copra operation that started as an island plantation and integrated forward by becoming the agent for its own product. We do, however, find several examples of trading houses that integrated backwards and became plantation owners.

### **Contemporary Pacific Island Export Development**

The gradual disappearance of sugar as a Pacific Island product over the last thirty years and the collapse of copra prices in the 1990s should not obscure the fact that both these industries were almost uniquely self-sustaining for over a hundred years. Yet the early history of these industries is rarely, if ever, invoked as a model for contemporary island export development. This is surprising since, as the sociologist Gary Gereffi has shown, the same partnership between local producers and distributors with links to the global market is the same institution that is being used by developed and undeveloped countries throughout the world to bring them into the global economy. (Gereffi 1994) Gereffi refers to these relationships as Global Commodity Chains and cites the Pacific Island garment factories as examples of how commodity chains have penetrated the region.

These operations, however, are not so much partnerships with local producers as they are foreign enclaves staffed with foreign managers and foreign labor. Even the raw and semi-processed materials are imported. Better examples of island-based Global Commodity Chains can be found in the agriculture and aquaculture industries in the Pacific. Hawaii papaya and Fiji fresh ginger and Tahitian black pearls and Marshall Islands giant clams demonstrate more clearly how commodity chains work as producer/distributor partnerships in the Pacific.

### Hawaiian Papaya and Fijian Ginger

The history of the Hawaii papaya growers' export partnership with AMFAC (American Factors), the direct descendant of the company originally begun by Heinrich Hackfeld in 1850, and the development of fresh ginger as an export product in Fiji are described in detail in two excellent case studies by Andrew McGregor.<sup>10</sup> Both case studies make it clear that the impetus for these successful export industries was a partnership between local producers and an individual or company with links to the global market. In Hawaii, AMFAC partnered with the Hawaii papaya growers to export their papayas on the U.S. mainland. This gave the papaya growers the benefit of AMFAC's size as well as its network within the U.S. food market where AMFAC was well established as a distributor of Hawaiian sugar and pineapple. In Fiji, the export of fresh ginger production began as a joint venture between the local fresh ginger growers and a representative of a New Zealand confectionary company who connected the ginger growers with Pacific Produce Ltd., a large West Coast produce importer/wholesaler in Vancouver.

### Tahitian Pearls

Tahiti's black pearl industry is another example of a uniquely Pacific Island export industry that was built on a partnership between a local producer and a distributor that was uniquely positioned to penetrate a well developed, well defended global market. In

*L'Île aux perles noires*, Jean-Claude Brouillet, one of the pioneers of Tahiti's black pearl industry, describes in detail the barriers he confronted when he tried to market his first pearls. His narrative exposes many of the hidden difficulties of marketing specialty products from remote Pacific Island Countries. Despite his local business experience and his international contacts, the pearl market was closed to Brouillet, partly due to his ignorance of the pearl industry and its distribution system, but primarily because of the policy of the Japanese who controlled the world's supply of pearls. Brouillet spent several years unsuccessfully marketing his pearls before he was put in touch with Salvador Assael. Assael was perhaps the premier pearl dealer in New York at the time, but Brouillet, who had tried unsuccessfully to sell his pearls in New York, had no knowledge of him. After a short visit by Assael to Tahiti, Brouillet gave Assael his pearls (with no more than a handshake for security) to take back with him to New York to sell. There, Assael had Brouillet's pearls transformed into fine jewelry. Six months later Assael invited Brouillet to come to New York to see his pearls and witness the enthusiastic response from New York's most exclusive jewelry houses. Brouillet and Assael eventually developed a formal partnership that gave Assael exclusive rights to sell Brouillet's pearls in the world market while Brouillet retained the exclusive right to sell his pearls in Tahiti. (Moukheiber)

After Brouillet's pearls were introduced in New York, Japanese pearl manufacturers saw the need to secure their own source of Tahitian pearls. They made an agreement with Robert Won, another successful Tahitian business man who had developed his own pearl

farm in Tahiti. In the 1980s and the 1990s the demand for Tahitian pearls grew very rapidly, with the Japanese being the primary buyers. (Hisada & Fukuhara: Tisdell & Poirine) As production increased, so did the transfer of technology to Tahitian pearl farmers. The Tahitian pearl industry became a leader in hatchery development and the use of x-ray, coated nuclei, and cleaner-boats. (Fassler) Not content to produce only loose pearls, Robert Won, who produces half of Tahiti's pearls, moved up the distribution chain and opened his own pearl market in Hong Kong to compete with the Japanese in offering matched strands of high grade pearls.

#### Marshall Islands Giant Clams

In 1984 an East West Center report was published on the development of mariculture in the Pacific in which the author, seemingly oblivious to what was happening with Tahitian pearls, observed that almost all of the aquaculture development efforts during the previous thirty years had fallen far short of their goal of creating a commercial aquaculture industry because of an,

“overzealous biologist or uninformed bureaucrat who often pushes for aquaculture development even when it is neither practical nor makes the best use of resources. The venture that results usually cannot market its product at a profitable level. The firm develops cash flow problems and subsequently folds. International projects often face the same end result. An aquaculture project is usually developed by experts who are brought in for a few years. When they leave, the project folds for lack of interest and/or lack of local technical know-how.” (Uwate, 1)

In the very same year, Gerald Heslinga – possibly unaware of Uwate’s report but certainly unsympathetic with its assessment of why aquaculture had failed in the Pacific – published an article documenting the successful mass culturing of giant clams at the Micronesian Mariculture Demonstration Center in Palau with the same enthusiastic claims for the economic potential for giant clams that Uwate had been so critical of. In a subsequent article, Heslinga claimed that a small giant clam farm (1 hectare) could produce clams for subsistence, resource enhancement and export sales. (Heslinga et al.) Heslinga’s enthusiasm for giant clam aquaculture was picked up by the popular media which published articles encouraging Pacific island governments to support giant clam mariculture. (Murphy; Rock). Soon, virtually all of the Pacific island states with support from a variety of development organizations were funding giant clam mariculture projects. But, twenty years after Heslinga’s first giant clam article, Cheng Sheng Lee, Director of the Center for Tropical and Subtropical Aquaculture (CTSA) in Hawaii acknowledged that: “After . . . years of intensive effort by CTSA to develop and transfer technology, the production of giant clams . . . has yet to make any significant contribution to the local (U.S. Affiliated Pacific Islands) economy.”

Giant clam development in the U.S. Affiliated Pacific Islands followed a development trajectory similar to that of the sugar industry in Hawaii and Fiji in the nineteenth century; only it was government funded giant clam farms that failed rather than private sugar growers. Like the early sugar growers, Heslinga, who had little marketing experience, underestimated the difficulty of penetrating the giant clam market. Early test

marketing in Hawaii, Guam, and Saipan of Heslinga's farm-raised clams produced discouraging results, (Shang et al. 1994, p.79) but subsequent market research identified a rapidly growing demand in the marine aquarium market for live, two to three year old giant clams. To supply the marine aquarium market with giant clams would require Heslinga's Micronesian clam farmers to shift to a different species of giant clams. They would also need to locate their farms close to airports to minimize handling and shipping. Both changes were costly, but development funds were still available to underwrite these changes. A second attempt to produce a viable giant clam industry, however, also ended in frustration as the farm-raised giant clams were unable to compete with less expensive, larger, giant clams that were being harvested from the wild. As a result of this second failure, the development agencies and their client governments ceased to fund giant clam aquaculture, and the farmers who had received clams through the project stopped growing them. The only exception was the privately owned giant clam farm that was established by Robert Reimers Enterprises (RRE), a family-owned, highly diversified island business that owed its success to the same characteristics that had made many of the family owned island trading houses in the islands successful a hundred years earlier.<sup>11</sup>

RRE was founded by Robert Reimers, a Marshallese who was trained as a boat builder by his uncle and worked for the Japanese between the two World Wars managing stores on Jaluit and Wotje where the Japanese traded for copra. After World War II, Reimers went to work for the U.S. Navy converting military vessels to civilian use. He formed a partnership with an American from Hawaii he met at the shipyards who supplied him

with specialty goods from Hawaii. Using his own boats, Reimers began trading throughout the Marshall Islands. By 1950, he was able to obtain a commercial bank loan (the first commercial loan given to a Marshallese) to build a large general store with freezer capacity capable of storing container loads of frozen food. As RRE grew, RRE hired hundreds of Marshallese. Some traditional leaders, though, felt that RRE had become too large and challenged Reimers in various ways. Rather than oppose their authority, Reimers accommodated their demands by finding ways to satisfy traditional authority and still do what he needed to do to operate his business. (Ramsey Reimers, Personal communication)

Reimers' decision to raise giant clams was prompted by the publicity it received as a low tech, low cost, profitable business. It also complemented RRE's other businesses: RRE could sell some of the clams in its grocery store. During the sixteen years (1986-2002) that RRE was involved in growing giant clams, the company experienced the same setbacks as the rest of the giant clam industry in the Pacific. RRE made the costly change from growing giant clams for food to growing them for the marine aquarium market. The RRE farm on Wau Island was destroyed by a storm in 1996 forcing Reimers to build a much more expensive upland facility on Long Island near the airport. Both farms were plagued by high turnover at the manager position. When the farms did produce marketable clams, transportation became a problem. Continental Airlines, the only airline that served the RMI, repeatedly bumped RRE's shipments of giant clams due to a lack of freight space. It is estimated that during the period that RRE developed and operated its clam farms it spent well over a million dollars on its giant clam operation.

Except for a few years when RRE was able to grow and sell giant clams successfully it covered its losses from its giant clam operation with income from its other businesses.

During the last four years that RRE owned the farm at Long Island (1998-2002), the farm experienced a brief period of stability and profitability. In 1998, RRE finally found a reliable manager who could produce clams consistently. By attending trade shows in the U.S., he was eventually able to find reliable buyers. It is surprising that it took more than a decade for giant clams from the Marshall Islands to penetrate the market. The brightly colored, electric blue and green maximas (*tridacna maxima*) that the Marshalls are famous for are prized by marine aquarium hobbyist throughout the world. But, once they had found a place in the market, RRE's giant clam sales increased rapidly going from almost zero in 1998 to 7,750 in 2002, when RRE's largest buyer, Oceans Reefs and Aquariums (ORA), bought RRE's Long Island farm. Since taking over the Long Island farm, ORA, has increased giant clam production even more. In 2005 the RRE/ORA farm exported over 18,000 giant clams from the RMI and recently announced plans to expand its operation in the Marshall Islands to use the remote lagoons of the outer atoll islands for grow out areas for their giant clams and cultured live corals.

### **Conclusion**

Despite the current focus on reforming the formal institutions in the Pacific – lending institutions, land tenure laws, government agencies, court system – as the key to private

sector development, the two institutions that have been the most instrumental in the development of the private sector in the Pacific have been and continue to be the self-enforced contract and the island trading house. This was true in the nineteenth century when trade began with sandalwood and beche de mer and later as sugar and copra became the backbone of island economies. The early trading partnerships between island producers and global traders gave island trade the security, reliable work force, capital, technical expertise and access to foreign markets that were essential for their success. Island trading houses provided the emerging sugar industry in Hawaii the time and the resources necessary to mature into a profitable industry that in turn provided the foundation for the development of other industries such as tourism and shipping that emerged in its wake. The trading houses in Fiji, Papua New Guinea and Micronesia that developed the copra industry turned a locally consumed subsistence crop into an international commodity by opening up markets in the United Kingdom and Germany.

Self-enforced contracts (between island producers and global distributors) and island trading houses continue to be at the cutting edge of Pacific Island private sector development. Their influence is evident in all of the important industries that have developed in the Pacific in the last fifty years from papaya and cut flowers in Hawaii and pearls in Tahiti to giant clams and live coral in the Marshalls to international hotels in Fiji and Guam. These examples of successful export should serve as models as well as provide foundations for future developments. As Gereffi and others have shown, one of the keys to developing undeveloped economies is linking them to the markets in

developed economies through mutually beneficial contracts that take advantage of the local knowledge and social capital as well as the cultural, environmental, technological and financial assets of both the producers and the distributors.<sup>12</sup>

It goes beyond the limited scope of this paper to describe in any detail what a development strategy based on exploiting the development potential of self-enforced contracts and the existing trading houses in the Pacific would look like. Suffice it to say, it would look very different from the current and recent approaches to economic development in the Pacific. It would not emphasize technology transfer independent of market demand and buyer participation as so many university based agriculture and aquaculture development projects have done. It would not attempt to create island entrepreneurs from walk-in clients (with little or no business experience, assets or business related network) with loans and workshops as the UNDP attempted to do in the FSM in the 1990s and the current SBDCs still continue to do. And it would not see local government initiatives and economic reform as the key to economic development. As much as institutions in the Pacific need to be reformed, governments in the Pacific will not reform themselves just because outside consultants argue that it is a good idea. Historically, island governments have reformed themselves to support private sector development only when the private sector and private sector driven economic opportunities have forced them to.

An economic development strategy based on self-enforcing contracts and island trading houses would be focused on the few but significant trading houses that exist in all of the PICs. The role of economic development agents would be to assist them in identifying the island products for which there are reliable, international distributors and significant market demand. Development agents would play the role of independent, objective brokers in the initial process of forming partnerships between island producers and off-island buyers. They would serve as a necessary catalyst that would in time drop out of the project altogether.

The economist's claim that the market will sort these things out on its own and that island producers and international markets will magically find each other should be seen for what it is, an idealized view of how transactions occur that has no relevance to how business has been done and is done in the Pacific. This myth should be set aside in favor of trying – through the careful analysis of case studies taken from the region – to better understand and support the complex process of forming commercial partnerships in the PICs and exploiting their potential for bridging cultural divides and serving as a framework for facilitating rapid, lasting technological and economic development.



## Notes

<sup>1</sup> See Holden et al., 2004; Duncan & Pollard, 2002; Abbott & Pollard, 2004; Lucas, 2005; Enterprise Research Institute, 2003 & 2006.

<sup>2</sup> Throughout this paper I use Avner Greif's definition of an institution: "An institution is a system of rules, beliefs, norms, and organizations that together generate regularity of (social) behavior." (Greif, 30) Greif prefers this broader understanding of institutions to a more restrictive definition that sees institutions as formal 'rules' that govern human interaction because: "Rules that prescribe behavior . . . do not influence behavior unless people are motivated to follow them. For rules to be part of an institution, individuals must be motivated to follow them." (ibid. 31)

<sup>3</sup> Hezel 2000; Lucas 2005, 28-9.

<sup>4</sup> Trade over long distances and the institutions that supported it developed in much the same way in Pre-Colonial Africa (Bates, 27 ff.), within Europe and between Europe and Asia and Africa from 1000 to 1400 (Weber, 195-222; Pirenne, 56-105; Greif, 55-153), between Europe and the rest of the world from 1480 to 1700 (Fernandez-Armesto, 153-288; Chanda, 35-70) and in the Pacific from 1750 to 1900 (Montes et al.; Kirch et al.; Sahlins; Maude 1959, 1964, 1968; Ward; Shineberg; Hezel 1983, 1992; Hanlon; Firth; Knapman; Scarr 1972, 1990; Newbury). It was carried out in marked contrast to local commerce and was rarely an expansion of the land-based, local, subsistence economy. Local subsistence goods were reserved for local use and were not traded over long distances except in unusual circumstances such as famine. (Pirenne, 45 ff.; Polanyi 1944, 45-80; Polanyi et al. 1957) Long distance trade was driven by the opportunity to achieve enormous profits. The barriers to entry were the high cost of transportation, security and information. These costs meant that long-distance trade was restricted to the elites who possessed the resources to pursue it. The institutions that grew up in support of long-distance trade were the self-enforcing contracts that bound traders together in international networks; the walled commercial centers that later became cities; and the multi-generational, international trading houses that were able to survive the rise and fall of empires.

<sup>5</sup> See Legge, 21 ff. on British policy in Fiji; Newberry, 76 ff. on French and British policy in Tahiti; and Daws, 114 ff. & 132 ff. on French, British and United States policy with respect to Hawaii.

<sup>6</sup> See Polanyi, 1947, 59-77; Polanyi et al. 1957; Hodgson, 274-6; Sahlins; Maude 1968.

<sup>7</sup> Dixit, 25 ff.; Barzel, 33 ff.; Bates, 27 ff.; Greif, 55 ff.

<sup>8</sup> From the 1840s until 1860, when whaling disappeared for the most part in the central Pacific, indigenous Hawaiians could make much more money with far less effort by growing produce for the whaling fleet than they could by hiring out as laborers on the sugar plantations. Sugar growers could only afford to pay \$.125/day (with a lunch of poi and fish valued at \$.01) while “laborers were refusing to work for less than \$.75/day.” (Kuykendall, 201-2; Hoyt, 29)

<sup>9</sup> On the role of Godeffroy und Sohn in the Pacific copra trade see: Spoehr and Firth . On Adolph Capelle’s copra trade in the Marshall Islands see Hezel 1983.

<sup>10</sup> See McGregor (1988, 1990, 1990a). McGregor’s case studies of agriculture development in Fiji, Tonga, Cook Islands and Hawaii also provide a detailed picture of the failed government attempts to develop export agriculture in Polynesia and Melanesia. As an alternative approach, McGregor initially advocated the use of Commercial Management Companies to bridge the gap between island producers and global markets by providing technology, management and marketing assistance (1989), but later he was critical of this approach because the cost of using CMCs was too great and would require at the very least a subsidy for start-up. (1991, 3-21) He continued to be an advocate, though, “for building on successful companies and organizations,” such as AMFAC, the Fiji Export Agencies and the Southern Development Company. (*ibid.*, 20)

<sup>11</sup> I have written a more detailed case study of the giant clam industry in the Marshall Islands which is summarized here to show in a single enterprise the evolution of a copra buyer to a trading house to a producer and exporter of a Pacific island product. See Cheshire.

<sup>12</sup> James Rauch has shown how the social networks among the Chinese diaspora have been successful in creating trading networks that use a production base in Taiwan, Hong Kong and the Peoples Republic of China and rely on market information from relatives living in the West. This partnership makes it possible for the producers, who have very little first-hand of knowledge of the markets they supply, to compete successfully in communities thousands of miles away. Yung Whee Rhee (Rhee; Rhee & Belot) has described how development catalysts were successful in developing a purchase agreement that created the garment industry in Bangladesh. The agreement served as a catalyst for the development of not one but several industries. Like export catalysts, the vertical cluster of industries in India and Brazil that Hubert Shmitz and Kahlid Nadvi describe also rely upon relationships between local producers in developing countries and marketing agents in developed countries. Gary Gereffi has declared this pattern of export development to be a global paradigm in which the newly developed countries such as Korea and Taiwan, that once

were the low cost suppliers for Japan and the U.S., are now competing with Japan and the U.S. for a share of the global market by partnering with low cost manufacturers in India, Bangladesh and the Peoples' Republic of China. (Gereffi 1994,1999; Gereffi & Korzeniewicz)

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