

# TRADE HOT TOPICS *Commonwealth*

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## **An EU-India Free Trade Agreement: Reflections on the Implications for Excluded Countries**

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### **Background**

In October 2006 a European Union–Indian High Level Trade Group agreed the parameters for an ambitious Free Trade Agreement (FTA) between the two. For Europe, this was part of the EU’s ‘Global Europe’ initiative which aimed at setting up trade agreements with large and rapidly growing markets around the world. For India, this provided the prospect of preferential access to one of its major markets, which already accounted for more than a quarter of its exports. The mutual mercantile attractions of the two partners are thus not hard to see. However, there is scope to be concerned about whether an FTA is the right approach, whether the FTA that actually emerges will be appropriate to the challenges and opportunities that exist, and, most importantly for this brief paper, whether an FTA might harm the many countries which it excludes. This issue of Commonwealth Trade Hot Topics summarises the key findings of a recent study commissioned by the Commonwealth Secretariat on the potential implications of an EU-India FTA on the excluded countries.<sup>1</sup>

The main conclusion of the aforementioned study is that non-South Asian countries overall will suffer little by way of negative shock from the trade diversion or reorientation under an EU-India FTA in either the Indian or the EU market. Nevertheless, particular sectors and the terms of trade for specific goods may suffer. Excluded countries may wish to monitor talks to identify such cases in advance, but they should not become unduly worried about their overall market prospects. For India’s immediate neighboring countries it is different. They have significant shares of exports exposed in one or both markets. They may face a very significant increase in competition from the EU in Indian market. For them, it may be worth engaging the partners with a view to obtaining concessions to mitigate or compensate for the shocks.

### **The Effects of an FTA on Excluded Countries**

The usual approach to studying the effects of an FTA on excluded countries is to focus on ‘trade diversion’ whereby, as a result of offering India preferential access to the EU market, the EU purchasers switch from importing from an efficient excluded country to importing from (a less efficient) India and similarly for Indian preferences offered to the EU. The Commonwealth study adds and quantifies two further concepts – trade reorientation and terms of trade. With trade reorientation EU preferences and

\* Views expressed in this paper are those of the authors involved in the study alone, and do not necessarily reflect those of the Commonwealth Secretariat or its Members.

<sup>1</sup> This study has been undertaken by a group of experts at CARIS, University of Sussex, UK, under the leadership of Professor L Alan Winters. It is forthcoming as a publication of the Commonwealth Secretariat. The main study also includes services sector, but this issue of Commonwealth Trade Hot Topics focuses only on trade in goods.

tariff cuts towards Indian suppliers again switch trade towards India (and vice versa), but this time there are no efficiency losses because the excluded country was initially supplying the EU not because of its efficiency but because it already had a preferential trade deal. The EU-India FTA ‘undoes’ that previous act of trade diversion and so saves the EU real resources. For the excluded country, however, the result is just the same as trade diversion – it loses sales. With terms of trade, the prices of excluded countries’ exports may be affected due to EU-India preferences to each other. This may be more significant than a decline in exports per se because it implies earning less on every unit of exports, rather than just losing marginal units of exports. The impacts of an EU-India FTA on third countries depend on the following factors:

- 1) **Importance of the respective markets for third parties.** The larger the importance of either the EU or the Indian markets for third parties, the larger will be the impact of being left out from a preferential agreement.
- 2) **Height of tariffs.** The magnitude of the effects of this agreement on third parties will depend on the extent of tariff cuts that partners offer each other. Regardless of the tariffs that the excluded countries face themselves, it is the extent of tariff cuts that determines the increase in the competitive pressure that they face in particular markets.
- 3) **Similarity of composition in trading structures.** The more similar are third countries in their trading structures to the signatories of the agreement, the larger the scope for the preferential agreement to cause trade diversion or trade reorientation in these third countries.

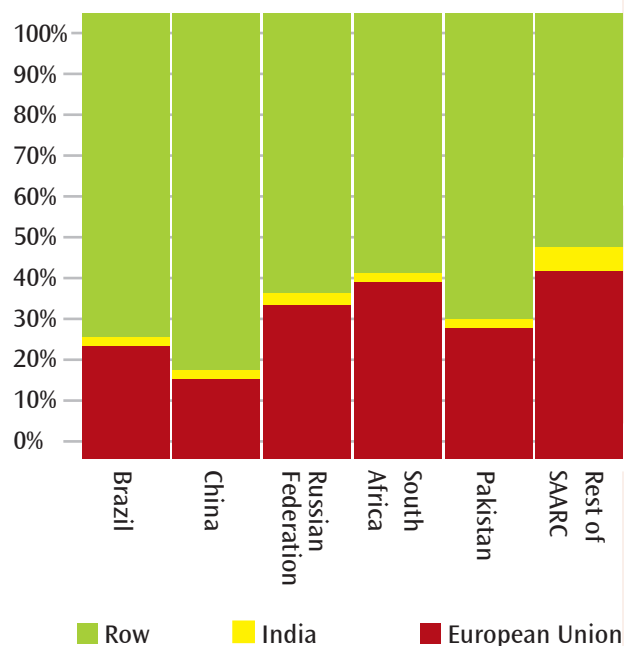
### Market Shares

The more important a market is to a given partner, the higher will be the cost of receiving less favourable access to this same market. The importance of the EU as a destination market for many countries’ exports is clearly seen in Figure 1. For China, the EU represents nearly 16 per cent of its total exports, while for the others it is capturing more than 20 per cent of their total exports. India, however, takes only 1 per cent of the total exports of the third countries except for the South Asian Association for Regional Cooperation (SAARC) where India takes about 5 per cent of their total exports. This suggests that the effects of the EU-India agreement are likely to be more important for third countries in the EU market rather than in the Indian market. However, the size of these effects will also depend on the tariff structures in the EU and India.

### Tariff Structure

Table 1 shows that the level of tariffs in India is substantially higher than that of the EU in all product categories. This a priori implies that the competitive edge granted to the EU in the Indian market is likely to be bigger than the competitive edge of India in the EU market vis-à-vis third countries. For both India and the EU, agricultural products have higher tariffs than other categories. This implies that any elimination of duties between the two is expected to have important effects on agricultural products. In terms of manufactures, we note a relatively low EU tariff around 3.5 per cent as compared to India’s at around 13 per cent. The effects of granting India zero tariffs on a third country that is supplying the same products as India does to the EU, will be equal to the extent of tariff cuts which in turn determines the increase in the competitive pressure a third country faces. Should India have a strong share in a given sector, it may well be able to command prices and cause a detrimental terms of trade effect on third parties. This could also occur with increased competition from the EU in the Indian market vis-à-vis third countries.

**Figure 1. Composition of exports of third countries (2003–2004)**



Source: UN Comtrade database

**Table 1. Tariffs on the European Union and India by sectors, 2007**

Sectors	European Union			India		
	Average tariff (%)	Standard deviation	Number of peaks	Average tariff (%)	Standard deviation	Number of peaks
Food & live animals	8.4	7.4	593	34.5	25.0	139
Beverages and tobacco	15.2	16.7	9	88.0	69.4	46
Crude material excluding food/fuel	0.7	3.2	8	15.4	10.7	5
Mineral fuel/lubricants	0.6	1.9	0	11.9	5.6	1
Animal/Veg. oil/fat/wax	5.2	3.9	0	63.3	32.7	56
Chemicals/products	3.7	3.0	1	13.4	7.9	5
Manufactured goods	3.8	3.3	0	13.4	2.7	0
Machinery/Trans. Equipments	2.2	2.8	21	13.3	16.3	59
Miscellaneous Manufactures	5.8	4.6	35	12.2	2.0	0
Other Commodities	0.0	0.0	0	12.5	0.0	0

Source: TRAINS Database

### Trade Similarity

The overall degree of import similarity by country of origin can shed light on the scope for both trade diversion and trade reorientation. The more similar are import structures from proposed preferential partners to those that are non-preferential, the higher the risk of trade diversion or trade reorientation. Table 2 studies this issue by constructing what are known as the Finger-Kreinin (FK) indices of trade similarity. Panel (A) examines the scenario where the EU grants preferences to India, while panel (B) provides the scenario where India grants preferences to the EU. Within each panel, there are three columns. Column (1) examines the similarity between imports from India and imports from the identified key partners in the EU market across all product categories. Column (2) calculates the FK index for all tariff lines in which India faces a positive tariff and hence will receive a competitive boost from the FTA.

**Table 2. FK indices of import similarity**

	FK for EU imports from India and imports from Selected partners (A)			FK for Indian imports from the EU and imports from Selected partners (B)		
	(1)	(2)	(3)	(1)	(2)	(3)
Afghanistan	0.058	0.052	0.00	0.008	0.008	0.008
Bangladesh	0.179	0.173	0.00	0.020	0.020	0.020
Bhutan	0.046	0.038	0.00	0.003	0.003	0.003
Maldives	0.016	0.013	0.00	0.014	0.014	0.014
Nepal	0.138	0.126	0.00	0.033	0.033	0.033
Pakistan	0.259	0.241	0.2	0.031	0.031	0.031
Sri Lanka	0.269	0.18	0.152	0.072	0.072	0.072
Brazil	0.161	0.105	0.046	0.085	0.085	0.085
Russia	0.073	0.039	0.008	0.095	0.094	0.094
China	0.247	0.205	0.106	0.242	0.239	0.239
South Africa	0.122	0.070	0.012	0.074	0.073	0.073
CARICOM	0.101	0.074	0.001	0.029	0.029	0.029
Central Africa	0.037	0.018	0.00	0.043	0.043	0.043
Eastern and Southern Africa	0.182	0.140	0.001	0.047	0.046	0.046
Pacific – EPA	0.031	0.013	0.002	0.01	0.010	0.010
SADC (less South Africa)	0.044	0.023	0.001	0.025	0.025	0.025
West Africa	0.056	0.034	0.001	0.031	0.031	0.031

Source: Author's calculations based on Comtrade database

This will give us an indication of the similarity of composition of EU imports from India with those from excluded countries in which there is a potential for any adverse effect arising from the agreement. Column (3) calculates the FK index by taking two issues into account – first, only those industries where both India and the excluded country export to the EU and second where both India and the excluded country currently face a positive tariff. This gives us an indication of the similarity of import composition of the EU from partners in lines which are likely to suffer from trade diversion possibly accompanied by some trade reorientation. Hence, here we are identifying all those cases, where an EU-India FTA would improve India's access to the EU vis-à-vis the tariff currently being faced by the excluded country. This, therefore, covers both the possibility of trade diversion and/or trade reorientation.

In the case of Bangladesh, for example, the overall FK index (column A1) suggests a low degree of similarity (0.179). The degree of overlap between India's and Bangladesh's exports to the EU in the cases where India currently faces positive tariffs, is smaller (0.173) (see column A2). There is no overlap at all between the exports of India and Bangladesh where both trade with the EU and both face positive tariffs (column A3) because Bangladesh's exports already enter the EU duty free under the Everything But Arms (EBA) preferences. There is very little negative trade diversion impact on Bangladesh. Any impact on Bangladesh's trade may arise from trade reorientation. From the point of view of the EU's welfare, this is positive, but nevertheless the impact on Bangladesh may still be important. However, columns A2 and A3 indicate that the scope for negative effects appears to be greatest with regard to Pakistan, Sri Lanka and China.

Column B1 shows that, except for with regard to China, India imports very different goods from the EU compared with the other countries considered here. The FK indicators are all below 0.1, except China where there is much more considerable overlap (FK = 0.242). This would suggest a priori that the scope for both trade diversion and trade reorientation is small for other countries, and that China is most likely to suffer some negative impact from Indian preferences granted to the EU. The data in columns B2 and B3 show strong similarity between total tariff lines and the tariff lines that could be affected by trade diversion and/or trade reorientation. This occurs because India does not have significant tariff-free access in different countries and has extended very few preferences.

## **Trade Diversion and Trade Reorientation**

In order to explore the possibilities for trade diversion and/or trade reorientation in more detail, the report then examined the bilateral trade flows between the EU, India and excluded countries at a detailed six-digit level of disaggregation. We identify four possible scenarios :

- No negative effect on excluded countries: If prior to any FTA both the excluded country and India face zero tariffs, then any agreement will not change the relative degree of access to the EU market for India.
- Trade reorientation effect: This could occur when an excluded country already benefits from zero tariff access to the EU market, and India matches this access through the EU-India FTA. There could be substitution across suppliers which would lead to increases in the market share of Indian at the expense of other exporters to the EU. This effect will predominate mainly for excluded countries already benefiting from better market access such as EBA.
- Trade diversion effect: This could occur when, before preferences are granted, the proposed preferential partner (India) currently faces a tariff into the EU market equal to that faced by an excluded country. The removal of the tariff on imports from India makes it a less costly supplier.
- Trade reorientation and trade diversion effect: A combination of these two effects would occur when, before preferences are granted, India faces a higher tariff than excluded countries in the EU market as explained above. The magnitude of trade reorientation is determined by the absolute difference between the tariffs and the magnitude of trade diversion depends on the height of the excluded country's tariff.

In order to explore these possibilities we compare the access by tariff line of each excluded country into the EU market against the access that India may have after signing the agreement. We also consider excluded country access to India compared to that of the EU. This enables us to measure the potential loss of access of excluded countries to both markets.

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2 For concreteness the discussion here is framed in terms of improved Indian access to the EU market, but a parallel analysis pertains with regard to EU access to the Indian market.

It is important to note the role of efficiency in the above stated scenarios. In scenario 2, if India is the most efficient supplier of a given good, matching the preferences will result in trade reorientation from previously inefficient sources towards Indian suppliers. This will result in an efficiency gain for the EU, but a loss to excluded countries due to the loss in market share as efficient Indian suppliers are replacing them. If on the other hand, India is not a more efficient supplier of a given good, then matching preferences should not result in changes in trade patterns with excluded countries. In scenario 3, if India is a less efficient supplier and the agreement improves its access to the EU market (where tariffs are maintained with excluded countries), there is scope for trade diversion. If India is a more efficient supplier, it would have captured the market when it faced the same tariff as other suppliers, and any increases in trade would be creation.

**Table 3. Impacts of EU preferences to India under EU-India FTA on excluded countries (by partner, in 2003, in US\$ 000s)**

	(1)		(2)		(3)		(4)		(5)
	No change		Trade reorientation		Trade diversion		Trade reorientation/diversion		
	Value	% of total Exports to EU	Value	% of total Exports to EU	Value	% of total Exports to EU	Value	% of total Exports to EU	
Afghanistan	56,592	99.1	482	0.9	-	-	-	-	27.0
Bangladesh	101,782	2.5		97.5		-		-	62.4
Bhutan	581	94	37	6	-	-	-	-	0.5
Maldives	1,945	8.3	21,627	91.7	-	-	-	-	20.9
Nepal	20,643	39.1	32,140	60.9	-	-	-	-	8.1
Pakistan	634,075	21.3	-	-		78.7		-	25.0
Sri Lanka	606,006	41.2	-	-	865,707	58.8		-	30.3
Brazil		74.4	-	-		25.6		-	26.9
Russia		92.1	-	-		3.5		4.5	35.7
China		71.4	-	-		28.6		-	24.1
South Africa		83.7	470,948	3.1		10.7	387,043	2.5	48.4
Caribbean		60.8	756,429	23.8	308,896	9.7	180,107	5.7	19.1
Central Africa		90.6	248,885	5	3,110	0.1	212,719	4.3	41.4
Eastern & Southern Africa Southern Africa		36.7		54.1	442,310	9.2	1,726	0	45.1
Pacific	362,068	61.2	120,412	20.4	108,875	18.4	13	0	7.9
SADC (less South Africa)		73.6		22.7	98,799	1.9	89,395	1.8	65.6
West Africa		84.4		14.2	30,707	0.2	156,323	1.2	38.3

Source: Author's calculations based on TRAINS database

Table 3 presents the value of exports of third countries to the EU according to the type of impact they could face. For each of our countries and country groupings, it considers all four scenarios outlined earlier. For example, 99.1 per cent of Afghanistan's exports to the EU falls in the products for which both Afghanistan and India currently face zero tariffs. An EU-India FTA would thus not improve India's access to the EU relative to Afghanistan and unlikely to have much impact on Afghanistan. Table 3 also enables us to detail the possible impacts of an EU-India agreement on excluded countries according to the preferential schemes in operation. In the case of Generalised System of Preference (GSP) countries (Brazil, China, Pakistan and Sri Lanka) there will be no trade reorientation from matching preferences, and all the impact is characterised by trade diversion. Overall, the country most likely to be affected will be Pakistan since 78.7 per cent of its exports to the EU will face increased competition from India. Given 25 per cent of Pakistan's total exports go to the EU, nearly 20 per cent of that country's total exports could

be vulnerable to some form of trade diversion (i.e. 78.7% of 25%). Sri Lanka could also be heavily affected with about 59 per cent of its exports to the EU facing some possibility of trade diversion. With regard to Brazil, China and Russia, the affected trade could be up to 26 per cent, 29 per cent and 4 per cent of their exports to the EU respectively, in which India would have better access to the EU market than they do.

A large part of the effects of the EU-India agreement on the small and poor countries of SAARC (Afghanistan, Bangladesh, Bhutan, Maldives and Nepal) will occur through India obtaining matching preferences in the EU (i.e. trade reorientation). Bangladesh and Maldives could be affected most: up to 97.5 per cent of Bangladesh's exports to the EU and 91.7 per cent for Maldives could be facing increased competition from India. The EU is also an important export market for Bangladesh, accounting for 62.4 per cent of its total exports, but less so for Maldives at 20.9 per cent.

The exports to the EU from the African, Caribbean and Pacific (ACP) group of countries fall mostly into the 'no change' category, but some could be affected both by trade reorientation and trade diversion. The smallest impacts appear to arise in the case of West Africa and Central Africa, since more than 80 per cent of their exports to the EU will not suffer any change in preferences. Eastern and Southern Africa would be affected more by trade reorientation (54%) as India matches their access to the EU than by trade diversion (9%), as India obtains duty-free access while they do not. The highest threats of trade diversion arise for the Caribbean and the Pacific regions. Finally, in the case of South Africa the likely negative impact will be of small magnitude. There may not be better access for India with respect to South Africa. This may well be the case for ACP under the EPA agreements as well.

**Table 4. Impacts of India preferences to the EU under the EU-India FTA on excluded countries (by partner, in 2005, in US\$ 000s)**

	(1)		(2)		(3)		(4)		(5)
	No change		Trade reorientation		Trade diversion		Trade reorientation/ diversion		
	Value	% of total Exports to India	Value	% of total Exports to India	Value	% of total Exports to India	Value	% of total Exports to India	Share of Export to India %
Afghanistan	474	0.8	20,385	35	12,371	21.3	24,967	42.9	28.0
Bangladesh	685	0.5	4,824	3.8	47,052	36.9	74,929	58.8	2.0
Bhutan	73	0.1	28,056	24.1	29,273	25.2	58,810	50.6	99.0
Maldives	0	0	0	0	1,969	99.3	13	0.7	1.8
Nepal	1,121	0.3	30,009	7.3	187,021	45.5	193,073	47	63.0
Pakistan	17	0	0	0	52,732	29.3	127,444	70.7	1.5
Sri Lanka	3,404	0.3	553,258	48.8	13,992	1.2	562,009	49.6	23.3
Brazil	10,564	1.2	0	0	862,577	97.7	9,337	1.1	1.2
Russia		27.1	0	0		72.1	92,809	0.9	2.5
China	2,631	0.1	0	0		99.9	0	0	1.5
South Africa	2,988	0.1	0	0		92.5	182,622	7.4	7.9
Caribbean	82	0.2	0	0	35,047	92.8	2,641	7	0.2
Central Africa	39	0	0	0	113,015	99.9	27	0	0.9
Eastern & Southern Africa	6,849	3.5	0	0	184,660	95.4	2,113	1.1	1.8
Pacific	132	0	0	0	295,539	99.8	448	0.2	4.0
Southern Africa Development Community (SADC)	453	0.2	0	0	197,229	99.6	381	0.2	2.6
West Africa	2,010	0.2	0	0	773,900	72.6	289,890	27.2	3.1

Source: Author's calculations based on TRAINS

Table 4 reports the results of the analogous exercise with regard to exports to India. The size of the effects on excluded countries of India granting preferences to the EU will depend largely on the value of their

exports to India and on the degree of comparative market access enjoyed by the EU as a result of these preferences. Bhutan (with 99% of its total exports to India) and Nepal (63%) are the two countries most heavily concentrated on India. Granting EU exports better access to India is likely to increase competition and could negatively impact these countries. The negative impacts will come in the form of both trade diversion and trade reorientation. However, it is important to note that the products produced and exported by the EU could well be qualitatively different from those produced and exported by excluded developing countries and, thus, that we might be overestimating the degree of competitive threat that the latter face. With regard to the ACP countries, their exports to India are very small and the negative impact will be insignificant. This can also be extended to Brazil, Russia and China, whose share of exports to India is small.

Overall, Indian preferences granted to the EU are likely to have the most direct effect on Bhutan and Nepal. However, given that there is little similarity between the EU exports and Bhutanese and Nepalese exports to India, the overall negative effect is likely to be very small. Thus, even though the EU, as a result of the EU-India agreement, will have a much better access to India than any partner country analysed here, the negative impact on excluded countries is likely to be insignificant due to the dissimilarity in export structures between the EU and the excluded developing countries and a relatively small market of India for many excluded countries.

### **Terms of Trade Effect**

The discussion so far has followed the well-worn track of trying to estimate the way in which the EU-India FTA will affect the volume of trade flows between the partners and other countries and to allocate the latter between trade diversion and trade reorientation. This section concerns the effect of the FTA on the terms of trade of excluded countries. Recall that while the changes in the terms of trade are driven by the changes in trade volumes of the sort we have been analysing so far, their potential effects on the terms of trade are related to the levels of trade.

As the FTA diverts demand from excluded to included countries, the prices commanded by the former are likely to decline. The important point for economic welfare, however, is not the volume or value of the lost exports per se – which may after all have cost just as much to produce as they earn in revenue – but the fact that as demand falls suppliers are driven back down the supply curves (or choose to cut their prices if they have any pricing discretion), so that the prices they charge on all their sales to the FTA may fall. The loss entailed in this is a function of the decline in price and the level of existing trade.

To try to summarise the effects, we calculated a series of indices to represent the extent to which different excluded countries are vulnerable to FTA-induced terms of trade effects. Our results suggest that terms of trade effects on third countries in the EU market are likely to be small. In the case of the terms of trade effects on third countries supplying in the Indian market we see bigger potential effects, which can be explained by two factors. First, the size of the absolute change in the tariff is bigger since the Indian MFN tariff is, on average, substantially higher than the tariff that India faces in the EU market. Second, the market share of the EU in the Indian market is higher than that of India in the EU market. The relative significance for excluded countries is also different, with the largest effects apparently falling on the Caribbean, Central Africa, Maldives and China. For these countries a significant degree of competitive pressure may be felt in the Indian market with the result that export earnings may be curtailed to a material degree. Part of the apparent effect, however, might be an artefact of the product classification – such that the EU and Central Africa supply the same six-digit headings to India, but essentially in non-competing forms. In this case, the index overestimates the effects.

Overall, the situation is that in neither the Indian nor the EU market is it likely many non-South Asian countries suffer a material negative shock from the trade diversion or reorientation under an EU-India FTA. Particular sectors and the terms of trade for specific goods may suffer. However, general market prospects for them remain more or less the same. The situation for India's neighbours is a different story. They have significant shares of exports exposed in one or both markets. They may face a very significant increase in competition from the EU in Indian market although there is some doubt that EU and South

Asian goods classified in the same tariff heading do really compete. For South Asian countries, it may be worth engaging the partners with a view to obtaining concessions to mitigate or compensate for the shocks.

## Policy Responses

With so many uncertainties about the FTA, and also about the extent of trade barriers, it is not sensible to identify specific sectors under threat. Moreover, even if one could, it is usually difficult to justify intervention to preserve them. Hence the advice is generic and general – but no less valid for that. Excluded countries need to react to the EU-India FTA with policies that would, even in its absence, boost their growth and economic flexibility. In addition, they may want to press the parties to keep them informed about negotiations and raise specific issues if details look particularly threatening; outside South Asia one should not expect wholesale losses of welfare as a result of the FTA, but within it, the stakes are material. These countries may wish to prepare to engage the partners over the difficulties they suffer and seek accession to the FTA or specific mitigating or compensating concessions. These may comprise asking the partners to extend the tariff preferences to them, relaxation of rules of origin, or aid to help meet EU standards and/or diversify into new markets. They might also indicate that they will seek to ensure that the World Trade Organisation's rules on FTAs are enforced to the extent that they protect excluded countries' interests.

In the end, however, there is little that small poor excluded countries can do about an EU-India FTA acting individually, so they should also think about their systemic response. This poses a large dilemma. On the one hand, they may conclude that they should 'play the FTA game' harder themselves, negotiating access to deep and meaningful FTAs with the partners and anyone else in ways that reduce the discrimination they face and support their own reform programmes. This will require them to make concessions and will be expensive but it may on balance eliminate distortions in the world economy and result in greater market access and reform than the current situation.

On the other hand, they may reason that negotiating FTAs diverts attention and effort from the multilateral system and runs the danger that even small adverse effects will be replicated many times over as the trading system fragments. On this view, they may wish to oppose the process of creating FTAs in international forums, not in an instrumental way based on trade calculations of the sort we have performed here, but as a matter of principle and as a systemic issue which could eventually undermine the benefits of multilateralism that we currently tend to take for granted. Of course, in maintaining such a position, they would need to show a fair amount of consistency and limit the extent to which they pursue FTAs themselves. Unfortunately, there is not sufficient evidence to resolve the dilemma completely.

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