6

The Economic Dimension: Response and Recommendations

6.1 The previous chapter drew attention to the urgent need for small states to undertake a number of reforms to improve their competitive position in the global economy. Most of them were inward directed with the principal task of creating and maintaining a stable macro-economic environment in which investment and the private sector can be encouraged. However, it was noted that the geographical region is an increasingly important arena for integration into the global economy and that, over and above this, small states must be pro-active in coping with challenges presented by the forces of globalisation. This chapter identifies three such challenges as the most immediate for all small developing states: the liberalisation of trade, improved marketing and resource mobilisation.

Trade Policies and Preferences

6.2 The major changes brought about by the liberalisation of trade and the emergence of regional trading arrangements have significantly altered the trade policy framework in which small states will need to operate in the future. While the Uruguay Round (UR) may have positive effects on small states in the long term, many of them are concerned about the transitional costs they face in adjusting to a freer international trading system. These will vary by country and by region depending on product, competitiveness and the degree of dependence on preferential access to major metropolitan markets.

6.3 The UR was launched under the auspices of the General Agreement on Tariffs and Trade (GATT) in 1986 and concluded in 1994. It is different from earlier multilateral trade negotiations by being more comprehensive in its scope and effect. Substantial reductions in most favoured nation (MFN) tariffs were agreed as well as the removal of a variety of non-tariff barriers. Estimates of the increase in global GDP from improved market access range from US$ 40 billion to US$ 315 billion annually, around one-third of which will accrue to developing countries. For most small states, however, as well as some larger ones in sub-Saharan Africa, the gains are expected to be small and some may even be net losers. While the figures have to be treated with caution, since overall increases in global trade may well increase demand for small states exports, the initial assessment is negative: Caribbean small states are expected to lose 3% of their export earnings per annum and South Pacific small states 1.1%. African ACP countries also face a 1.1% decline. Some of the countries which are likely to be significant losers are The Bahamas, Guyana, Jamaica, Kiribati, Mauritius, Papua New Guinea, Samoa and Trinidad and Tobago.

6.4 These anticipated losses are largely the result of reduced preferences. The reduction in MFN tariffs has also reduced the margins of preference small states have enjoyed under the Generalised System of Preferences (GSP) and the various regional preferential schemes to which they belong. In the case of the GSP schemes the impact is likely to be limited for two reasons: first, most small states receive more generous terms of access to their principal export markets under other schemes and second, the degree to which they can benefit from GSP is limited by a variety of restrictions and exclusions. The result is that small states are not significant users of GSP schemes and the proportion of their exports receiving GSP treatment is relatively low.

6.5 By contrast the other preferential trade schemes are very important. The major preferential trade schemes that benefit Commonwealth small states are the Lomé Convention, the CBI and SPARTECA. Since different rules govern their operation the best way to assess the effects is a sector approach.

Bananas and sugar

6.6 The two most important products which are likely to experience a negative effect are bananas and sugar. For CARICOM banana producers, especially Dominica, St Lucia, and St Vincent and the Grenadines, any reduction in preferences could have serious economic repercussions. The EU banana regime, under which these and other ACP countries are receiving a tariff-free quota, is under sustained attack by some Latin American banana exporters and the US and has been ruled illegal by the WTO. In addition, some EU member countries have questioned the legality of the scheme and with the accession of Austria, Finland and Sweden to the EU – all importers of low cost Latin American bananas – there has been increased pressure to amend the regime. Some changes have been introduced by the European Commission but these have not been sufficient to satisfy those opposing the regime and it is now almost inevitable that the regime will not be renewed in its present form when it comes to an end in 2002.

6.7 The small states in the Caribbean played an important part in the negotiation of the regime in the sense that they were able to put their views across, and to some extent get them acted upon, in the European

Commission and in several EU member states. The arguments they made then are still valid, but the negotiation of the regime was a difficult and protracted exercise which cost an enormous amount in time and resources for all concerned. The prospect of beginning again is daunting. The optimum position for the Caribbean small states is therefore a vigorous defence of the current regime over the next few years, combined with attempts at improvement in quality and price, to make their bananas more competitive with those from Latin America, although there are limits as to what can be achieved. The same applies to diversification. While it is imperative that the Caribbean banana producers make full use of the structural funds available under the European Development Fund (EDF) and take early steps to diversify their product base, the opportunities are limited. As yet no equivalent substitute has been identified in terms of economic and social welfare and resilience to hurricanes. These are considerations which point to bananas being an exceptional case to which exceptional measures need to apply.

6.8 Under the Sugar Protocol the EU guarantees to buy specific quantities from particular ACP states at an annually negotiated fixed price. In the past it closely followed the price guaranteed to EU sugar-beet growers. A number of small states have benefited significantly from this arrangement. A large fall in the EU internal price would be reflected in a lower price paid to sugar exporters. As a result of the agreement in the UR, a reduction in the price, of the order of 10%, is probable and would lead to a major drop in export earnings of sugar exporting countries. The most seriously affected would be Barbados, Guyana, Jamaica, Mauritius, Swaziland and Trinidad and Tobago.

Beef

6.9 The Beef Protocol is similar to the Sugar Protocol in that it provides specific quotas for export to the EU from specific countries for which exporters receive roughly the EU intervention price. Since the quotas are not fully used the main effect of liberalisation will be on export prices. A reduction of some 20% has been thought possible. Since 60% of Botswana's exports to the EU are beef the loss in earnings could be substantial. Smaller losses may also be experienced by Namibia and Swaziland.

Rice

6.10 Some ACP countries benefit from preferential access for their exports of rice to the EU. At present they receive a price roughly half-way between the world price and the intervention price paid in the

EU. As a result of the UR, a reduction in the prices of some 10% seems likely. The major impact will be on Guyana which has also been in dispute with the EU over access to its market for rice. In January 1997, at the initiative of the EU rice producing countries, the EU imposed safeguard measures which limit the export of rice into the EU from its Overseas Countries and Territories. This had the immediate effect of suddenly and substantially curtailing rice exports from Guyana and Suriname. There was no prior consultation with these countries, although this trade route had been legitimately used by them over a period of years.

Textiles and clothing

6.11 Under the UR the Multi-Fibre Arrangement (MFA), which has regulated the international trade in textiles and clothing, will be phased out over a period of ten years. Some ACP countries have taken advantage of the export restrictions imposed on Asian producers to develop a substantial export business based on tariff-free entry to the EU market. Caribbean exporters have also benefited from tariff advantages in the US market under the so-called 807A provision. Among the small states which have utilised these advantages to good effect to establish major export industries are Belize, Jamaica, Mauritius and St Lucia.

6.12 It is difficult to predict the pattern of trade in textiles and clothing that will emerge after the ten year transitional period. Even under MFA constraints the sector is unusual in that the product cycle is often as short as ten years. Preferential access and low labour costs attract foreign investment by producers from either the target market country or other developing countries which have had their access constrained. Sometimes the new producers themselves soon become subject to quotas (though this is not the case for ACP countries on the EU market) or their labour costs rise and/or alternative uses of labour become more attractive and the industry shrinks. Hence it is difficult to predict which countries will have a comparative advantage through low labour costs or higher productivity. Small states will probably continue to benefit from some advantages in tariff preferences in the EU and the US markets. Whether these will be high enough to maintain a competitive industry in the long run, however, is questionable.

Other products

6.13 A range of tropical products which in the past have been given favourable treatment, such as coffee, cocoa, and palm oil, will also be affected by the erosion of preferences. Even though the overall effects are likely to be small, some exporters in the Caribbean and the South Pacific are likely to lose market share. The same applies to some manufactured products which will face increased competition. Small states that are likely to be adversely affected include Botswana, The Gambia, Mauritius and Swaziland.

Other issues

6.14 The UR agreements also incorporated a number of new features. These include the agreements on TRIMs, TRIPs and the General Agreement on Trade in Services (GATs). The impact of these will in general be favourable even though it will necessitate major policy changes and some new costs. TRIPs, for example, is expected to lead to larger royalty payments but enhance access to technology. GATS, through the establishment of a sound multilateral framework, should impact favourably on countries which are exporters of labour intensive services. An indirect benefit would also follow from a reduction in the prices of services that small states purchase as inputs from the rest of the world.

6.15 The implementation of the UR agreements will make the multilateral trading system more orderly. The strengthening of existing rules and the establishment of more precise procedures will benefit small states. The reaffirmation of the principle of special and differential treatment for developing countries, the right to use import restrictions to support infant industries, while primarily designed to assist the least developed countries, will benefit some small states. However, the agreement on subsidies for non-agricultural products will prohibit the use of such instruments and will adversely affect middle income small states such as The Bahamas, Barbados, Cyprus, Jamaica, Malta, Mauritius, and Trinidad and Tobago. Some of the policy constraints arising from these agreements may not be entirely negative. Small states will also benefit from changes in the trading system that will be ushered in by the WTO regime in respect of anti-dumping and safeguard measures, non-tariff barriers and dispute settlement procedures.

Overall assessment

6.16 With further multilateral trade liberalisation and progressive decline in MFN tariffs expected, the scope of preferential arrangements such as Lomé will diminish over time. Small states will need to consider the future role of such arrangements. The priorities and interests regarding post Lomé arrangements may be different in each region, governed in the main by the structure and destination of its exports. The African states are largely dependent on EU markets and Lomé preferences are therefore important to them. For the South Pacific states, Lomé represents a limited benefit covering a small part of their exports. The circumstances of the Caribbean are more diverse and complex. The US market is the more significant market for many of the products exported by the majority of Caribbean states. However, for countries such as Guyana, Barbados, and the other Eastern Caribbean states, the EU is a major market for products such as sugar, rice, rum and bananas. Thus for the Caribbean, one or more of the preferential regimes offered by the EU and the US are important.

6.17 Small states will need to seek optimal arrangements in any new agreements that emerge after the expiry of the current Lomé Convention. As noted earlier, the European Commission has already published a Green Paper setting out some of the issues. The development problems for small states as a distinct group are not directly addressed at any point in it, though there are references to the particular difficulties facing the Caribbean ACP in respect of fashioning regional trade strategies and to problems peculiar to the small island economies of the South Pacific. This may be indicative of a preference for regional agreements. In this case small states will need to weigh up the pros and cons very carefully. The various regional fora need to be fully engaged in this process as well as the ACP Secretariat. The Commonwealth Secretariat can play a valuable role in the provision of technical assistance.

6.18 In the meantime the existing preferences in the EU could be more fully exploited. The financial and technical assistance resources available from the EDF for the promotion of ACP exports in global markets under the Trade Development Project should be more fully utilised. At the same time any relaxation of the rules of origin would provide tangible benefits for ACP countries.

6.19 Additionally, the Caribbean faces challenges from NAFTA. The advantages it had through preferential access to US and Canadian markets have been eroded with significant consequences for clothing and textiles and processed foods, particularly exports of orange juice and grapefruit juice. There will be two main effects. First, Caribbean exporters will face increased competition through lower prices for clothing and textiles manufactured in Mexico and for citrus fruit products. Second, new investment in the textile industry in the Caribbean is likely to suffer from diversion to Mexico as the result of its security of access to the US market and lower production costs, particularly labour costs. In addition, investment from other countries such as the EU could also be diverted to Mexico as a means of gaining entry to the US market. The countries most affected by these developments are The Bahamas, Jamaica and St Lucia.

6.20 The Caribbean has sought to counter the threat of NAFTA by seeking an interim parity agreement. However, there have been political difficulties in getting the proposed measure through the US Congress. The current US administration has promised to implement measures to increase Caribbean preferential access to the US through an improved CBI, but significantly a request for NAFTA parity received only token support. The US also rejected a request by Caribbean Heads of Government in early May 1997 to withdraw its opposition to the EU banana regime. This led one Caribbean prime minister at the time to be reported as commenting 'It must be clear to President Clinton and all his advisers that if the small Caribbean countries cannot live by trade in selling bananas to Europe and other goods to the US, then they will collapse and the region will become a playground for the narcotics cartels' (*Financial Times*).

Commercial and Marketing Policies

6.21 Many small states have recognised the need for diversification of their economies and have attempted to achieve that objective by encouraging private sector development activities. They have encouraged local and foreign entrepreneurs to invest while reducing the scope of their own involvement in the ownership of businesses by disinvesting. These governments have embarked on a programme of policy reforms and attempted to create an environment where the private sector assumes the role of an engine of growth. As exports have become more diversified, the need for further market development through a more dynamic and aggressive marketing strategy has become apparent. While joint ventures and transnational corporations have taken the lead and pursued their own marketing strategies, small and traditional domestic producers have been unable to mount similar efforts. Their expansion and diversification efforts have been constrained, largely because of their size and lack of sophistication. Studies have demonstrated the need for improved marketing arrangements. Some progress has been made. For instance, Geest boats can handle products other than bananas and the Eastern Caribbean Export Development Agency seeks to identify market opportunities in North America. However, the lack of funding in other areas has constrained the effort to promote and market other products.

6.22 Increased co-ordination and funding are needed in all areas of present and potential exports. While the private sector must bear the greater burden, a case can be made for public funding, especially for market information gathering and technical assistance in marketing. Past government efforts have not been particularly successful because of weak organisational arrangements. If governments are to be successful in a supporting role, they need to develop professionally competent and goal oriented organisations with strong links with private enterprises. Thus, a private–public sector partnership is essential.

6.23 Even with an effective orientation, many governments will still lack the means for launching successful marketing initiatives. These governments individually have limited financial and human resource capacities and are unable to 'go it alone'. Co-operative arrangements between several governments within a region do offer opportunities for the launch of successful joint programmes that enable potential markets to be turned into actual markets. This is important in all areas but particularly so in the tourism sector. Similar efforts in promotion of investment in a range of fields would also have large payoffs.

Aid Policies and Resource Mobilisation

6.24 A common characteristic of many small states has been the high level of dependence on ODA. High levels of ODA flows on a per capita basis to small states are unlikely to be sustained in the future and cut-backs will put strains on them. The decline in future ODA flows can be postulated on the basis of three emerging trends. In the first place the general aid fatigue and domestic policy concerns of the major bilateral donors have resulted in sharply reduced aid budgets. The US has reduced both its bilateral aid programmes and contributions to the IFIs. It has pledged a sharply reduced contribution to the next replenishment of IDA. The US actions have triggered lower contributions by other donors to multilateral aid programmes. These donors have also reduced their bilateral assistance. The second element concerns the intention of both bilateral and multilateral donors to channel resources to new claimants. These new claimants are either new member states in East and Central Europe, now in transition to a market economy, or countries and entities such as Bosnia, Croatia and the West Bank, that are emerging from prolonged periods of civil strife and are attempting a reconstruction of their devastated economies. Thus, the already reduced pool of ODA resources is being spread over a large number of countries. The third main theme of ODA policies is to assist the poorest of the poor countries, especially in Sub-Saharan Africa where poverty is overwhelming. Under these circumstances, small states are likely to see a reduction in the flows of ODA, particularly because of the perception that most small states are relatively well off.

6.25 While it is true that in most small states average income per head puts them into the category of middle income developing countries, per capita GNP is not a comprehensive, and therefore an altogether appropriate, indicator of development in small states. There are several reasons for this. One is these states' heightened vulnerability to internal and external shocks, both economic and environmental, which warrant the inclusion of an element of risk discounting in GNP calculation. Another is the higher unit costs per capita incurred from size in the provision of basic infrastructure and public services, which has already been highlighted. Third, the delivery of such services can be exceptionally costly, especially in the case of very small and remote communities in archipelagic SIDS, where duplication of provision is inevitable. The inescapable conclusion is that nominal income alone should not be used in determining the eligibility of small states for loans from IFIs.

6.26 However, access to these sources of finance is constrained by inflexible eligibility criteria. The IDA, the concessional resource arm of the World Bank, along with the Inter-American Development Bank (IDB) in its concessional lending, adopt a strict per capita GNP criterion for their credits, currently US$ 1,500 (1996 dollars). Accordingly, it appears that eligibility in 1998 will be confined to only 10 Commonwealth small states in the case of the IDA – The Gambia, Guyana, Kiribati, Lesotho, Maldives, Papua New Guinea, Samoa, Solomon Islands, Swaziland and Vanuatu – and in the IDB only to Guyana.

6.27 In contrast to IDA and IDB eligibility, the International Bank for Reconstruction and Development, another lending window of the World Bank, adopts a more flexible approach. Currently, it graduates out of its resources those countries with per capita incomes above US$ 5,435 (1996 dollars), with graduation usually occurring within five years of a country reaching the appropriate point. The decision to graduate is subject to two other important influences: access to capital markets on reasonable terms; and the extent of progress in establishing key institutions for economic and social development.

6.28 As noted earlier, small states are particularly disadvantaged in accessing international capital markets at reasonable cost. They also have difficulties in establishing stock exchanges to attract portfolio investment. As a consequence, it is difficult to believe that several Commonwealth small states which stand on the threshold of graduation (Antigua and Barbuda, Seychelles, St Kitts and Nevis) and others who may shortly follow, are as likely to meet the criteria as fully as other graduates of recent years (Ireland, Israel and New Zealand). In the case of small states, special considerations should apply.

6.29 It is our understanding that the Executive Directors of the World Bank have not considered for some years the special problems of very small economies (i.e. borrowing members with a population of less than 1.5 million) as a whole. In the past, the World Bank has recognised the special problems of small states, though it has not recommended any variation of the graduation policy. The time has come when existing policy should be reconsidered.

6.30 On their part, most small states will have to rely more on domestically generated savings than in the past. This will require governments to adopt fiscal policies which will generate increased public sector savings through surpluses. Private savings will need to be encouraged through improvements in financial markets where they exist, or through the development of institutions that will be capable of mobilising private savings. Fiscal policy will need to focus on constraining inflation, maintaining a stable exchange rate, and enhancing foreign competitiveness.

6.31 On the revenue side, small countries will need to broaden the tax base by reducing exemptions and concessions, and strengthening tax administration. Governments will need to curtail expenditure growth through measures that reduce the size of government, impose user charges for services and privatising government enterprises. Savings effected will need to be channelled into resources for infrastructure development in partnership with external financing sources.

Recommendations

6.32 The UR agreements and other changes in the international trading system pose major transitional challenges to small states. To benefit from them, **small states will need to re-orient their economies and diversify their production base**. They will need to strengthen the physical and human infrastructure in order to attract FDI flows. Sound macroeconomic management, a competitive exchange rate, and a dynamic role for the private sector will need to be in place. The international community will also need to respond appropriately to support the efforts of small states.

Trade policy

6.33 In the field of **trade policy**, Commonwealth small states would need to:

- assess and monitor changes in market access and identify new opportunities;
- eliminate any anti-export bias (i.e. high import duties which discourage export production);
- assess the rights and obligations of member states in the emerging global trading system, taking into account the special and differential treatment accorded to developing countries;
- review domestic policies, legislation and procedures to achieve conformity with the requirements of TRIPs, TRIMs and GATS;

- identify and introduce institutional and other support measures to enable the private sector to benefit from new trade opportunities.

6.34 In conjunction with these actions, governments will also need to undertake **new measures** to adjust to the changes brought about by the UR. Amongst the measures of importance are:

- ensuring greater use and exploitation of existing preferences under Lomé;
- increasing the awareness of the private sector to new market opportunities;
- improving competitiveness and product diversification;
- counter-balancing the erosion of preferences for particular product groups;
- investing in capacity building in the clothing and textile industry.

6.35 In respect of **new issues** in the UR small states should seek:

- the development of trade and labour intensive services within the context of GATS;
- to establish policy and institutional frameworks consistent with TRIMS to attract foreign investment;
- to promote accession to the WTO by those states who are not currently members.

6.36 These are major adjustments which small states will find difficult to realise without **external support**. One source is regional organisations. Many of the measures identified above can be co-ordinated regionally, particularly in negotiating changes in trade policy. The other source is the developed countries, especially those with which they have preferential trading arrangements. Small states must point out that it is in the interests of these countries as well as in their own interest that there is an orderly transition. They should therefore encourage them to take action in support of the reform programmes being undertaken. Among the measures which could be undertaken include:

- getting developed countries to provide fiscal incentives to their companies in order to encourage flows of FDI;
- elimination or removal of consumption taxes in developed markets to encourage imports of tropical products such as coffee and cocoa;
- encouraging more permissive 'rules of origin', not only in manufactures but also in fishing where the area of catch

for 'originating' purposes could be extended to include the EEZ, in line with the UNCLOS.

6.37 IFIs, the EU and developed countries bilaterally can also devise **special regional development funds** for small states aimed at:

- identifying emerging trade opportunities for goods and services currently produced in small states or in which they might acquire a dynamic comparative advantage;
- the promotion of special projects to facilitate the transfer of production technology and marketing skills, as well as trade promotion.

6.38 Finally, the UR is likely to lead to an increase in prices for food produced in temperate zones. Since many small states are net-food importing countries this will lead to trade and welfare losses. The UR included a commitment by the developed countries, through the WTO, to consider providing food aid and/or compensatory finance from bilateral or multilateral aid programmes to the least developed and net-food importing countries who found themselves seriously affected. **The developed countries need to be reminded of their obligation to provide such assistance should it be needed.**

Marketing policy

6.39 Specific actions that ought to be taken in **marketing policy** are:

- a public sector role in gathering market data from the main markets, both present and potential;
- well financed joint private–public sector programmes in export promotion of both products and services;
- fiscal incentives to enterprises in the form of tax rebates against expenditures incurred in export promotion;
- joint government and private sector investment promotion missions to seek FDI flows.

6.40 At the **regional level,** joint intergovernmental trade representation would make a considerable contribution to economising resources. So too would joint trade and investment promotion efforts by the private sector and collaboration between the public and private sectors in these fields. For products common to several small countries in a region, a joint marketing and promotion effort should be established with cost sharing as an element for co-operation. Both traditional products, such as bananas and sugar, and services such as tourism should be covered by such arrangements.

6.41 Although a number of **international programmes of assistance** are in place to support product and market diversification (encompassing product adaptation, development of standards, export packaging, development of marketing skills, and marketing of tourism), the available resources are limited. **The bilateral and multilateral donor agencies should be urged to augment resources and earmark for these purposes.**

Resource mobilisation

6.42 The **mobilisation of domestic resources** through the appropriate fiscal policies, within the context of an overall macroeconomic policy framework that creates a competitive environment, will demand focused attention by governments. Governments will need to take steps to encourage private investment, both foreign and domestic. These steps will need to include an aggressive investment promotion effort and the removal of impediments to investment and any export bias. **Governments will need to make a strong case to donors for assured flows of ODA during a transition phase** in which they strengthen their capacity to mobilise both domestic and foreign resources.

6.43 At the international level, bilateral and multilateral donors should take a number of steps that contribute to national efforts. In so doing the **special position of small states** must be recognised. The vulnerability dimension must be taken into account along with the limited resources available to small states to implement the changes which are needed. The IFIs should reconsider their present approaches to determining eligibility to concessional lending by taking account of a broader set of criteria other than per capita incomes. We request Commonwealth Ministers to urge the **World Bank and the IDB to review their graduation policies and establish multiple criteria,** which take into account the special vulnerabilities and costs of its smallest borrowing member countries.

6.44 The development of **a robust vulnerability index** for the purposes sought by the 1995 meeting of the Commonwealth Ministerial Group of Small States (MGSS), namely 'to assist international consideration of the special problems of small states, including their access to concessional resources from international financial institutions', is essential to this exercise and should receive the highest priority.

6.45 Aid should be directed at **capacity-building,** both in terms of infrastructure and the development of human capital. Education and training should receive high priority. National financial institutions, donors and others should be encouraged to provide catalytic, equity financing schemes to assist in the development of a class of entrepreneurs who would strengthen the private sector. **A combination of capital and technical assistance should be targeted towards meeting the goals and objectives of the Barbados Plan of Action.**

Reform and the private sector

6.46 The pace of reforms needs acceleration in all states. **Small states that have yet to embark upon reforms need to do so as a matter of urgency**. Amongst the specific measures that are required are:

- a broadening of the tax base together with an elimination of customs surcharges and other taxes that have an anti-export bias;
- simplification of tax structures together with a strengthening of tax administration;
- an acceleration of the pace of privatisation of government-owned enterprises to increase efficiency, and use of the proceeds from the sale of public assets for investment in infrastructure;
- simplification of the regulatory framework aimed at encouraging private investment;
- provision of the necessary information to facilitate business decision-making;
- investment in development of the human resource base to underpin private investment.

6.47 Measures promoting trade and co-operation amongst a region's entrepreneurs, taking the form of business councils, regional Chambers of Commerce, product standardisation and sponsorship of trade and investment promotion missions is also likely to have a positive impact in **strengthening the private sector**. Indeed, a change in attitudes towards the role of the private sector, viewed as a full partner in development, is likely to make a significant contribution to enhancing the role of the sector and the prospects for sustainable development.