

# trade hot topics

## Export Diversification and Climate Change: Overcoming the Emerging Constraints

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### Background

Until or unless the successor to the Kyoto Protocol which expires in 2012 is agreed, there remains a considerable degree of ambiguity in relation to the potential conflict areas between trade and climate change regimes. Given this uncertainty, developing states, particularly least developed countries (LDCs) and small vulnerable economies (SVEs), need to be prepared to defend their offensive and defensive trade interests. This approach is necessary so as to ensure that the actions being taken to mitigate climate change by developed countries facilitate rather than hinder existing export diversification strategies.

This issue of *Commonwealth Trade Hot Topics* outlines a number of policy tools which can be used in order to overcome some of the real and regulatory challenges faced by developing countries in their efforts to diversify exports in the face of climate change concerns. This article introduces several emerging physical and regulatory challenges to traditional export diversification strategies and then discusses some of the potential development-friendly approaches to dealing with these concerns.

### Adapting and designing export diversification strategies

Diversifying exports is a necessary part of the process of development and structural change. It is particularly important for small countries and LDCs, given the small size of their domestic markets and overwhelming dependence on a few sectors for production and exports. It is always a difficult process, which may become more so because of climate change. The processes by which the diversification of productive structures takes place depend on the external trade environment and countries' ability to both adopt, and adapt to, relevant new imported technologies and match them to their factor endowments. Late industrialisers now also face the additional challenge of climate change. This includes not only physical effects — such as changes in precipitation patterns, increases in global temperatures and the likelihood of extreme events — but also regulatory changes related to the mitigation of further temperature increases.

The opportunities and benefits for countries that start to adapt productive structures to climate change are increasing, in addition to the opportunity costs for them of *not* doing so. Climate

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change might necessitate changes in what is produced, what is traded, and how it is traded. Along with the physical effects of climate change, developing countries will need to adapt to the changing rules and regulations (public and private) likely to shape trade in a future carbon constrained world.

The compound effect of all of these changes may imply that in some cases the routes used in the past to diversify exports may no longer be viable, requiring new strategies to be designed. Broadly defined, strategies will comprise increasing the resilience of existing productive structures, moving into new products and services related to global climate change mitigation efforts, and making full use of rights provided by the international trade system.

### Addressing the new physical and regulatory constraints

Even if the most ambitious measures to address climate change are adopted, global temperatures are projected to increase by at least 2 degrees Celsius by the end of this century, if not sooner. The only certainty in the context of climate change is the increased uncertainty of temperatures, precipitation and extreme events. Agricultural producers are inevitably the most susceptible to the physical effects of climate change. A number of countries in Sub-Saharan Africa are likely to experience declines of at least 20 per cent in farm outputs should climate change continue unmitigated, jeopardising the prospect for agricultural export earnings. Commodity prices are likely to become more volatile with serious implications for macroeconomic management, among others. The effects of climate change, including policies designed to mitigate it, will be country, product and value chain specific.

A significant proportion of Commonwealth developing country exports comprises natural gas and petroleum oils and other primary products. For many of these export items, new market openings are related to the efforts to mitigate global climate change. For example, in the case of sugar cane, this could include new sources of demand for bioethanol related to the substitution of fossil fuel with biofuels not only in such major markets as the European Union and USA, but also in domestic markets of many other developing countries. Changes in energy use can increase costs affecting competitiveness.

### Increasing the resilience of existing productive structures

As adverse shocks due to climate related factors are likely to become more frequent, existing mechanisms to help commodity exporters cope with adverse trade shocks will need updating and enhancing. UNCTAD (2010) suggests the establishment of a counter-cyclical financing facility for low-income commodity dependent countries to better deal with external shocks, involving physical and virtual reserves.<sup>1</sup> Mechanisms could be designed *ex ante* rather than *ex post* and take into account new indicators of vulnerability related to climate change. Other ways in which to make existing productive structures more resilient include enhancing insurance facilities. For example, in the case of the Global Index Insurance Facility (GIIF) being implemented by the International Finance Corporation, payments are triggered on the basis of rainfall and variation of temperature; regional approaches include the Caribbean Catastrophe Risk Insurance Facility.<sup>2</sup>

While technical assistance programmes should implicitly prepare countries well to meet any challenges associated with the trading environment, some changes may be so large and uncertain that trade support must allow for them explicitly. The Aid for Trade initiative, like climate change mitigation and adaptation finance, is about the delivery of global public goods. But any new purpose for Aid for Trade related to increasing the resilience of productive structures to the physical effects of climate change needs new resources in order to avoid diverting from existing needs. There are governance issues which need to be resolved so as to ensure the additionality and optimal utilisation of funds, and avoid potential conflicts between competing demands and agendas.

### Addressing new regulatory constraints

The World Trade Organization (WTO) does not have specific provisions to deal with climate change, despite there being some obvious potential clashes between the trade and climate regimes. The Doha development round (DDR) of negotiations do not address it specifically, and although environmental goods and services are included within the round

<sup>1</sup> UNCTAD (2010). The Least Developed Countries Report, Towards a new international development architecture for LDCs. Geneva: UNCTAD.

<sup>2</sup> See European Commission (2011). 'Scaling up International Finance after 2012', Staff Working Paper.

there remain sticking points over the products that are currently listed, including the distinction between agricultural and industrial goods, for example bioethanol.

Regarding the next round of negotiations for the post-2012 UNFCCC climate change regime (COP17 to be held in December this year in Durban, South Africa), unless a comprehensive agreement is reached, countries may resort to various unilateral trade measures which could adversely affect the trade interests of Commonwealth members. The breakdown in negotiations for the second commitment period of the Kyoto protocol (2008—2012) in Copenhagen in 2009 at the Fifteenth Session of the Conference of the Parties to the UNFCCC (COP15) meeting was due to the desire by developed countries to create a new global agreement on climate change, the Copenhagen accord. This was supported as an alternative to remaining within the framework already established by the United Nations Framework Convention on Climate Change, under the Kyoto protocol.

A new incremental approach to negotiations was adopted at the COP16 meeting in Mexico. But the final outcome from that meeting — known as the Cancun agreement — leaves a number of options open. It comprises decisions undertaken under two tracks: the Kyoto protocol track and the working group on long-term co-operative action (LCA) track. These include decisions on finance, the adoption of land-use related measures to reduce emissions and the extension of negotiations for the successor to the Kyoto accord by one year. It remains unclear how negotiations undertaken within each track will be reconciled. This could result in legal uncertainty since, although imperfect, the Kyoto protocol remains the only legally binding international commitment to reduce greenhouse gas emissions. This could pit supporters of the Kyoto protocol against those of the LCA.

Both the revised EU Emissions Trading Scheme (ETS) Directive and the recent US Clean Energy and Security Act will require importers to participate in emissions trading schemes and purchase emissions allowances according to the carbon content of products being supplied to these markets; this is even if importing countries are under no obligation to reduce their emissions under the Kyoto protocol. If importers fail to purchase these allowances, border tax adjustments will be levied so as to level the playing field between domestically produced

and imported products. Carbon-related border adjustment measures (BAMs) would mainly target imports of carbon-intensive products, such as paper, cement, rubber, glass, plastics and iron. Although it is unlikely that exports from low income Commonwealth members will be targeted by such measures at the current time, this does not rule it out in the future.

BAMs are likely to violate non-discrimination rules because they discriminate between products based on where and how they are produced, which means the remedy in some cases could be to take such actions to the WTO's dispute settlement mechanism. Alternatively, levying a carbon exports tax could be a tool developing countries use in order to counter or pre-empt border adjustment measures imposed by developed countries; this would result in revenue being retained rather than being transferred. Such an approach would level the playing field between products subject to no carbon regulation and those that are. It could also be adopted in response to the inclusion of the aviation industry within the EU's ETS from 2012, which is likely to increase the cost of travelling to some Commonwealth member states disproportionately more than other destinations — because it is badly designed — in the Western hemisphere, potentially reducing tourism exports.<sup>3</sup>

Other strategies may need to be pursued to ensure access to the EU's ETS and carbon market, which has been the major purchaser of certified emissions reductions (CERs) from developing countries under the Clean Development Mechanism (CDM) established by the Kyoto Protocol.<sup>4</sup> In the absence of an ambitious international climate agreement post-2012, access to the EU's ETS may be limited to CERs obtained from LDCs only. The ETS is likely to include the forestry sector from 2020 onwards. The carbon market for reduced emissions from deforestation and forest degradation (REDD) essentially represents a new market for existing products; this is because CERs can be obtained through improving the management of forestry reserves and enhancing carbon sequestration processes. But CERs obtained from the forestry sector in countries such as Guyana, which is a small and vulnerable economy, could be excluded from

<sup>3</sup> Bartels, L (2011). 'The Air Passenger Duty: Recent developments and WTO law aspects', presentation made at a Commonwealth Secretariat workshop on Safeguarding the Trade of Small States and LDCs, held on 13–14 June 2011 in Hampshire, UK.

<sup>4</sup> Keane, J and Potts, G (2008). 'Achieving Green Growth in a Carbon Constrained World', ODI, London.

the ETS if the 'LDC only' rule remains. Principles of special and differential treatment between the trade and climate change regimes should be maintained, including regarding trade in carbon, but there remains uncertainty as to how these principles will be upheld in practice.

Trade in CERs is payment for a service, which means that different rules apply from those that regulate trade in goods. Therefore if firms within emissions trading schemes, such as the EU's, are allocated emissions permits for free this could violate the WTO agreement on subsidies and countervailing measures because it is a type of subsidy. The future inclusion of the aviation industry within the EU's ETS is likely to be highly contentious, particularly if permits are allocated for free to the European aviation industry. Commonwealth member countries should be prepared to defend their interests in this respect.

The introduction of new regulatory measures such as more stringent standards which require carbon emissions reductions by developed countries may require the use of more sophisticated production methods. There are technical and financial barriers to monitoring, reporting, verifying and certifying emissions reductions, with the potential to exclude already low carbon producers unable to overcome these. Adhering to new standards results in costs of compliance and/or changes in how production is undertaken, and so does harmonising them across different products and markets. If all inputs are priced to reflect both their scarcity and any external diseconomies, then shifting production to the most efficient producers should reduce the impact on climate as well as improving development prospects, but this will not happen if developing countries cannot demonstrate their lower carbon costs. There could be a role for trade facilitation measures such as Aid for Trade to assist developing countries in the design of carbon standards, meeting them and demonstrating compliance.

The UNFCCC has already developed guidelines on how to measure the carbon content of land which suggests that further links could be made between the trade and climate change regimes. Biofuels certification schemes are already evolving rapidly in the major markets of the EU and USA which distinguish between products based on whether the biofuel has been produced using feedstock grown on land classified as having a high carbon stock. Even though the EU has since moved towards the

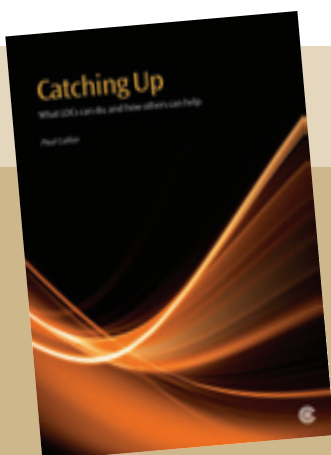
mutual recognition of private voluntary standards, as well as national schemes, including those of Argentina and Brazil, these schemes typically introduce additional social and environmental criteria over and above already stringent mandatory market access requirements.

These initiatives could result in the potential exclusion of those exporters least able to meet stringent standards based on production processes, because of technical, as well as financial, barriers. Along with legal uncertainty, there are concerns over how far they would serve as non-tariff barriers to potential exporters of biofuel from other countries. This is important because the development of standards to ensure sustainable production of biofuels can help avoid some of the dangers such as food/fuel trade-offs, as it has done in other countries such as Brazil, and indeed play a developmental role. This may assist diversification efforts of, for example, sugar cane exporters, but the risk is the exclusion of certain developing countries from this rapidly growing market.

## Conclusion

Policy-makers need to address the regulatory gaps and potential conflicts between the trade and climate change regimes to develop synergies between them. The importance of doing this for most Commonwealth member countries is amplified because of their inherent structural characteristics: limited scale economies in the domestic market that enhances the role of trade as a contributor to growth and limited productive capacity that results in excessive dependence on a few sectors for production and export. Therefore, ensuring that the post-2012 climate change regime facilitates rather than hinders the process of export diversification and structural change should be considered with utmost urgency.

# Recent publications from the Commonwealth Secretariat



## **Catching Up: What LDCs can do, and how others can help**

Paul Collier

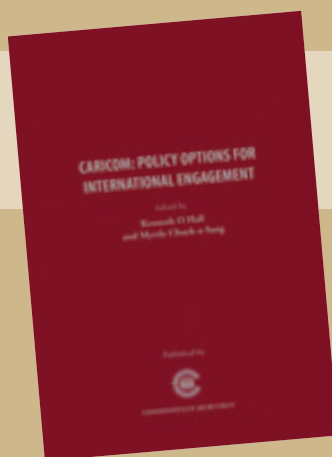
ISBN No: 978-1-84929-051-7

Despite solid gains made during the last decade, the Least Developed Countries (LDCs) are not keeping pace with other countries and the gap between them and the rest of the developing world has in fact widened. This means that LDCs will have to progress even faster to avoid being left further behind.

In this publication, economist and award-winning author of *The Bottom Billion*, Paul Collier, suggests a menu of strategic policies around which governments might rally that could help LDCs to reduce this differentiation. He argues that the only actors who can lead this process are the governments of LDCs themselves working together towards clear and well-founded goals.

He emphasises the need for effective change and highlights potential future problems associated with the management of natural resources and the threat of climate change. Implementing the right policies, he argues, is essential if LDCs are to catch up and not become detached from the rest of mankind.

Available from [www.thecommonwealth.org/publications](http://www.thecommonwealth.org/publications)



## **CARICOM**

### **Policy Options for International Engagement**

Kenneth Hall, Myrtle Chuck-A-Sang

ISBN: 978-976-637-413-6

CARICOM's success in navigating the global environment calls for a paradigm shift in diplomatic initiatives from a bi-lateral platform towards a collective and synchronised effort at the regional, hemispheric and global levels. The development of a cohesive CARICOM foreign policy would provide a more structured foundation for maximising the collective efforts, resources and gains.

In *CARICOM: Policy Options for International Engagement*, the contributors bring a wealth of experience and knowledge in putting forward the critical questions policymakers must consider and answer, in charting the course and laying the framework for this coordinated structure and foreign policy plan. Divided into four sections, the volume firstly presents the perspectives that corroborate the need for collective action. The second section focuses on the emerging powers and the need for South to South Cooperation while the third section discusses the external trade negotiations and the impact of the loss of EU preferences and subsidies; the EPA and trade negotiations in the WTO; and the new CARICOM-US trade relations. In the fourth and final section, the volume is rounded out by an examination of the kind of cooperation that is needed first at the regional level to sustain economic development. The need for harmonisation of fisheries policies and the prevention of maritime degradation; the preservation of the environment and the need to reverse the effects of climate change; the need for a cohesive regional security policy and a viable air transportation industry as well as the legal framework to implement multilateral treaties are all examined as imperative to CARICOM's development of a coordinated regional foreign policy plan.

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This Trade Hot Topic is brought out by the International Trade and Regional Co-operation (ITRC) Section of the Economic Affairs Division (EAD) of the Commonwealth Secretariat, which is the main intergovernmental agency of the Commonwealth — an association of 54 independent states, comprising large and small, developed and developing, landlocked and island economies — facilitating consultation and co-operation among member governments and countries in the common interest of their peoples and in the promotion of international consensus-building.

ITRC is entrusted with the responsibilities of undertaking policy-oriented research and analysis on trade and development issues and providing informed inputs into the related discourses involving Commonwealth members. The ITRC approach is to scan the trade and development landscape for areas where orthodox approaches are ineffective or where there are public policy failures or gaps, and to seek heterodox approaches to address those. Its work plan is flexible to enable quick response to emerging issues in the international trading environment that impact particularly on two highly vulnerable Commonwealth constituencies — least developed countries (LDCs) and small states.

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ITRC undertakes activities principally in three broad areas:

- It supports Commonwealth developing members in their negotiation of multilateral and regional trade agreements that promote development friendly outcomes, notably their economic growth through expanded trade.
- It conducts policy research and consultations increase understanding of the changing of the international trading environment and of policy options for successful adaptation.
- It contributes to the processes involving the multilateral and bilateral trade regimes that advance the more beneficial participation of Commonwealth developing country members, particularly small states and LDCs.

## ITRC Recent Activities

ITRC's most recent activities focus on assisting member states in the WTO Doha Round and the Economic Partnership Agreement (EPA) negotiations involving the African, Caribbean and Pacific countries (ACP) the European Union (EU), undertaking analytical research on a range of trade policy and development issues, and supporting workshops/dialogues for facilitating consensus-building on issues of Commonwealth members' interest, exchange of ideas, and disseminating results from informed analysis.

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22-24 June 2011: ACP High Level Meeting in Preparation for the 3rd Global Review on Aid for Trade held in Geneva, Switzerland

16-June 2011: Consultation meeting on the Impact of the European Parliament Resolution on the Pacific EPAs, held in London, UK

13-14 June 2011: Meeting on Climate Change Mitigation and Safeguarding the Trading Interests of Small States and LDCs held in Hampshire, UK

31-May 2011: Export Group Consultation - Trade & Climate Change held in, London, UK

9-13 May 2011: Meeting and Symposium on LDC development events at the UN LDC IV Conference held in Istanbul, Turkey

5-6 May 2011: Trade Policy Seminar for Commonwealth Parliamentarians (Southern Africa) held in Livingstone, Zambia

12-13 April 2011: Workshop on Caribbean Public Procurement held in Montego Bay, Jamaica

11-April 2011: Expert Group Meeting on The UN LDC IV Conference and the Way Forward held in London, UK

6-8 April 2011: Roundtable on Competition Law and Policy held in, Boston, USA

28-29 March 2011: OECD workshop on Aid for Trade held in Paris, France

9 March 2011: Consultative Meeting on Trade Effects of Rules on Procurement for Commonwealth ACP members held in London, UK

## Selected ITRC Publications

Collier, P. (2011). *Catching Up: What LDCs Can Do, and How Others Can Help*, London: Commonwealth Secretariat.

Calì, M., Razzaque, M. A. and Te Velde, D. W. (2011). *Effectiveness of Aid for Trade in Small and Vulnerable Economies*, Economic Paper No. 91, London: Commonwealth Secretariat.

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Razzaque, M. A. (ed) (2009). *Trade, Migration and Labour Mobility*. London: Cameron May.

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