

ACP-EU Trade and Aid Co-operation

Post Lomé IV

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and A. Swinbank*



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*A Report prepared for the Commonwealth Secretariat by
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Foreword

The Lomé IV Convention, which provides the framework for development cooperation between the European Union (EU) and 71 African, Caribbean and Pacific (ACP) developing countries, is to expire in the year 2000. Negotiations on a successor arrangement are scheduled to begin in September 1998. The form it takes will be crucial to many of the ACP countries, particularly those dependent on the special trading arrangements of the Convention for the terms of market access for their principal exports.

As many as 39 of the 50 developing countries in the Commonwealth belong to the ACP Group. Naturally, given their shared concern about the future of ACP countries' relations with the European Union, Commonwealth governments have in their meetings – notably at CHOGM in October 1997 – paid close attention to developments in this area. They have also asked the Secretariat to provide support to the ACP countries in ongoing discussions on a successor arrangement.

After the EU Commission published a Green Paper on future ACP-EU relations in November 1996, the Secretariat commissioned Professor Matthew McQueen, Dr Christine Phillips, Dr David Hallam and Professor Alan Swinbank, from the University of Reading, to prepare a study examining the various options under consideration and suggesting the elements of a successor arrangement capable of addressing the diverse trade and development interests of the ACP countries. This study examines the factors accounting for the limited success of the Lomé Conventions in contributing to the development of the ACP countries. It analyses how in a new arrangement, instruments of cooperation in the areas of trade, development finance and technical assistance could be better designed and co-ordinated, in order to enhance the supply capabilities of the ACP countries and promote diversification of their economies.

The study has been finalised in the light of comments made at a workshop for ACP country representatives which was jointly organised by the Commonwealth and ACP Group Secretariats and held in Brussels on 26-27 May 1997.

This study is being published in the hope that its technical analysis of the issues involved and its recommendations of improvements will continue to be useful to the governments of the ACP countries in the negotiations ahead with the EU.

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Executive Summary

1 ACP-EU Relations in a Changing World Economy

- 1.1 The increasing integration of markets for factors of production and products, driven by technological change, new systems of control and production, and the liberalisation of trade and capital markets, has generated both costs and benefits for the ACP countries. It has eroded their traditional comparative advantages in resource based and labour intensive production. At the same time, the new technologies, combined with trade liberalisation, have also opened up new production and market opportunities, both directly for exporters and indirectly for small and medium-sized sub-contractors. But in order to take advantage of these opportunities, ACP firms, particularly micro, small and medium-sized enterprises, need a network of services and support from public and private agencies. A new ACP-EU agreement needs to concentrate on developing a strategy aimed at providing this support and enabling the ACP countries to participate more fully in the world economy.
- 1.2 Trade is particularly important to the growth of output and employment in the ACP countries. On average, exports of goods and non-factor services account for 30% of GDP and, in some ACP countries, 60% of GDP, reflecting the small size of the domestic market of most ACP countries.
- 1.3 Because the comparative advantage of ACP exports lies in utilising intensively their relatively abundant factor of production, an outward-oriented strategy of development offers the possibility of combining 'growth with equity'. This will also fulfil the poverty-oriented focus of EU development co-operation, as stated in the Maastricht Treaty.
- 1.4 A key factor underpinning the continued liberalisation of world markets is the outcome of the Uruguay Round of multilateral trade negotiations. This has lowered tariff and non-tariff barriers to trade in goods and services, and strengthened the rules-based system of international trade, enhancing the degree of protection of ACP members of the World Trade Organisation (WTO) from discriminatory action on their exports.
- 1.5 It has also substantially lowered the margin of preferences for ACP countries, both as a result of the lowering and abolition of tariff and non-tariff barriers to trade, and because tariffs on the final stage of production have generally been reduced by more than earlier stages, by reducing effective tariff (and therefore preferential) rates.
- 1.6 At the same time, all members of the WTO have to accept WTO rules as a single undertaking, and, especially for ACP countries which are recent members of WTO, this implies a very substantial level of obligation. A variety of bilateral technical co-operation agreements and international organisations provide assistance to developing countries in meeting these obligations, but these are largely concerned with training individuals and preparing studies. A new ACP-EU agreement needs to assist the ACP countries in building their institutional capacity to implement their WTO obligations and explain trade rights, opportunities and

obligations to the private sector. The WTO is essentially a 'member driven' organisation and the ACP countries, both individually and collectively, also need assistance and support in monitoring, pursuing and defending their interests in the WTO.

- 1.7 The period since 1989 has seen a large decrease in the relative importance of the ACP countries in EU trade. In 1990 EU non-oil imports from the Central and East European Countries (CEEC) were one-third those of the ACP, but by 1993 they already exceeded EU imports from the ACP. EU non-oil imports from China were one-fifth less than those from the ACP in 1990 and by 1993 were twice those from the ACP. South Asian non-oil exports to the EU were half those of the ACP in 1990 and are now equal to those of the ACP countries. This represents both actual or potentially increased competition for ACP exports, but it also offers new market opportunities especially in the CEEC, ASEAN and Latin American countries, as these economies industrialise and open up their markets to international trade. It is important that a new ACP-EU Agreement enables the ACP countries to diversify their exports into these new markets. EU special preferential agreements, particularly with the CEEC and NIS countries, could be used to assist this process.

2 The Export Record of the ACP Countries and the Role of Trade Preferences

- 2.1 Sub-Saharan Africa's share of world commodity markets has fallen by 54% and that of the Pacific countries by 33% over the period 1975-93, in contrast to a 39% rise in the share of the Asian developing countries. The ACP countries' share of world production of cocoa beans has also fallen by 17%, coffee beans by 45% and palm oil and kernels by 67% over the same period of time. This, along with falling shares in EU imports, is often interpreted as evidence of domestic policy failures by the ACP countries.
- 2.2 But falling shares in world markets in cocoa and palm oil and kernels occurred *despite* a 30% and 40% increase, respectively, in ACP production. Declining shares in world markets were the result of huge increases in production and exports by Indonesia and Malaysia.
- 2.3 Commodities are subject to low price and income elasticities of demand, and the excess of world production over demand exacerbated the long run trend of falling commodity prices and export earnings instability. Over the period 1984-94, real commodity prices for all ACP commodity exports except tropical hardwoods, copper and manganese, have fallen (and 1984 prices were 27% below 1977 levels); in the case of coffee and cocoa by 10% to 11% p.a.
- 2.4 ACP countries could try and offset falling trend prices by raising productivity and there are certainly lessons to be learned from the Asian countries in achieving this. But, as we have seen, there is a potential 'fallacy of composition' in this argument in that if most major producers follow this strategy, then world prices will fall even faster and countries will simply 'invest in decline'.
- 2.5 A more promising strategy is vertical export diversification, that is, adding value by processing raw materials. For example, ACP exports of cocoa butter obtain twice the unit value of cocoa beans, and coffee concentrates etc., two and a half times the price of coffee beans.
- 2.6 The experience of the ACP countries in exporting processed primary products to the EU, however, has not been encouraging, despite preferences, with low or negative growth rates in

both volume and value and with significant instability around these trends (e.g. in coffee and cocoa products, cotton fabrics, veneers and plywood). PMDT (processing, marketing, distribution and transport) is mentioned several times as an objective in the Convention, but no concerted action has been taken both to identify problems and produce practical remedies. This should be a priority in a new Convention.

- 2.7 Sub-Saharan African countries depend on the EU market for an average of 58% of their exports, a much higher proportion than, for example, Latin America on the US market (23%). On the other hand, it is important to recognise that only ten of the SSA countries have increased their dependence on the EU market over the period 1970-1993.
- 2.8 ACP exports to non-EU markets have grown more quickly than exports to the EU; for example, exports of foodstuffs to Japan and in intra-developing country trade, ores and metals to the US and developing countries, and manufactured goods to the US. Pacific ACP countries have sharply decreased their dependence on the EU to a quarter or less of total exports, as have Dominica, Grenada and Surinam in the Caribbean. Thus, while the EU market will remain important for many ACP countries, they may well be able to increase the growth of exports by increasingly diversifying to non-EU world markets.
- 2.9 The growth of exports can also be substantially increased by diversifying exports by product. Contrary to the pessimistic view, the ACP countries have increased the proportion of non-traditional products in exports. Twenty-five ACP countries have increased the share of manufactures to 20% or more of non-oil exports. The share of non-traditional exports in non-oil exports to the EU has increased from 8% in 1987 to 13.5% in 1994, generating substantial increases in employment as well as increasing the growth of output and the supply of foreign exchange.
- 2.10 But ACP export concentration ratios are still well above comparable countries. Only 17 out of 42 ACP countries have recorded a decrease of 20% or more in their concentration ratios over the past 25 years, and only 8 countries have increased the number of products (3 digit SITC Rev.2) exported. Also, only one or two countries usually account for over 60% of non-traditional exports to the EU of any given product and export volumes are often highly variable.
- 2.11 The important conclusion of this analysis for a future ACP-EU Agreement is that supply side policies need to be considerably strengthened. Even countries like Ghana, with a good record of implementing structural adjustment policies, have found that while generally helpful, structural adjustment policies are not sufficient on their own to sustain export diversification. A new agreement must therefore provide the integrated framework of assistance required by the private sector in ACP countries.
- 2.12 Where domestic conditions have encouraged exports, then preferences can provide a useful additional incentive. This has not only taken the form of a price advantage over less preferred countries, but has also taken the form of total or partial exemption from non-tariff barriers (notably exemption from MFA quota restrictions). The development of the clothing industry in Mauritius is a particular example of a preference-induced rise in exports, but the ACP have also recorded high shares in EU imports of processed cocoa, fisheries and horticultural products, some fruits and hardwood veneers, where there has been a useful margin of EU preferences over non-ACP countries.

- 2.13 Systematic analysis of the effects of preferences, however, shows only a small positive relationship between the growth of ACP exports and the margin of preferences for fresh vegetables, and no significant relationship for fruit, processed products, cut flowers, and fisheries products. The most important single factor explaining the growth of ACP exports of non-traditional products was the growth of the EU market. Also, non-price factors such as quality and reliability are often more important than the margin of preference.
- 2.14 The trade, industrial, agricultural, financial, technical and regional co-operation provisions of a new agreement must therefore be closely integrated to assist the development of a diversified export capacity in the ACP countries.

3 Trade Co-operation in a New Convention

- 3.1 The EU has tried to defend the validity of the Lomé Convention with the GATT in terms of a combination of Article XXIV (covering customs unions) with Part IV (on Trade and Development), but this was never a credible defence and Lomé has now been placed on a GATT compatible basis by the EU, obtaining a waiver under Article XXV from the provisions of Article I. If the EU has the political will to do so, a further waiver could be granted for the period after 2000.
- 3.2 The EU has argued that a further waiver would create uncertainty and therefore undermine the benefit of a renewed Convention compared to a free trade area, but this underestimates both the security of a waiver and the possibility of challenge to an FTA.
- 3.3 A more important question is whether a renewed Convention is in the long term interests of the ACP or particular groups of ACP countries such as the Caribbean countries.
- 3.4 An ACP-EU free trade area (or areas) would create complex costs and benefits which would vary significantly between different ACP countries. The measurement of these effects is subject to a large margin of error and the most important effects are long term and a matter of informed judgement based on future development strategies.
- 3.5 Most of the benefits from an FTA can be obtained from unilateral and multilateral trade liberalisation and would avoid the trade diversion costs of an FTA.
- 3.6 An FTA must therefore offer benefits which could not otherwise be obtained through trade liberalisation, and the weaknesses in EU free trade agreements with other groups of countries raise doubts about the possibility of the ACP countries obtaining such additional benefits. Conversely, the strengthening of GATT rules and procedures and the more rapid growth of non-EU markets reinforce the importance of the ACP countries, especially in SSA, increasing their exports to non-EU markets.
- 3.7 The strengthening of GATT rules, especially the Understanding on Article XXIV, and the disputes procedures, means that the EU practice of greatly limiting the liberalisation of trade in agricultural products in its FTAs is now much more likely to be challenged and undermines the EU's assertion of the superior security of an FTA over a renewed Lomé Convention.
- 3.8 The substitution of the GSP for the Lomé Convention would, in general, result in a reduction in the present security of access to the EU market, although differences in the margin of

preferences between the EU's enhanced GSP and Lomé preferences are almost nil on industrial products and limited in the case of agricultural products.

- 3.9 This raises the option of increasing the acceptability of a renewed waiver for the Convention in the WTO and reducing the possibility of challenge, by extending the Lomé trade co-operation provisions to all least developed countries or to the wider group of developing countries (Andean and Central American) covered by the enhanced GSP. Even greater security in the WTO could be obtained by opening trade co-operation to all developing countries with a similar economic structure to the ACP (e.g. a GDP of \$50,000 million or less).
- 3.10 Regional ACP-EU agreements do not appear to be a viable option, given the heterogeneity of the various regional groupings.
- 3.11 The divergent interests of the ACP group could be accommodated through an 'umbrella' agreement' under which, for example, the least developed (UN definition) ACP countries could be covered by a renewed Convention, and the remaining ACP countries could negotiate an FTA or rely on the GSP. Alternatively, individual ACP countries could elect either to join a renewed Convention or an FTA or rely on the GSP.
- 3.12 An FTA would best be negotiated by the ACP countries acting as a group for all those interested in such an agreement, with a general timetable being agreed for trade liberalisation covering transitional arrangements over a period, which for WTO compatibility, could probably not exceed 15 years. The negotiation of such an agreement would be complex and in the meantime would probably need a WTO waiver extending the Convention for all ACP countries.
- 3.13 It is essential that the variations between ACP-EU agreements be kept to a minimum, otherwise the growth of intra-ACP trade could be harmed. It is also essential that the negotiation of an ACP-EU agreement does not distract attention and resources from the more important task of trade liberalisation by the ACP countries, binding these reforms in the WTO and integrating their economies more closely into the world economy.

4 Improving Supply Responses in ACP Countries: Government and the Private Sector

- 4.1 The conventional wisdom regarding structural adjustment is that 'get your prices right' is both a necessary and sufficient condition for growth. This report takes the view that 'getting prices right' is necessary but not sufficient. It suggests that some interventions are also required.
- 4.2 These can be divided into two categories, functional and selective. The former are those interventions which address market failures without favouring any specific activity (e.g. provision of infrastructure, institutional capacity, education), whereas the latter 'are designed to favour individual activities or groups of activities in order to remedy specific failures or externalities that would lead to sub-optimal resource allocation either in a static or dynamic sense' (Lall, 1994b, p.65). Selective interventions address a market failure concerning the creation of a dynamic capacity within an economy, in particular information and technology upgrading and skills formation.

- 4.3 Governments also have important roles to play in the co-ordination and timing of policies. This ensures that the skill creation, technological capacity and know-how are developed in line with requirements. However, 'government failure' exists in developing countries, and assistance is required to help overcome the resulting problems.
- 4.4 An example of this approach is seen in Taiwan ROC where the complementarities between market mechanisms and government interventions have been very successfully exploited. The case study of Taiwan provides many important lessons for other developing countries.
- 4.5 Increased globalisation means that growth must be private sector led. This requires greater emphasis being placed on micro, small and medium-sized enterprises (SMEs). The report examines the importance and potential benefits of small firm development in developing countries, and stresses the need for a strategy rather than *ad hoc* development. This is particularly important since small firms experience greater efficiency when they operate in clusters or groups. Under such conditions horizontal and vertical links develop between enterprises. These, together with subcontracting, result in a network of formal and informal relationships which greatly enhance flexibility and speed of reaction time.
- 4.6 Any post Lomé agreement needs to target assistance towards overcoming 'government failure', and to provide assistance to support small enterprise developments.

5 Improving Supply Responses in ACP Countries: Private Sector Development with Particular Reference to SMEs

- 5.1 Governments and the EU need to demonstrate visible commitment to private sector development. ACP governments must be steadfast in their commitment and not capitulate when faced with inevitable adverse exogenous shocks. To create a workable partnership, a minimum set of governing rules and procedures that are acceptable to all parties will need to be developed and adhered to by all parties.
- 5.2 At present the CDI is responsible, within the EU, for assisting ACP countries with industrial development. It has produced a sound plan for private sector development. Its effectiveness is currently hampered by having to operate, at times, under cumbersome, centralised, bureaucratic procedures. Ways of reducing these need to be investigated. Potentially there is much to be gained by ensuring other organisations are also included, and by increasing and targeting funds towards projects, particularly in areas such as financial sector development and institutional support for SMEs.
- 5.3 More research is required into the development of environments conducive to business growth. For example, there is a need to relate the shortcomings in infrastructure with the ability to produce and market goods at internationally competitive prices, match skills with needs, and balance general and vocational training. ACP policymakers require more information. In order to obtain this, links between public and private sectors need to be strengthened.
- 5.4 Private sector led growth requires the development of a sound financial sector. In many ACP countries, financial sectors are plagued with market failures. Increased dialogue is needed to find appropriate solutions. Foreign direct investment, technology and know-how agreements are important for the creation of an indigenous research capacity. Centre-satellite systems are

a means of diffusing skills, knowledge and technology, and creating employment opportunities. More research into their potential in ACP countries would prove useful.

- 5.5 There is much to be gained from the development of micro, small and medium-sized enterprises. Under the correct conditions, they have the potential to act as an engine of growth for the manufacturing sector. A co-ordinated policy for their development is required to ensure their sustained proliferation. The challenge of any post Lomé arrangement is to ensure that:
- (a) SME development must be given priority.
 - (b) Legal and regulatory frameworks need to be upgraded to meet the requirements of SMEs.
 - (c) An efficient support system is required for ongoing, large-scale, small firm development. This includes the provision of a large range of private and public institutions and agencies, and the development of financial, supply, and export channels in research institutes, and training programmes.

6 Aid and Foreign Investment in a New Agreement

- 6.1 The ACP countries have become more dependent on EU aid (bilateral plus institutional) flows, with the EU share in total aid flows increasing from an average of 40% for the period 1983-87 to an average of 47% for the period 1988-93. Within these flows, the share of institutional aid (EDF and EIB) in total EU aid to the ACP has increased from 18% to 21%. It is therefore disturbing to note that the nominal increase in EDF 8 (1995-2000) funding was 10% less than the amount required to maintain the real value of EDF 7, despite the enlargement of the EU.
- 6.2 Despite a large increase in EU aid to the CEEC and NIS, there is no evidence, as yet, in terms of disbursements of aid that this aid has 'crowded out' aid to the ACP countries. More important factors which will make it difficult for the EU to increase aid to the ACP countries are the general budgetary pressures in the EU arising from the need to meet the requirements of the monetary union, combined with the effects of high unemployment levels, the costs of financing EU programmes (notably the CAP) and the future costs of integrating new members into the EU. It is therefore essential that existing aid flows are used as efficiently as possible.
- 6.3 Aid under the Lomé Conventions has too many objectives and instruments, with the result that only 43% of aid is freely available to finance programmes in the ACP countries, the remainder being pre-allocated for particular purposes. Independent researchers also point to deficiencies in the management of the EU aid programme and the fact that it is too big for the Commission's capacity to manage it.
- 6.4 Pressures to increase the efficiency of aid have also eroded the principle of partnership which is fundamental to the Convention and, indeed, one of its main features.
- 6.5 The complexity of Lomé aid has become, in itself, a barrier to its efficient utilisation and only a very few people fully understand its provisions and opportunities.
- 6.6 There is therefore an urgent need to simplify both the objectives and the instruments of the Convention and to concentrate on a very limited number of objectives which are complementary to the activities of the member states (fulfilling one of the objectives of the Maastricht Treaty) and which are realistic, given the limited resources available.

- 6.7 The report recommends that increasing the capacity of the ACP countries to participate in the world economy should be a central objective of a new agreement. Given that trade is wholly an EU responsibility, then this is also the most obvious area in which EU aid would be complementary to that of the member countries. As we have argued, such a strategy of development would also enable the ACP countries to combine 'growth with equity' and so also help fulfil the poverty-oriented objectives of the Maastricht Treaty.
- 6.8 Simplifying and focusing the range of policy instruments also requires the ACP to evaluate the effectiveness of existing policy instruments, notably Stabex. The existing rules governing claims under Stabex are arbitrary and can lead to a perverse allocation of funds. The funds available are also inadequate for the task. The ACP must therefore carefully evaluate the cost of Stabex in terms of the alternative uses that the funds could be put to, and, if it is decided to retain Stabex, then reform it along more rational lines and in conformity with a feasible objective (e.g. disaster relief).
- 6.9 In order to implement an integrated and co-ordinated strategy of integrating the ACP countries more fully into the world economy, we recommend that the existing separate function of the DG8, the CDI and the EIB are combined into a joint ACP-EU organisation (which could be named the ACP-EU Productivity Centre). This Centre would have at its disposal a significant proportion of the overall financial protocol and would be responsible for all matters relevant to increasing the export capacity of the ACP countries (as discussed in Chapters 4 and 5). The governing body and members of the Centre would be drawn from both the public and private sectors of the ACP and EU.
- 6.10 Flows of foreign investment into the ACP countries have, in some cases, recovered from low levels but they are still generally inadequate, especially given the importance of FDI in transferring knowledge and providing access to markets.
- 6.11 Title III, Chapter 3, of the Convention needs to be substantially revised to signal to potential investors the willingness of ACP countries to provide guarantees of treatment to foreign investors which would reduce perceived risks. Equally, the EU could provide strong investment guarantees to EU investors in ACP countries under agreed terms.
- 6.12 EU technical assistance could also be obtained to improve the institutional environment affecting foreign investors.
- 6.13 Further areas for joint ACP-EU action could include EU private investment for privatisation programmes in ACP countries, particularly in the provision of infrastructure and financial services.

7 Future Prospects for ACP Exports to the EU for Agricultural and Horticultural Products Covered by the CAP

- 7.1 Despite the Mac Sharry reforms of 1992, and the *Agreement on Agriculture* concluded in the Uruguay Round of GATT negotiations, the Common Agricultural Policy [CAP] will continue to apply high levels of border protection on third country imports of agricultural produce into the EU for the foreseeable future.
- 7.2 Products for which high levels of border protection apply include sugar, beef and veal, milk

and milk products and olive oil. Little border protection is applied to tropical products not grown in the EU, oilseeds other than olive oil, and tobacco. The Mac Sharry reforms of 1992, coupled with the limitations imposed by the *Agreement on Agriculture*, mean that the levels of border protection for cereals and rice have been considerably reduced. Under the European Commission's recent proposals in *Agenda 2000*, border protection on cereals and beef could be eliminated altogether. The levels of border protection on fruit and vegetables are often surprisingly high as a result of the minimum import price regime that applies.

- 7.3 For sugar, dairy products, olive oil, and fruit and vegetables, continued preferential access to the EU market will remain a *potentially* valuable trade concession for the EU's partners.
- 7.4 The Uruguay Round Agreements also tightened up the requirements that must be met if a free trade area agreement is to be deemed compatible with GATT. In particular, it does not seem likely that agriculture could be excluded from future agreements. However, given the CAP, a free trade area agreement between a third country and the EU would imply the adoption of the CAP, or CAP-compatible mechanisms, by that third country, to avoid trade deflection, and would imply that trade within the free trade area should take place at CAP rather than world market prices. This would impose considerable burdens upon net-food importing countries. Thus, unless these major agricultural products can be excluded from a Free Trade Area, the continued operation of the CAP militates against the replacement of the Lomé Convention by one or more free trade areas between the EU and the ACP states.
- 7.5 The EU's GSP provisions for agricultural products are potentially valuable, particularly for the 'least-developed developing countries'. A preliminary comparison of the Lomé concessions with those in the GSP indicates that there are some instances under which a 'least-developed developing country' ACP state *could* secure superior concessions under the GSP compared to Lomé.
- 7.6 The Sugar Protocol has been incorporated as a country-specific tariff quota in the schedule of commitments entered into by the EU in the context of the Uruguay Round Agreements. We are reasonably confident that country-specific tariff quotas will not be challenged in GATT, and that this tariff quota has an existence independent of the Lomé Convention, but further consideration of the implications of the recent banana panel ruling, and in particular of Article XIII of GATT, needs to be undertaken.
- 7.7 The Sugar Protocol cannot readily be improved: instead, the challenge for the ACP states is to retain the benefits it contains. The individual ACP states that benefit from the Sugar Protocol should treat the price advantage of protected sugar sales into the EU market as a windfall gain. Local producers should be encouraged to produce (to fill the tariff quotas) at costs approximating those of efficient producers elsewhere in the world, and the governments concerned should impose an export tax to ensure that this is the case. The proceeds from such export taxes should be used to provide a sustainable future income source for the country, preferably by productive investment in the wider economy.
- 7.8 For beef there seems to be little prospect that the EU will be willing to expand the ACP tariff quota beyond existing volumes; in part, because of the severe problems of over-supply on the EU's market, and in part because of the past failures of the ACP to fill the tariff quota. Furthermore, a substantial reduction in the level of EU prices is to be expected as a consequence of the European Commission's *Agenda 2000* proposals. Nonetheless, while the

EU maintains market prices for beef well in excess of those prevailing in world markets, the existing tariff quota is *potentially* of significant benefit to the ACP states, and negotiating efforts might best be directed to ensuring greater flexibility in the reallocation of tariff quota in the event of supply shortfalls. An alternative to the existing mechanisms, which would maintain the financial benefit to recipient states, would involve the free transferability of export licences between ACP states.

- 7.9 The ACP states now enjoy duty-free access for light rum, unconstrained by tariff quotas, and the tariff quota constraints on the duty-free access for dark rum are due to be abolished in 2000. Consequently there is no further concession that can be negotiated.
- 7.10 The EU's protective regime for fruit and vegetables involves minimum import prices (known as entry prices) as well as customs duties. Both customs duties and entry prices vary during the year, and there is a bewildering array of preferential access arrangements including GSP and Lomé. The ACP states should undertake an investigation to determine whether or not the entry price system is having a harmful effect on their exports to the EU. If it is, then on those products the ACP should seek to have special – lower – entry prices determined for ACP produce. If ACP states can identify products that they could export to the EU if tariff concessions were conceded, then tariff concessions on these products should also be sought. However, it is doubtful that the EU would be willing to extend significant further concessions on fresh fruit and vegetables. One over-riding consideration is the complementarity of EU and ACP production seasons. If ACP suppliers are competing with EU production, particularly with expensive 'out-of-season' EU produce, then Europe's farm lobby will be opposed to further concessions. Nonetheless, if product – and calendar – niches can be identified that involve ACP supplies that do not compete directly with EU farm production, opposition is much less likely. Indeed Europe's retailers wish to obtain good quality, competitively priced, supplies throughout the year to ensure continuity of supply on their supermarket shelves.
- 7.11 The tariff abatement on rice is conditional upon the exporting country collecting 'an export charge of an amount equivalent' to the tariff reduction. Thus, from the perspective of the trader, there is no commercial advantage to be gained from the concession: in effect, the trader faces the EU's full mfn rate, of which part is collected on export, and part on import into the EU. Set against these circumstances, the ACP export volumes are creditable. If the intent really is to increase exports, rather than simply to transfer tax revenue to the ACP, then some part of the tariff concession should be reflected in lower overall charges faced by the trader, thus encouraging exports.
- 7.12 Whilst an increase in agricultural exports, and higher export prices on sales to the EU, is of direct benefit to the ACP states, the benefits could be enhanced if those same agricultural exports were to be exported, not in unprocessed or semi-processed form, but in processed foods and other products. An important principle to establish with the EU in any successor agreement should be that where tariff concessions have been extended to the ACP states on agricultural goods, these same concessions should be carried through to processed products. This would eliminate tariff escalation, and encourage the location of processing industries in the ACP. Although this may have little practical effect at the outset, the long term development prospects of a number of countries could be enhanced.

8 The Banana Protocol

- 8.1 A special protocol of the Lomé Convention assures preferential treatment of banana exports to the EU from 'traditional' ACP exporters. These preferences are delivered by the EU's banana trade regime, which is currently challenged in the WTO. The loss of banana trade preferences could lead to the loss of the banana industry in certain ACP states, notably the islands of the East Caribbean, with far-reaching economic and political effects.
- 8.2 The EU banana regime was introduced in 1993 to replace individual member state banana trade policies after the creation of the Single European Market. The EU regime consists of a tariff quota system which guarantees duty-free access for traditional ACP supplies up to 858,000 tonnes and access at around 20% duty of 2.5 million tonnes from Latin-American exporters. Beyond these amounts prohibitive tariffs apply. Import licences are issued for the import of 'dollar' bananas with 30% of these (so-called B licences) allocated to traditional ACP traders.
- 8.3 The Lomé protocol has been successful in maintaining ACP exports, but less successful in raising competitiveness of ACP exporters. Without the preferential treatment accorded by the EU regime, ACP exports could not compete on EU markets because of high costs and variable quality compared to Latin American supplies. Certain ACP exporters, notably the Windward Islands, are highly dependent on banana exports in terms of contribution to GDP and employment.
- 8.4 The future of the Lomé protocol is under threat as a result of the WTO challenge to the EU regime. The Interim Report of the WTO panel has found against the specific mechanisms of the tariff quota and licensing system. It is uncertain whether the preferences can be delivered without these mechanisms, so preservation of the status quo is the best outcome for the ACP exporters. A preferential tariff system would not be sufficient to offset the competitive advantage of the dollar suppliers.
- 8.5 Whatever the outcome of the WTO case, it is essential to raise the competitiveness of ACP banana exports, and the trade development provisions of the Lomé protocol need to be emphasised. A smaller industry producing higher quality bananas is the likely result.
- 8.6 Diversification opportunities in the Windward Islands are limited. Competition in world markets for alternative horticultural crops is severe. Tourism development thus far has arguably contributed little to the local demand for agricultural products.

ACP-EU Relations in a Changing World Economy

Summary

The rapid pace of technological change, the liberalisation of markets and the spread of new systems of organising and controlling production have eroded the traditional sources of comparative advantage of the ACP countries in resource and labour intensive goods, and the relative importance of trade preferences. The Uruguay Round of multilateral trade negotiations has accelerated this process and placed substantial new obligations on ACP members of the WTO. At the same time, these fundamental changes in the world economy open up a complex variety of new opportunities in international trade. The relative importance of the ACP in EU trade has also declined, especially since 1990, and the importance of the ACP group in EU trade relations has also been eroded by new EU trade and co-operation agreements with Eastern Europe, Asia, Latin America and the Mediterranean countries. These new arrangements, particularly with Eastern Europe, could be used to assist the ACP countries in gaining access to new markets. In view of these substantial changes in the world economy and in EU trade relations, and the fundamental importance of trade to output and employment in the ACP countries, it is essential that, in contrast to the existing Convention, a new agreement *concentrates* on enabling the ACP countries to adjust to these changes and to participate more fully in the world economy by closely *integrating* the trade, industrial, agricultural, technical and financial co-operation provisions in a coherent strategy to increase the export capacity of the ACP countries.

1.1 Globalisation and Liberalisation: Implications for the ACP Countries

The increasing integration of markets in factors of production and products and services is the inevitable outcome of international trade and in this sense 'globalisation' is not a new phenomenon. Also, we are still a long way away from living in a truly 'global economy'. However, the rate of integration markets in factors and products and services has been greatly accelerated by the pace of innovations in technology and in the management and organisation of firms. Falling costs in the fields of telecommunications, transport and information technology, and new groups of technologies such as micro-electronics, biotechnology and new materials technologies, have all changed the face of industrial development. This process has gone hand-in-hand with the development of multinational companies. Their competitive advantage derives primarily from their ability to overcome market failures (both inefficient markets and missing markets) by internalising markets and transactions within the firm; as well as by developing new systems of control and production (e.g. just-in-time production). Liberalisation of markets in goods, services, and factors of production (especially capital) by the industrialised countries and by many developing countries have fuelled this process. The result of this is that international trade is now best viewed in terms of 'processes' rather than 'products', with production being organised through an intricate and rapidly expanding network of cross-border transactions. That is, products are produced through a series of processes carried out in different geographical

locations according to the specific requirements of that particular stage of production and the cost and other advantages of that location.

Globalisation has tended to change previous sources of comparative advantage. For example, the technological revolution has often decreased economies of scale in production and this, together with just-in-time production has shifted the location of production closer to the market (in the industrialised and higher income developing countries), enabling a quicker response to changes in market conditions. New technologies also greatly economise on the use of raw materials in production, and micro-technologies economise on the use of labour in production. All of these factors erode (though do not eliminate) the traditional advantages of the ACP countries in resource-based and labour intensive production. It is worth noting that ACP merchandise exports grew at the same rate as international trade until the recession in world trade in 1980. After the end of the recession in the mid 1980s, the merchandise exports of ACP African and Caribbean countries grew at substantially less than both the growth of world trade and the exports of other developing countries (excluding major exporters of oil and manufactures). Only the Pacific ACP countries recorded an increased growth in merchandise exports. Part of the explanation for this declining share of world trade (falling by over 50% in 1975-93) may be found in the anti-export bias of the domestic policies of a number of ACP countries, but a declining global demand for traditional exports has also played an important part.

On the other hand, the new technologies and the liberalisation of world trade open up new market opportunities. For example, the ability of the new technologies to decrease the minimum efficient scale of production, and economise on the use of skilled labour, combined with the world-wide sourcing and marketing strategies of companies, (not only large multinationals) has opened up new 'niche filling' opportunities for enterprising firms in ACP countries. In this respect, the very rapid establishment and growth of the clothing industry in Mauritius

is a good example of what can be achieved with limited resources in a very short period of time. Similarly, exports of services which now represent one-fifth and one-third of the merchandise exports of Sub-Saharan Africa and the Pacific respectively, and a much higher proportion of the exports of a number of Caribbean countries, have grown on average at 5% p.a. for Sub-Saharan Africa and 10% p.a. or more for the Caribbean and Pacific. Trade liberalisation, particularly by developing and industrialising countries in Asia and Latin America, and by the Central and East European countries, combined with a rapidly changing structure of production and trade as these countries move up the ladder of comparative advantage, opens up potentially large market opportunities for the ACP countries lower down the ladder of comparative advantage.

Enterprises, particularly the small, medium and micro-enterprises which predominate in the ACP countries, however, cannot take advantage of these market opportunities either directly or indirectly (as suppliers of intermediate goods and services) without help from other agents both in the public and private sector, and they in turn need external assistance and resources. ACP-EU trade, industrial, financial and technical co-operation needs to be much more closely *co-ordinated* than in the past and *focused* on enabling the ACP countries to achieve a greater integration into the world economy. Liberalisation and structural adjustment policies, if properly designed to fit the economic and social conditions of the country, can provide the necessary conditions for sustained growth and development, but by themselves will not be sufficient, particularly in achieving a substantial improvement in the standards of living of the poor. The combination of liberalisation and structural adjustment, with an ACP-EU Agreement focused on improving the supply response of the ACP countries, could rapidly transform the economic condition of the ACP countries.

In a few, very poor, ACP countries, exports account for only a small proportion of national

production, but on average exports of goods and non-factor services account for 30% of output, and in countries such as Kenya, Trinidad and Tobago, Botswana, Jamaica, Mauritius and Papua New Guinea, exports account for 40% to 60% of GDP. For very small ACP countries (micro states), exports are the mainstay of the economy. Also, rapidly growing economies are characterised by an even more rapid growth of exports so that the current, high, share of exports in GDP can be expected to rise to even higher levels with economic development. Both theory and evidence also demonstrate that increased exports by developing countries can generate a substantial growth of employment, since their comparative advantage will lie in the production of goods which are intensive in the use of the relatively abundant factor(s) of production. Mauritius, for example, was able to take advantage of its preferential access to the EU and US markets (principally in clothing) and its relatively abundant supply of labour, to rapidly increase its exports from the EPZ so that the EPZ accounted for most of the increase in employment and enabled unemployment to fall from a crisis level of 20% in 1980 to 3% (full employment) in 1988. Production of higher value crops can also generate a substantial amount of employment both directly and indirectly. For example, a recent joint venture between Kenyan and French firms to export canned green beans created employment for 20,000 poor farmers in West Kenya. Further employment can also be created in processing, distribution and transport and in associated suppliers of goods and services.

1.2 Implications of the Uruguay Round and the Establishment of the World Trade Organisation

Why the Uruguay Round was so important

The Uruguay Round (UR) of multilateral trade negotiations was the most far reaching of all of the GATT negotiations and has given a substantial impetus to the globalisation and liberalisation of the world economy. It has also

decreased both the need for, and the benefits from, an ACP-EU preferential trade agreement. The UR covered not only traditional areas such as tariffs on industrial products, but also non-tariff barriers, in particular the phasing-out of voluntary export restraint agreements and the quantitative restrictions on textiles and clothing under the Multi-Fibre Agreement (MFA), and for the first time, reductions in the protection of agriculture. In addition, it covered a series of trade related areas concerning foreign investment, intellectual property rights, and services, which had previously been left to the discretion of individual governments. GATT 'disciplines' have also been strengthened, for example, discipline on safeguards, anti-dumping measures, subsidies and countervailing measures (except agriculture) and other agreements on technical barriers to trade, standards, etc. have been clarified, while the 'Understanding on Rules and Procedures Governing the Settlement of Disputes' has improved the speed and automaticity of the dispute settlement procedures. There is also great pressure from the developed countries for the developing countries to become members of the World Trade Organisation (WTO), and unlike the previous arrangements which allowed the developing countries to agree to a proportion of the provisions of the GATT, all members must now accept it as a *single undertaking* while membership of the WTO is conditional on countries having schedules of commitments and obligations.

The effects of this large programme of reform on the ACP countries will only be revealed over the next decade but the pressure for these changes has arisen from the globalisation of production and widespread liberalisation of world trade, particularly by the developing countries and the transitional economies of Eastern Europe. Short of a world-wide depression of the dimensions of the 1930s, these forces are sufficiently powerful to ensure that this fundamental shift towards a rule-based system of international trade will continue to strengthen, although we are still a long way short of a world of free

trade. It is for this reason that this report emphasises the fundamental importance of building up the capacity to participate in an expanding world economy. We can already see a widening gap between the more industrialised developing countries which have built up their technological capacity and engaged in outward-oriented trade policies, and the less advanced countries which desperately need a strategy to develop their competitiveness in world markets. In the context of the Lomé Convention, these fundamental changes in the world economy mean that trade preferences of any significance will be of limited value early in the next century. A new agreement must concentrate on building export capacity and assisting the ACP countries in participating in this new world trading system.

There are many comprehensive studies on the impact of the Uruguay Round on the developing countries (e.g. Page and Davenport 1994, and Safadi and Laird 1996) as well as studies directly relevant to the ACP countries (Greenaway and Milner 1995, Davenport 1995, Davenport, Hewitt and Koning 1995). We therefore do not seek to re-work this ground but simply highlight the main results of the Uruguay Round relevant to the ACP countries and their implications for a new ACP-EU agreement.

Agriculture – temperate products

European and North American countries have heavily protected their agriculture through a complex system of non-tariff barriers and guaranteed prices well above world prices. As a result, output has greatly increased while consumption in Europe has been reduced by high prices and with the excess supply being dumped on world markets, depressing world prices. The UR agreement on agriculture has attempted to reduce these distortions by turning all non-tariff border measures of protection into tariff equivalents and then reducing these tariffs by an average of 36% over six years (24% over ten years for developing countries). Export subsidies have to decrease by 36% in value and 24% in terms of the volume of exports. Because of the methods chosen for cal-

culating the tariff equivalence, it is generally accepted that the reductions in border protection will be minimal and that the inclusion of agriculture in the GATT and the tariffication process is more important in laying down the basis for future liberalisation in agricultural trade. The other important point to note is that domestic subsidies to agriculture (EU compensation payments and US deficiency payments) are not part of the liberalisation agreement.

Liberalisation of world trade will increase world food prices as a result of the decreased supply of subsidised exports and this will adversely affect ACP net food importers such as Angola, Côte d'Ivoire, Senegal and Nigeria (Davenport, Hewitt and Koning). EU support for agricultural producers can also be expected to switch from border protection to producer subsidies (i.e. shifting the costs of protection from EU consumers to taxpayers). Ultimately there could be something like free trade in temperate products (though in the case of sugar this is only expected to occur in the very long run) and, as a result, ACP sugar and beef exporters covered by the protocols of the Convention (particularly Mauritius, Fiji, Guyana, Jamaica, Swaziland, Botswana and Zimbabwe) would suffer a significant loss of revenue due to the decrease in the EU price, though in the medium term, EU sugar prices are expected to only slowly decline. (Chapter 7 examines the implications for these and other products covered by the EU's common agricultural policy in more detail). The long run effects of liberalisation on both the level and variability of world food prices are difficult to estimate since they depend on assumptions about the size of domestic subsidies of northern agriculture, the supply response of other producers, notably in Eastern Europe and the non-ACP developing countries, to high world prices, as well as the probability of China becoming a net food importer, but the expectation is that food prices will rise and fluctuations decline.

The implications for the ACP countries are that a *new ACP-EU agreement must address the need for sugar exporters which are substantially dependent on the EU market to engage in a long run*

programme of diversifying their agricultural production. Trade liberalisation by the industrialised countries, non-ACP developing countries, and by the transitional economies, will open markets both by country and product and a new agreement could provide the technical and financial resources to exploit these opportunities. In the case of net food importing ACP countries, the WTO agreement provides for the monitoring of the effects of the agreement on the least developed and net food importing countries, but does not provide resources for remedying adverse consequences on these countries. International institutions are already under financial pressure and are therefore unlikely to be able to provide additional assistance. Since most of the countries likely to be adversely affected are ACP countries, it seems appropriate that *a new agreement should target resources aimed at enabling these countries to adjust to rising world food prices*, both by improving their agricultural sector and by increasing their export revenues (and therefore increasing their capacity to import food).

Agriculture – tropical products

The largest reductions in EU tariffs were the 100% decreases in coffee beans (previously 5%) and cocoa beans (previously 3%). Although the margin of tariff preference for the ACP was small, it nevertheless represents a straightforward trade diversion loss to ACP exporters since all the other major cocoa importers already had zero tariffs and so there is no opportunity for any compensating UR induced increases in import demand for ACP exports in non-EU markets. Other significant losses of preferences in important ACP exports are in tobacco, fruits, cut flowers and nuts and spices, although reductions in duties in non-EU countries may open up unexploited markets for these products.

As will be discussed in Chapter 2, a number of ACP countries have diversified into fish and fisheries products and EU reductions in tariffs on these products from 14.8% to 11.8% (GSP rate of 10.6%) could also produce significant trade diversion losses.

Industrial products

The largest single impact from the liberalisation of trade in industrial products on the ACP countries will be the phasing out of the MFA by 2005. Exemption from MFA quantitative restrictions in the EU market was particularly important in developing the clothing industry in Mauritius as well as in Jamaica, Zimbabwe, Kenya, Côte d'Ivoire, Lesotho, Botswana, Ethiopia (McQueen and Stevens 1989) and in an increasing number of ACP countries including Mozambique, Namibia, Tanzania, Zambia, Dominican Republic, Haiti and Fiji. ACP exports of clothing to the EU were worth an average ecu 544m p.a. in 1990-92 (Davenport, Hewitt and Koning, 1995). Unrestricted access for other developing countries can be expected to lead to a substantial increase in imports from low cost suppliers (relative to the ACP countries) in Asia and in Turkey who are currently constrained by quotas. It will also make it more difficult for major exporters of cotton textiles such as Benin, Burkina Faso, Cameroon, Chad, Côte d'Ivoire, Mali, Mozambique, Namibia, Sudan, Tanzania and Togo to develop exports to the EU from their embryonic clothing industry. There may be some compensating increase in exports to other markets such as the Caribbean countries to the US market, but this is likely to be small, while major ACP exporters such as Mauritius have been unable to fill their existing US quotas and so cannot expect any trade stimulating effect from liberalisation.

Of the remaining industrial products, decreases in tariffs on veneers and plywoods and wood pulp and paper will adversely affect Cameroon, Côte d'Ivoire, Gabon, Ghana and Papua New Guinea. The ODI study also identifies significant losses in metals and minerals for Angola, Congo, Gabon, Ghana, Guinea, Liberia, Mauritania, Sierra Leone, Zaire, Zambia, Zimbabwe, Dominican Republic and Papua New Guinea. The Bahamas records substantial losses for chemicals, transport equipment, and industrial products. Significant losses (given the size of

their manufactured exports) in 'other industrial products' are also recorded for Ethiopia, Kenya, Madagascar, Mauritania, Mauritius, Mozambique, Senegal, Zaire, Dominican Republic, Jamaica, Surinam, Trinidad and Tobago (also adversely affected in chemicals).

Dynamic effects

Although the static loss arising from the preference erosion is estimated at only 1.3% of total ACP exports (ODI, 1995) this understates its true significance. As the ODI report indicates, some ACP states such as Djibouti, The Gambia, Guinea-Bissau, Cape Verde and W. Samoa (ODI, 1995 Table A12) will suffer a loss of export earnings substantially above this average.

Secondly, these losses will be concentrated in particular sectors of the economy and often in embryonic industries which could form the beginnings of diversification of exports out of a dependence on primary products.

Thirdly, loss of preferences has not simply been in terms of cuts in *nominal EU tariffs* but also in terms of *effective tariffs* (and therefore effective preferences) since the degree of tariff escalation (in terms of the absolute increase in tariffs at each stage of processing), has fallen in almost all products. For example in the case of EU duties on coffee:

EU % Tariff	Pre-UR	Post-UR	Decrease in Tariff
coffee beans	5.0	0	5
coffee, roasted/ground	15.1	7.4	7.7
coffee extracts, prep.	18.0	9.0	9.0

Source: computed from Greenaway and Milner, 1995.

By decreasing the tariff on the final stages of processing (for example, the roasting and final preparation of coffee) more than on the raw material (for example, coffee beans), the effective degree of protection of processing has been reduced. ACP countries have only been engaged in a small amount of processing of raw materials

and so the reduction in effective rates of protection (preferences) will have little effect on existing foreign exchange earnings, but it will make it more difficult for them to engage in this in the future.

The only exception to the reduction in the effective margin of preferences is cocoa:

EU % Tariff	Pre-UR	Post-UR	Decrease in Tariff
cocoa beans	3	0	3
cocoa paste	15.0	9.6	5.4
cocoa butter	12.0	7.7	4.3
cocoa powder	16.0	8.0	8.0
cocoa chocolate	12.5	10.0	2.5

Source: computed from Greenaway and Milner, 1995.

Fourthly, preference erosion can be expected to reduce investment in these sectors from what would otherwise have been the case in the absence of reductions in tariffs and tariff escalation.

Against these dynamic losses must be set the growth effects arising from the general liberalisation of trade. The average trade-weighted tariffs on industrial goods facing developing countries as a whole has decreased by 34% to 4.5%, and while this has lowered the margin of preferences for the ACP countries, it should have a trade stimulating effect on other, less preferred developing countries, who in turn will increase their imports as their real income rises. In addition, these countries have decreased their tariffs on imports from other developing countries to a trade weighted average of 7.1% (Safadi and Laird, 1996). The proportion of tariff bindings (i.e. maximum tariffs declared to the WTO and which cannot be increased) on industrial products has also been substantially increased by developing and transitional economies.

Tariff bindings in the industrial countries now average 99%. In Africa, tariff bindings on industrial products have also substantially increased but declared bound rates are often well above actual applied rates and so cannot be expected to have a significant effect and act as an 'anchor' for trade liberalisation policies.

Table 1.1 Tariff Changes under the Uruguay Round

	% tariff lines bound		% imports under bound tariffs	
	Pre-UR	Post-UR	Pre-UR	Post-UR
Developing countries	22	72	14	59
Transition economies	73	98	74	96
Latin America	38	100	57	100
Central Europe	63	98	68	97
Asia	17	67	36	70
Africa	13	69	26	90

Source: Sofadi and Laird, 1996.

The combination of the phasing out of the MFA, the prohibition of 'grey area' measures (voluntary export restraints, orderly marketing arrangements, etc) and the elimination of existing safeguard measures (new safeguards must demonstrate actual damage or that of serious injury and can only discriminate among suppliers in exceptional circumstances), together with the decrease in tariffs and increase in bound tariffs, should stimulate the growth of output in the developing and transitional economies and open up new markets for ACP exports. *The ability of the ACP countries to take advantage of the new trade opportunities, will, however, depend on their capacity to export and it is on this, rather than claims for preferences that the ACP countries should concentrate the provisions of a new agreement.*

Anti-dumping rules

ACP countries have not been subject to discriminatory protective actions by the developed countries but this is mainly because they have not been exporters of significant amounts of sensitive products. This situation could change in the future if countries switch towards contingent protection (i.e. if the criteria deferring a particular 'injury' are met, then compensatory trade restrictions can be imposed) as a result of the prohibition of 'grey area' measures and increased competitive pressure on an increasing list of sensitive industries. Foremost among contingent protection measures are the use, or threat of instigating, anti-dumping procedures. The UR seeks to strengthen the procedures through the

'Agreement on Implementation of Article VI of GATT 1994', for example regarding the methodology of calculating the margin of dumping, injury, etc., and specifies that anti-dumping duties can only remain for five years unless it can be proved that removal of the duty would lead to a resumption of dumping. However under Art. 17.6 (i) GATT disputes settlement panels can only 'determine whether the authorities' establishment of the facts was proper and whether their evaluation of those facts was unbiased and objective. If the establishment of the facts was proper and the evaluation was unbiased and objective, even though the panel might have reached a different conclusion, the evaluation shall not be overturned' (p.193).

In view of this the ACP may wish to consider including in any future agreement a clause which stipulates that the EU will not use any measure of contingent protection provided the ACP states comply with certain agreed criteria. This would then enable the ACP to move beyond the protection of GATT 1994 and obtain the assurance of market access which investors and exporters require. Such an assurance would be potentially more valuable than any further trade preferences.

Settlement of disputes

Annex 2 of the Marrakesh Agreement covers the 'Understanding on Rules and Procedures Governing the Settlement of Disputes' and in a number of respects has greatly strengthened the procedures. A Disputes Settlement Body (DSB) has been established and the adoption of panel

reports has been changed from a 'consensus to accept' to the need for a 'consensus to reject' panel reports. This 'virtually guarantees the adoption of panel findings' (Safadi and Laird, 1996, p.1238) compared to the pre-UR position where the adoption of a panel report could be blocked by a veto. If there are objections to the panel findings then the DSB refers the matter to a three person Appellate Body whose adopted rulings are binding. Appeals are limited to 'issues of law covered in panel reports and legal interpretations developed by the panel'. A strict timetable is enforced on the proceedings, WTO members must use the multilateral disputes settlement procedures and the Agreement prohibits unilateral actions contrary to these procedures. Article 24 also requires Members to 'exercise due restraint in raising matters under these procedures involving a least developed country Member'.

In total, these measures greatly strengthen the GATT as a rule-based system governing international trade and 'protect the weak (developing countries) from the strong' (developed countries). In this important sense the ACP countries have less need than in 1975 for a trade agreement with the EU to guarantee market access and can have more confidence in developing their multilateral trading links. The downside of this, as ACP banana exporters have suffered from, is that any aspects of the EU's favourable treatment of the ACP as compared to other developing countries, are also now more subject to successful challenge.

TRIPs and TRIMs

Trade-Related Aspects of Intellectual Property Rights (TRIPs) Agreement requires members to apply national treatment and MFN treatment for all intellectual property covered by the Agreement. It stipulates minimum standards of law and enforcement for copyright, trademarks, geographical indications, industrial designs, patents on layout-designs of integrated circuits, protection of undisclosed information, control of anti-competitive practices in contractual

licences. Developing countries have a 5 year period and the least developed 11 years to put these measures into place. Some ACP countries may, to a small extent, benefit from the Agreement through attracting increased flows of foreign direct investment and transfers of technology. Against this must be set the substantial costs of compliance and the increased price of products with a significant intellectual property component, such as hybrid seeds, pharmaceuticals and agricultural chemicals.

The Agreement on Trade-Related Investment Measures (TRIMs) requires members to apply national treatment to investment measures related to trade in goods (not services) and in an Annex provides an 'illustrative list' of TRIMs that are inconsistent with GATT 1994, including local content requirements, trade and foreign exchange balancing requirements, restrictions on access to foreign exchange (and home imports), local equity requirements, technology transfer requirements. Article 4 allows developing country members to deviate *temporarily* from these measures but only under the provisions of Article XVIII (infant industry protection) and GATT rules on balance of payments safeguard measures.

Safadi and Laird (1996) argue that the TRIMs Agreement is beneficial to developing countries because the prohibited measures have a trade and investment distorting effect on developing countries, and because they discourage foreign direct investment, since they act as an implicit tax. The alternative view is that the Agreement weakens the bargaining power of host developing countries in their dealings with multinational enterprises (MNEs) and may reduce their developmental impact. It is also at variance with the way in which the NICs successfully managed their relations with foreign companies' involvement in their economies and maximised their developmental impact.

TRIPs and TRIMs raise substantial issues for the ACP countries both in terms of drawing up an inventory of what is needed to comply with WTO requirements, analysing the implications

of compliance with these requirements, identifying the legal and administrative measures which are needed for compliance, estimating the costs of compliance, and identifying whether there are alternative measures which would influence the activities of MNEs and maximise their contribution to the host economy.

There is much discussion on the need to increase the participation of MNEs in the ACP countries and their potential contribution is analysed in Chapter 8. As part of this policy, *the ACP countries need to obtain financial and technical assistance in a new agreement which deal with the complex and largely unexplored issues concerning the impact of TRIPs and TRIMs.*

General Agreement on Trade in Services (GATS)

The GATS may be seen as a first step in dealing with a neglected but rapidly growing segment of national economies and international trade. Members participating in the GATS make sector specific commitments concerning the degree of national treatment and market access conditions by all forms of delivery of the service (trade, movement of consumers or producers, commercial presence). Obvious areas for ACP offers are in financial services, transport services, telecommunications, tourism, and professional services, agreements on which could increase the export earnings of participating countries both directly (e.g. tourism) and, most importantly, indirectly by providing services complementary to production in export sectors. Also, Article IV of the GATS is specifically concerned with 'increasing the participation of developing countries' in world trade through negotiated specific commitments relating to:

- (a) the strengthening of their domestic services capacity and its efficiency and competitiveness, *inter alia* through access to technology on a commercial basis;
- (b) the improvement of their access to distribution channels and information networks; and

- (c) the liberalisation of market access in sectors and modes of supply of export interest to them.

Also, developed countries, and to the extent possible other members, are required to establish *contact points* to facilitate the access of developing country service suppliers to information relating to their markets on:

- (a) commercial and technical aspects of the supply of services;
- (b) registration, recognition and obtaining of professional qualifications;
- (c) the availability of services technology.

Special priority is to be given to the least developed countries in achieving these objectives, while both Article IV and Article XIX recognise the difficulty of the developing countries, and particularly the least developed, in liberalising sectors and types of transaction.

The ACP countries may wish to consider whether many of the issues and matters concerning the GATS would not be best organised on a regional basis. Implementation of GATS Agreements could also be effectively organised through a successor ACP-EU Agreement, especially since most of these areas are subject to the provisions of the EU Single Market Agreement.

Establishment of the World Trade Organization (WTO)

Prior to the Marrakesh Agreement, the GATT had an ill-defined status as both an agreement and an institution (the Secretariat). The establishment of the WTO emphasised the objective of strengthening and firmly establishing a rule-based system of international trade as a single undertaking in which members have both rights and obligations. Members of the WTO obtain protection from discriminatory actions in return for providing specific undertakings and agreeing to certain disciplines governing trade in goods and services. Amid all the details of the UR and attempts to quantify its benefits, this is generally

acknowledged as the most important achievement of the UR and of particular value to the developing countries. The WTO, however, is a 'member driven' organisation in the sense that it responds to initiatives taken by members rather than initiating proposals on its own behalf like the World Bank or the European Commission. There are (in January 1997) 53 ACP members of the WTO with a further 5 applications being considered by the WTO (see Table 1.2).

The ACP countries are, however, at a disadvantage since many countries do not have permanent offices in Geneva, and of those that do, most have to cover all of the international bodies in Geneva. *There are therefore clear advantages in the ACP countries (who will soon comprise 57 of the 160 members of the WTO) co-ordinating and pooling their resources so that they can more effectively represent their interests and monitor the many proposals going through committees which could affect them (e.g. trade related environmental and labour issues) and initiate actions which could enable them to obtain*

greater benefits from participating more fully in the world economy.

The WTO, in co-operation with developed country member states, UNCTAD and the ITC, have various programmes for providing technical assistance and co-operation but these efforts concentrate on training individuals and preparing studies. *A new Agreement could assist the ACP countries in building the institutional capacity of the ACP countries to enable them to obtain the maximum benefit from their membership of the WTO and to implement their obligations as members.* This would act as a counterpart to the EU's pressure on ACP countries to become members of the WTO and enforce WTO disciplines. The EU would provide, as appropriate, financial and technical assistance to individual ACP countries, groups of ACP countries, and the ACP group as a whole, to enable them to:

- ❖ maintain and staff effective representation in Geneva, particularly directed at assisting the least developed countries;

Table 1.2 ACP Members of the WTO (as at 29.1.97)

Angola	Ghana	Papua New Guinea
Antigua and Barbuda	Grenada	Rwanda
Barbados	Guinea-Bissau	St Kitts and Nevis
Belize	Guinea, Rep. of	St Lucia
Benin	Guyana	St Vincent and the Grenadines
Botswana	Haiti	Senegal
Burkina Faso	Jamaica	Sierra Leone
Burundi	Kenya	Solomon Islands
Cameroon	Lesotho	Surinam
Central African Republic	Madagascar	Swaziland
Chad	Malawi	Tanzania
Côte d'Ivoire	Mali	Togo
Djibouti	Mauritania	Trinidad and Tobago
Dominica	Mauritius	Uganda
Dominican Republic	Mozambique	Zaire
Fiji	Namibia	Zambia
Gabon	Niger	Zimbabwe
The Gambia	Nigeria	

Observer Governments

Congo, Seychelles, Sudan, Tonga, Vanuatu

- ❖ exercise their rights and benefit from the protection offered by the WTO Agreements;
- ❖ define and pursue their individual and collective interests in negotiations;
- ❖ implement their obligations as members of the WTO;
- ❖ explain the implications of membership of the WTO to the private sector in ACP countries in terms of their rights of market access, the opportunities which these rights offer, and obligations and constraints which membership imposes, and the increased competition which they may face;
- ❖ identify market opportunities, particularly as these evolve with the implementation of WTO disciplines by other countries, including other developing countries, and as a result of subsequent negotiations.

1.3 Changes in the Geographical Composition of EU Trade

The changing patterns of EU trade

The period since 1989 has seen a fundamental transformation of the 'transition economies' of Russia, the Central and East European countries (CEEC), other Newly Independent States (NIS), China and Vietnam, while India has embarked on a major programme of structural adjustment. Together, these economies have a population of 2.7 billion people and their impact on EU trade has already been substantial and will be even greater in the future.

Eastern Europe for example, traded around 19% of its exports and 17% of total imports with the EU in the 1980s. By 1992 these proportions had increased to 42% and 44% respectively. In the case of China, South Asia and the ASEAN countries, the proportion of exports and imports from the EU have broadly remained the same, but the high growth rates of trade have greatly increased the value of trade with the EU.

Table 1.3 summarises these large and rapid shifts in EU trade in non-oil products for different groups of countries. Whereas EU non-oil imports from the CEEC in 1990 were about one-third those of the ACP, by 1993 they had already exceeded those of the ACP. Similarly, EU imports from China in 1990 were 22% less than imports from the ACP but by 1993 they were nearly double the value of imports from the ACP and increasing rapidly. Imports from South Asia were roughly half those from the ACP but by 1993 were nearly equal to those from the ACP. With the increase in EU imports from these countries has also gone a substantial increase in EU exports to these countries. Of the nine regional groupings shown in Table.1.3 the ACP was the third largest market for EU exports in 1990, but by 1993 the ACP had fallen to sixth position and, given the growth of EU exports to Russia, is now probably in seventh position and will soon also be overtaken by China.

Poland, Hungary and the Czech Republic have been at the forefront, both economically and politically, in the EU's rapidly developing relations with the CEEC. Thus trade with these countries which averaged around \$10 billion in 1988/89 had increased to over \$40 billion by 1994. Most of this trade was with Germany but has increasingly included Austria and Italy in the case of the Czech Republic, and the UK in the case of Poland. EU trade with Russia, mainly involving Germany, but also with Italy, France, the UK and Austria, has also begun to grow quite rapidly. Overall, EU trade with Eastern Europe has more than doubled over the period 1988-94.

Implications for ACP exports to the EU

The largest single impact on the EU trade with developing countries has been the return of China to world markets. The degree of similarity with ACP exports is small and confined largely to clothing, as China's other exports are largely confined to labour intensive manufactured goods such as toys, sports goods, footwear and consumer electronics, which are not exported by the ACP

Table 1.3 Geographical Distribution of EU's Non-oil Trade

ecu bn	EU Imports		EU Exports	
	1990	1993	1990	1993
ACP	13.5	10.6	16.6	16.4
CEE Countries	4.8	10.9	12.1	20.1
Former USSR	7.5	10.9	11.2	15.8
Med. Basin	25.4	24.6	44.5	51.2
Latin America	22.6	20.1	15.6	24.0
China	10.5	19.4	5.3	11.3
ASEAN	16.6	25.5	16.1	22.9
4 NIEs in Asia	26.3	31.2	23.3	34.0
South Asia	6.9	9.3	8.3	9.3

Source: Adapted from *The European Union and World Trade*, European Commission, 1994.

countries. Much more important is the general problem posed by the rapidly increasing involvement of the developing countries in Asia and to a lesser extent, Latin America, in world markets. The 'first tier' NICs had to become competitive in world markets relative to the high labour cost industrialised countries, while the 'next tier' NICs have had the more difficult task of becoming competitive relative to the low cost and high quality levels of the NICs. A third group of developing countries are now emerging in Asia and Latin America to challenge this group. The ACP are therefore faced, in turn, with having to become competitive in both the price and quality of the goods exported against this established competition, – a potentially much more difficult task than that facing the 'first tier' NICs.

Fortunately, the task is not quite as formidable as it appears, as the process of economic development enables countries to ascend the 'ladder of comparative advantage' and vacate the lower rungs of the ladder occupied by the production of labour intensive goods using relatively unskilled and semi-skilled labour. EU imports of footwear from South Korea and clothing from Hong Kong have been reduced relative to more capital and skill intensive goods, making it easier for the EU to absorb increased imports from, for example, China. In addition, the growth of these economies has fuelled the rapid growth of intra-industry trade among the developing countries.

Thus as countries move up the ladder of comparative advantage they leave room for other countries in the markets they have vacated and become new markets for labour intensive goods. Also, the increase in real incomes in world markets and the increased competitiveness of these goods produces a more than proportional increase in demand.

The transition, however, is not a smooth process and empirical evidence demonstrates that countries retain their comparative advantage in goods such as footwear and clothing for some considerable period of time by investing in labour saving technology, quality up-grading, and improving on organisational and marketing efficiency. Latecomers to industrialisation such as the ACP, therefore have to find and develop their niche both in terms of products and markets, in this complex and rapidly changing world of global trade. This may be found in EU markets largely vacated by more industrialised developing countries, in the markets of the more industrialised developing countries, transitional economies, or in non-EU developed economies. In a world of international trade increasingly dominated by differentiated products, developing countries, including the ACP, will also increasingly become simultaneously importers and exporters of the same broad class of manufactured goods. *The ACP will, however, only be able to participate in this process if they greatly improve on*

the flexibility and adaptability of their economies and a successor arrangement to Lomé IV should concentrate on meeting this objective.

EU trade with the CEEC and the Baltic states

With regard to the CEEC countries, analysis of measures of revealed comparative advantage suggests that these countries have fundamentally different competitive advantages to the ACP. They have a substantial stock of physical and human capital and a long history of manufacturing and trading, but the previous command economy structures created many activities which were not competitive in world markets. As a result, they have to endure the costs of a period (whose length will vary substantially from one country to another) of adjustment. This has involved the reallocation of resources, investment in infrastructure, plant and machinery and investment in training to develop more modern, broader and flexible skills, as well institutional development in government finance and in their legal systems. Association with the EU has been seen by both parties as strengthening and deepening this process through liberalising access to each other's markets and providing a secure foundation for flows of European investment into these economies. Above all, the 'Europe Agreements' of 1994 and 1995 providing for association and leading ultimately to accession to the EU, were seen from the beginning as making the political changes in the CEEC countries irreversible.

Thus, whilst there is, at present, some degree of overlap in the exports of the CEEC and the ACP to the EU in such products as clothing, fish and furniture, this is not substantial and can be expected to be even less important in the long run as these countries diversify into medium and high skill intensive products and 'heavy' indus-

trial products such as steel and chemicals. Competition in the EU market will then be with the more industrialised countries in Asia and Latin America and less efficient producers in the EU. Of greater significance is the fact that exports of agricultural and manufactured goods from the CEEC will compete directly with higher cost producers in the EU. As will be discussed in Chapter 3, the Europe Agreements envisage free trade *only* in industrial products by the year 2002, (with exceptions in a few agricultural products), and with safeguard clauses to protect EU producers. It is doubtful, however, whether such exclusions will be able to persist over the long term both in terms of compatibility with GATT rules governing free trade areas and customs unions (Article XXIV) and with a vision of a wider European Union.

The positive aspect of these events is that they open up a potentially very substantial new market for ACP exports. The EU Association Agreements (Europe Agreements) cover all aspects of co-operation between the EU and the CEEC and Baltic countries and in addition, encourage these countries to liberalise trade between themselves, for example through the creation of the Central European Free Trade Association and through the PHARE multi-country trade development programme. *The ACP could link the provisions of a successor arrangement to Lomé IV with the Agreements for the CEE countries.* By linking the Agreements through institutional arrangements and technical assistance, the ACP could obtain preferential access to these markets (which have a combined population of 122 million) not only in terms of exemptions from the trade restrictions applied by these countries during the pre-accession period, but also in terms of knowledge of the requirements of these markets.

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The Export Record of the ACP Countries and the Role of Trade Preferences

Summary

The small size of population and the generally low level of income means that the growth of most of the ACP countries will be constrained by the small size of the domestic market and that they must participate in international trade to a greater extent than larger countries at a comparable level of development. It is often claimed that the ACP countries have failed to respond to this challenge and that falling shares in world commodity markets and in EU imports are evidence of the failure of domestic policies. Also, the continued dependence on exports of primary products is seen as evidence that the ACP countries have failed to take advantage of Lomé preferences to diversify the product composition of their exports. A high dependence by the ACP group on the EU market is also interpreted as indicating a lack of market diversification compared to other developing countries, with adverse effects on the growth of exports. This chapter examines these claims and emphasises both the fundamental problems faced by the ACP countries in world commodity markets and, contrary to the pessimistic view, the increasing extent of export diversification by the ACP countries. The problem is not one of an absence of structural change, but that this needs to be both broadened and deepened. Preferences have been of

some use in stimulating export diversification, but will be of limited value in the next century and a new agreement needs to concentrate on a co-ordinated strategy to reduce the variability of existing production for export and support further export diversification by product and by market.

2.1 The Share of Exports in GDP and the Level of Economic Development

The share of exports in GDP tends to increase the higher the level of economic development of a country, because the increasing diversity of the economy and efficiency of the operation of factor and product markets enables the country to become more competitive in world markets. This general tendency, however, is subject to a significant degree of variation since it depends on the initial resource endowments of the economy and, in particular, on the size of the population of a country. A small size of population combined with a relatively low level of per capita income (only 7 ACP countries, with a population of more than 1 million are classified by the World Bank as having a per/c GNP greater than \$725) produces a small size of domestic market and to overcome this constraint small economies must enter into international trade at an earlier stage of development than large economies (Chenery and Syrquin, 1975; Perkins and Syrquin, 1989).

Table 2.1 Size Distribution of ACP Populations

	Africa	Caribbean	Pacific	Total
50 million+	2	0	0	2
15m-50m	7	0	0	7
less than 15m (of which <5m)	38 (21)	15 (13)	8 (8)	61 (42)

Source: World Development Report, 1996, World Bank.

Empirical work usually divides countries into very large (population over 50 million), large (15-20 million) and small (under 15 million) economies (see Gillis, Perkins, Roemer, Snodgrass, 1996, p.49). On this basis, 61 of the 70 ACP countries can be classified as small, and of this nearly two-thirds have a population of less than 5 million.

The two largest ACP countries are Nigeria (108 million) and Ethiopia (55 million), while the seven countries in the 'large category' are Zaire (41 million), Tanzania (28.8 million), Sudan (27 million), Kenya (26 million), Uganda (18.8 million), Ghana (16.6 million) and Mozambique (15.5 million). The competitiveness and growth of the export sector is therefore of even greater importance to the growth of the ACP countries than for developing countries as a whole.

2.2 ACP Exports to the EU

The alleged failure to take advantage of preferences

The generally accepted view of the record of ACP exports to the EU since the first Lomé Convention in 1975 is that, despite being at the apex of the EU's 'pyramid of privilege' providing free access (subject to rules of origin) for 95% of their exports, the ACP countries have failed to take advantage of their preferential status and, indeed, performed poorly in comparison with other developing countries. Moss and Ravenhill (1987) state that 'the ACP were markedly less successful than other developing countries in maintaining their share of non-oil exports to the Community: whereas non-oil exporting ACP states lost 40% of their share of the EEC market from 1970 to 1984, the market share of other non-oil exporting countries remained relatively stable. As a result, the share of non-oil ACP States in EEC imports from the non-oil-exporting LDCs declined substantially' (p.112). A recent survey by Davenport, Hewitt and Koning (1995) of ACP trade performance makes a similar point in emphasising that, despite the

number of Lomé beneficiaries increasing from 46 countries to 69 countries over the period 1975-92, the share of ACP non-oil-exports in EU imports declined from 6.1% to 2.9%, and 'if ACP exports to the EU are compared with those of other developing countries which enjoyed less preferential access to the European market, the deterioration in the ACP performance becomes even more apparent.' (p.5).

Whilst such general statistics are useful in focusing attention on the marginalisation of the ACP in the EU's external trade relations, they run the risk of leading to the conclusion that the Lomé Conventions have therefore been of no practical value in increasing the exports of the ACP. To reach such a conclusion on the basis of this evidence would, however, be misleading. The Convention covers more than just trade preferences, the impact of preferences has complex dynamic as well as static effects which are not captured by such simple comparisons, while 'ACP exports' are dominated by a few countries and products, most of which are primary commodities subject to low growth and instability. Comparisons with the non-oil developing countries on the basis that they are 'less preferred' are also misleading because EU imports from this group are dominated by the NICs and such large and industrially developed economies as Brazil and China, none of which are comparable to the ACP countries. An analysis of 'ACP exports' must therefore be conducted at a more disaggregated level, both by product and country.

ACP exports depend on the performance of a few countries and products

The ACP comprise a heterogeneous group of countries with a widely different export experience. The performance of the 'ACP group' however depends upon the performance of a very limited number of countries and range of products. Over the period 1990-94, Nigeria accounted for around one-fifth of ACP exports to the EU and 12 countries were responsible for a further 50% of EU imports from the ACP group. The share of oil and oil-related products in exports to

Table 2.2 Main ACP Exporters to the EU

	% Share AV 1990-94	Average Growth 1990-94	Average Growth 1976-92	Main Exports to EU, 1994 (and % of Total Exports to EU)
Nigeria	22.1	-2.7	1.4	oil (89%)
Côte d' Ivoire	8.7	1.1	2.9	cocoa beans (32%), wood (14%), coffee (9%)
Cameroon	6.3	-5.0	7.4	oil (40%)
Gabon	5.5	-6.1	7.0	oil (50%)
Zaire	4.5	-9.7	-1.3	diamonds (39%), copper (23%)
Mauritius	4.4	2.0	10.2	sugar (32%), clothing (54%)
Angola	4.1	-15.5	18.1	oil (81%)
Ghana	3.6	1.9	4.0	aluminium (29%), cocoa beans (23%)
Kenya	3.0	3.4	4.6	tea (26%), coffee (21%)
Zimbabwe	3.0	-0.5	8.2	tobacco (29%), clothing & textiles (11%)
Congo	2.9	-1.7	13.0	oil (51%), diamonds (24%)
Liberia	2.1	-14.8	2.2	diamonds (49%)
Senegal	1.7	-8.5	-1.4	nut oil (21%), fish etc. (36%)

Value exports 1994 Ecu 18.2 billion.

Sources: European Commission, External Trade of the EU with the ACP Countries and OCT's Luxembourg, 1995; Column 4, Davenport et al, 1995.

the EU varies according to the world price of oil but has averaged around 30%. A further nine products (defined at the 4 digit CN level – diamonds, cocoa beans, coffee, sugar, wood in the rough, aircraft, bananas, refined copper, sawn wood) accounted for 43% and twenty-six products account for over 70% of the ACP non-oil exports to the EU. Table 2.2 lists the 12 ACP countries responsible for 72% of ACP exports to the EU in 1994 and shows their high export dependence on one or two product categories. Variations in the performance of a few key ACP countries and/or in a small number of products will therefore largely determine the performance of 'ACP exports'.

Problems of low growth and instability

Exports of primary commodities are generally subject to very low and declining income elasticities of demand, producing low growth rates in the volume of exports. They are also subject to a long term decline in real commodity prices, with considerable instability around this downward trend.

Table 2.3 analyses the \$ price change of twenty-two primary products over the period 1984-94 which together accounted for 42% of ACP non-oil exports to the EU in 1994. Nearly half of these commodities experienced a downward trend in their current \$ price and all but four products (tropical hardwoods and plywood, copper, manganese) experienced declining real product prices which, in the case of coffee and cocoa, averaged -10.4% and -11.5% pa over the ten year period. The data also demonstrates that not only have ACP exporters been faced with declining prices, but there has also been a high degree of instability around this adverse trend with price variations often being a large multiple of the trend rate of change. The implications of this for ACP commodity exports to the EU in recent years is illustrated in Table 2.4.

For example, in the case of cocoa beans, the ACP increased the *volume* of exports to the EU by 7.7% pa over the period 1988-94 (as a result, in part of the implementation of structural adjustment programmes in Ghana and Côte d'Ivoire) and the EU import share from 78% to 86%, but

Table 2.3 Trends in Commodity Prices 1984-94

	% Variation ¹	Annual Average Rate of Change, %		% EU Non-oil Imports from ACP
		current \$	constant \$2	
Coffee	24.7	-6.7	-10.4	6.8
Cocoa	12.6	-7.8	-11.5	7.9
Tea	16.3	-2.6	-6.3	1.5
Pepper	39.8	-9.1	-12.8	0.04
Palm oil	24.5	-1.6	-5.4	0.7
Coconut oil	30.1	-2.5	-6.2	0.3
Palm kernel oil	29.4	-1.6	-5.3	
Groundnuts	7.4	-3.1	-6.8	0.04
Groundnut oil	23.8	1.0	-2.7	0.6
Copra	28.9	-2.1	-5.8	0.1
Rubber	12.9	0.8	-2.9	1.0
Cotton	14.6	0.8	-3.4	2.1
Tobacco	5.9	0.7	-3.0	2.4
Tropical sawnwood	12.4	9.9	6.2	2.7
Tropical logs	9.5	6.6	2.9	4.4
Plywood	14.2	9.4	5.7	0.9
Sisal	7.8	0.5	-3.2	0.07
Hides & skins	19.2	-1.7	-5.4	0.6
Copper	19.4	5.3	1.6	4.7
Aluminium	23.5	0.0	-3.7	2.4
Iron ore	5.0	3.0	-0.7	1.6
Manganese ores	28.1	9.9	6.1	0.7
				41.6

Sources: Commodity Yearbook 1995, UNCTAD Eurostat, 1995.

Notes: 1 % deviation from exponential trend value

2 Current \$ divided by index of export unit value of manufactured goods exported by developed market economies.

the falling \$ world prices of cocoa beans (-45% 1988-92 before rising by 130% 1992-94) meant that the *ecu value* of export receipts increased by only 0.2% pa. Similarly, whilst the *volume* of coffee exports declined by an average of -3.3% pa, export *receipts* (in ecu) fell by -9.7% pa and in the case of cotton, a decline in *volume* of -6.5% pa translated into a -10.1% pa in *value*. Only in the case of tropical hardwoods do we observe a rise in ecu unit values sufficient to offset the rise in the price of imported manufactured goods. Also, it is only in the case of sawn hardwoods that variations in export volume (i.e. export supply) are greater than those for export earnings, in all other cases the variation in export values is greater than volume, suggesting

that in recent years, instability in export earnings in these products has been more a price (measured in ecu, which, given that 55% of Sub-Saharan Africa's imports come from Europe, is probably the most appropriate numéraire) problem than supply-side problem.

A declining share of world commodity markets

Taking a longer run perspective, the declining share of ACP countries in world commodity trade is often taken as evidence of a failure to compete effectively in world markets.

This decline over the period 1975-93 has certainly been dramatic, as shown in Table 2.5, with a 54% fall for Sub-Saharan Africa and a 33% fall for the Pacific. This can be contrasted with a

Table 2.4 Exports of Traditional Products to the EU

	Value 1994 Ecu m	Volume 1988-94		Share in Extra-EU Imports	
		Av.Growth %	Variation in Growth	1988	1994
Cocoa beans	1028.4	7.7	1.8	78	86
Coffee	1105.8	-3.3	1.2	42	31
Tea	177.2	-3.3	0.8	60	
Palm oil	123.0	9.7	1.9	19	29
Palm kernel oil, etc.	49.2	0.7	2.5	11	11
Wood, rough (4403-34/35/99)	611.4	-5.8	2.3		61
Wood, sawn (4407-22/99)	441.6	3.8	1.7	n/a	43
Cotton, not corded	223.6	-6.5	1.2	24	19
Copper, refined	143.8	-22.6	5.5	23	5

Source: Computed from Eurostat (1995).

1 Av growth rate uses the formula $\log X = a + b(t)$

2 Variation in the growth rate is the standard error of the coefficient b and shows the typical % deviation around the estimated trend growth rate.

Table 2.5 Share in World Primary Commodity Trade (Excluding Fuels) by Value

	1975	1993	% Change in Share
Developing countries (excluding major petroleum and manufactures exporters)	31.5	29.2	-7.3
Asia	10.9	15.2	+39.4
Developing America	12.5	10.3	-17.6
Sub-Saharan Africa (excluding South Africa)	5.2	2.4	-53.8
Oceania	0.6	0.4	-33.3

Source: Computed from UNCTAD Commodity Y.B. 1995.

Table 2.6 Share of Sub-Saharan Africa in World Production of Major Commodities

	1975	1993	% Change in Share
Cocoa beans	64.3	53.4	-17.0
Coffee, green	29.5	16.1	-45.4
Tea	9.9	12.4	+25.3
Palm oil	40.4	13.1	-67.8
Palm kernels	52.0	17.0	-67.3
Cotton	4.0	5.5	+37.5
Non-coniferous wood	7.2	7.2	0.0

Source: Computed from UNCTAD Commodity Y.B. 1995.

Av.Growth %	Value 1988-94		Share in Extra-EU Imports		Main Exporters % Share in ACP (exporters)
	Variation in Growth	1988	1994		
0.2	2.0	80	87		Côte d'Ivoire (56%); Ghana *17%); Nigeria (11%)
-9.7	5.0	39	29		Côte d'Ivoire (16%); Uganda (13%); Kenya (13%); Cameroon (10%)
48	-2.7	1.2	54		45 Kenya (75%); Malawi (12%)
10.6	2.4	19	31		PNG (52%); Côte d'Ivoire (33%)
1.0	4.9	13	12		PNG; Côte d'Ivoire
-2.6	2.5		76		Cameroon; Gabon; Côte d'Ivoire, Congo
6.6	1.5	n/a	43		Côte d'Ivoire; Cameroon; Ghana
-10.1	2.3	24	18		Chad (15%); Mali (13%), Zimbabwe (11%)
-28.6	5.7	23	4		Zambia (47%); Zaire (46%)

much smaller decrease for Developing America and for the developing countries as a whole; while Asia has increased its share by 39%. The substantial increase in the share of Asia has been largely due to the rapid growth of primary commodity exports up to the second half of the 1980s by Turkey, China, Hong Kong, Taiwan, South Korea, Indonesia, Malaysia and Thailand, and there are, without doubt, important lessons to be learnt by the ACP countries from the success of the Asian countries. When, however, we compare in Table 2.6 the shares in the volume of world production of the main ACP commodities listed in Table 2.4, then a somewhat different picture emerges.

The largest decrease in the share of world production over the period 1975-93 was in palm oil, but this was despite a 41% increase in the volume of production. The declining share was produced by the exceptional increases in production by Indonesia (762%) and Malaysia (488%). Similarly, the decreased share in cocoa beans was due to very large increases in production by Indonesia (4 m.t. to 239 m.t.) and

Malaysia (13 m.t. to 2126 m.t.) which far outweighed the 32% increase in production by Sub-Saharan Africa (which itself comprised large increases in production by Côte d'Ivoire and substantial decreases in production by Ghana and Nigeria). The 63% increase in world production from 1.56 billion metric tonnes in 1975 to a peak production of 2.54 billion metric tonnes in 1989 produced the sharp decline and instability in world prices previously noted. The decline in production and exports by Ghana and Nigeria were probably due to inappropriate economic policies, but falling prices and instability also serve as an illustration of the 'fallacy of composition' (Cline 1985). This states that what may be a sensible strategy for one country, when considered in isolation, may not be sensible for all developing countries simultaneously. The sharp decline in the ACP countries' share of particular world commodity markets certainly deserves detailed study, but it would be wrong to ascribe this exclusively to a 'failure of policy', nor does this necessarily lead to the conclusion that the ACP should seek to re-establish their share of

world commodity markets where world production has exceeded world demand and which are characterised by declining and unstable prices.

ACP exports and trade preferences

The previous sections have emphasised the significance of country and commodity concentration in ACP exports. A third factor affecting an analysis of the trade effects of the Convention is that if Lomé preferences are to have a trade stimulating effect, then there must be a significant margin of preference in the form of exemption from tariffs, import quotas, minimum import prices and other barriers to trade relative to competing countries. Most ACP exports are composed of primary products, and the EU Commission has calculated that 63% of their exports would have entered the EU duty-free under MFN or GSP treatment in 1993 (since the EU's final offer bringing the tariff rate on cocoa beans down from 3% to zero was implemented in 1995, we can infer that this proportion has increased to over 70%), while a large proportion of the remaining products have been subject to tariff preferences of a trivial level of 5% or less. As a result, Lomé preferences could not have had any quantifiable trade stimulating effect on most ACP exports.

The combination of the dependence of ACP exports on commodities with little or no margin of preference and on the performance of a few countries leads to the conclusion that a discussion about the declining share of the ACP countries in EU imports *despite* Lomé preferences, while perhaps being useful in highlighting the plight of the ACP, fundamentally suffers from the error of misplaced aggregation. The appropriate counterfactual is 'what would the performance of the ACP have been without the Lomé Convention?' One view (McQueen and Stevens, 1989) is that, given the internal situation in many countries and external world market difficulties faced by the ACP countries, it is difficult to imagine that the situation would have been better in the absence of the Convention. Furthermore, while preferences can

never be a sufficient condition for export growth and diversification, they may be of significant help to small, infant economies. The alternative view is that the elimination of trade preferences would break a certain psychological dependency on the EU market and make them more aggressive in searching for new markets (Davenport, 1992). It is also argued that preferences create a 'false' comparative advantage for recipient countries which leads to a misallocation of resources and lower growth. These issues concerning export growth and diversification by market and product are clearly of importance to a new ACP-EU agreement and are therefore considered in some detail.

2.3 Export Diversification

Why is export diversification so important?

The objectives of export diversification are to reduce dependence on a few primary products subject to fluctuations in export volume and falling and unstable prices. Diversification is seen as increasing both the growth and stability of export earnings, reducing the risk and uncertainty of investment in the economy in general, and thus accelerating growth. A related form of export diversification is geographical diversification, based on the assumption that cyclical fluctuations in demand in different countries are not closely correlated and so diversification will increase the stability of export earnings. Also, in the long run, markets will grow at different rates as economies develop different structural characteristics and unless exporters respond to shifts in market conditions, export opportunities will be lost and earnings stagnate or decline.

Geographical distribution of ACP exports

A striking characteristic of African ACP exports is a much higher degree of dependence (58% total exports) on a single market, the EU, compared to either developing countries as a whole, or to any other regional grouping of developing countries and developed countries (e.g. Latin America and South and South East Asia depend

Table 2.7 Exports by Destination

Destination	EU			USA			Japan			Developing Countries		
	%	Growth		%	Growth		%	Growth		%	Growth	
Commodity Group	1970	1992	1970-92	1970	1992	1970-92	1970	1992	1970-92	1970	1992	1970-92
Developing Africa												
Food	54.1	57.1	4.9	14.5	5.1	-0.2	2.3	6.2	9.4	11.8	19.2	7.0
Agric. Raw Materials	39.6	55.8	5.9	4.9	3.3	2.4	5.3	4.9	3.9	14.9	22.7	6.3
Ores & Metals	63.5	54.6	2.1	1.5	7.4	10.6	13.4	13.2	2.7	4.4	14.6	8.6
Manufactures	35.7	59.3	15.1	2.7	5.6	16.2	0.7	0.6	11.8	44.4	26.7	9.9
Developing Countries												
Food	36.7	28.7	7.4	23.3	15.7	6.7	5.5	12.9	12.9	15.3	29.6	11.9
Agric. Raw Materials	29.6	24.4	5.8	7.6	10.3	8.2	17.6	15.9	6.3	22.0	36.3	9.2
Ores & Metals	42.5	28.0	4.8	17.2	10.3	4.3	18.9	20.3	7.1	6.7	26.6	13.7
Manufactures	19.1	19.9	19.4	27.0	25.2	18.8	4.5	6.8	21.5	32.5	37.6	19.1

Source: UNCTAD Handbook of International Trade and Development Statistics, 1994.

on the USA for 23% to 25% of their exports). Such a high degree of dependence on the EU market may increase the instability of export earnings since variations in the growth of the EU market will be transmitted as fluctuations in the derived demand for African goods.

A further difficulty is that EU imports from the developing countries of food, agricultural products, ores and metals have, in a number of important respects, been growing less rapidly than imports by other developed countries or intra-developing country trade. These two characteristics of market dependence and growth are explored in more detail in Table 2.7 for non-oil exports and from which the following conclusions can be drawn:

- 1 Africa's dependence on the EU market for exports of food, agricultural raw materials and manufactured goods has increased to between 56% to 60% over the last two decades, while the dependence of developing countries as a whole on the EU has declined to around 20% to 29%.
- 2 The growth of Africa's exports of foodstuffs to the EU has been lower than that to Japan and to the developing countries.
- 3 The growth of Africa's exports of agricultural raw materials to the EU has

been lower than that to the developing countries.

- 4 The growth of Africa's exports of ores and metals to the EU has been lower than that to the USA, Japan and the developing countries.
- 5 The growth of Africa's exports of manufactured goods to the EU has been lower than to the USA.
- 6 The growth of the developing countries' exports of food, ores and metals, to the EU has been significantly lower than that to Japan and intra-developing country trade.
- 7 The growth of the developing countries exports of agricultural raw materials to the EU has been substantially lower than that to the USA and intra-developing country trade.

These observations suggest that Africa's concentration on the EU market may have led to it losing out on the globalisation of markets and contributed to the lower growth performance of its exports. Diversification of existing exports to more rapidly growing markets combined with a long run strategy of a much greater diversification into processed and manufactured goods is clearly essential if the ACP countries are to break out of

Table 2.8 Geographical Distribution of ACP Exports

	Developed Market Economies		EU		Developing Countries	
	1975	1992/3	1975	1992/3	1975	1992/3
Africa (Developing)						
Angola	95.8	92.5	16.4	24.9	4.2	7.1
Benin	66.2	80.0	53.3	55.6	18.0	17.8
Burkina Faso	40.5	60.9	38.4	34.5	58.9	39.1
Burundi	95.9	78.6	44.3	64.6	3.2	21.4
Cameroon	74.1	77.3	68.1	61.0	14.8	20.9
C.African Rep	89.2	92.4	67.4	87.3	8.7	7.6
Chad	70.9	51.7	70.9	42.9	28.7	47.5
Congo	86.4	97.5	66.9	51.5	12.6	2.3
Côte d'Ivoire	76.0	65.2	62.9	56.6	18.3	26.9
Ethiopia	57.8	74.9	24.3	47.9	38.7	24.5
Gabon	81.5	88.0	60.6	48.7	16.2	8.8
The Gambia	97.3	85.5	97.1	56.5	2.7	11.6
Ghana	71.9	87.2	45.9	61.7	9.6	9.0
Guinea-Bissau	80.6	38.2	80.6	17.7	19.4	58.0
Kenya	54.3	62.5	37.0	52.0	26.1	35.1
Liberia	95.0	79.9	67.7	66.8	2.6	18.5
Madagascar	56.9	76.5	40.8	49.4	41.4	17.0
Malawi	82.7	76.1	64.1	27.3	17.1	21.5
Mali	26.6	39.1	22.7	34.1	50.7	34.4
Mauritania	97.6	83.0	84.0	58.2	2.1	6.2
Mauritius	97.7	92.5	86.8	71.3	2.2	7.5
Niger	70.1	63.7	66.7	53.1	29.9	35.8
Nigeria	82.4	89.4	46.5	36.6	15.4	10.0
Rwanda	70.2	79.4	29.0	52.9	13.1	13.2
Senegal	70.7	56.0	67.1	53.8	22.1	35.0
Sierra Leone	89.6	80.5	73.9	46.3	0.7	7.4
Somalia	8.4	54.5	8.2	52.3	83.2	45.5
Sudan	52.5	38.4	44.2	29.9	31.4	47.3
Togo	92.3	55.2	89.7	38.7	6.2	36.0
Uganda	78.9	89.5	39.7	74.1	14.3	9.1
Tanzania	53.4	69.1	38.7	58.1	37.9	29.1
Zaire	63.9	84.6	52.8	58.7	5.6	10.9
Zambia	86.9	83.0	64.1	39.0	10.5	16.4
Caribbean						
The Bahamas	96.5	97.3	8.7	7.1	3.5	2.7
Barbados	79.1	53.0	35.5	22.5	20.1	48.0
Belize	81.7	78.1	34.8	33.3	17.6	21.9
Dominica	75.7	67.3	73.9	62.5	18.9	32.7
Dominican Republic	96.4	87.0	16.3	21.4	3.3	12.9
Grenada	86.1	63.1	79.6	44.8	13.6	36.9
Haiti	97.7	94.2	20.8	12.4	2.3	5.8
Jamaica	81.8	86.9	26.5	23.4	13.8	12.7
Surinam	94.8	78.5	35.1	38.8	5.2	16.4

Table 2.8 Geographical Distribution of ACP Exports (continued)

	Developed Market Economies		EU		Developing Countries	
	1975	1992/3	1975	1992/3	1975	1992/3
Trinidad & Tobago	77.5	55.9	7.9	4.8	17.7	39.2
Pacific						
Fiji	88.6	73.9	74.4	25.3	11.4	19.8
Papua New Guinea	96.7	82.8	43.5	15.8	0.9	16.5
Solomon Islands	89.7	78.7	40.4	25.7	7.7	21.3
Tonga	94.8	92.2	70.7		3.4	7.8
West Samoa	94.3	75.9	54.3	13.8	5.7	24.1

Note: 1 1970

Source: UNCTAD Handbook of International Trade Statistics (various years).

their present vicious circle of a low growth of exports producing a low growth of output, and the low growth of productive capacity limiting the ability to increase exports.

On the other hand, it is important to recognise the diversity of experience among the ACP countries. Of the 33 African ACP countries listed in Table 2.8, nineteen depend on the EU market for more than 50% of their total exports, but only ten of these countries increased their dependence on the EU over the period 1970-92/3. Of the remaining fourteen African ACP countries where the EU accounts for less than half their exports, only four countries (Angola, Ethiopia, Mali, Madagascar) increased the share of exports to the EU. Similarly, more than half (18) of the African ACP countries have increased the share of exports to other developing countries. In the case of the Caribbean countries, only Dominica, Grenada and Surinam have historically been substantially dependent on the EU market and, with the exception of the Dominican Republic (which recorded a small increased share of exports to the EU), this dependence has fallen. Conversely, most of the Caribbean countries have increased the share of exports to other developing countries, in some cases (Barbados, Belize, Dominica, Grenada, Trinidad and Tobago) to quite substantial levels. The Pacific countries rely on the EU for around a quarter or less of their exports but the major change is a sharply decreased dependence on the

EU and an increased share accounted for by other developed market economies and other developing countries.

Thus a picture of ACP-EU trade relations being one of an unaltered and high dependence by the ACP on the EU, would be an oversimplification of what is a more complex reality of considerable variation in dependence both between ACP countries and over time, and lead us to reject the hypothesis that Lomé has had a systematic tendency to maintain a high degree of dependence on the EU market. Nevertheless, while the EU market will continue to be of importance to many ACP countries, it is also clear that many ACP countries could increase the growth of their exports by increasingly looking to non-EU markets *and it is essential that a new ACP-EU Agreement helps to develop ACP exports to world markets and not just to the EU.*

Export diversification by product

Diversification may be *horizontal* into new products within the same broad sector of production (e.g. new agricultural products), *vertical* into the processing of domestically produced raw materials, and *diagonal* into the processing or manufacturing of imported inputs.

Table 2.9(a) examines changes in the overall structure of ACP exports over the period 1970-93. Contrary to the perception that there has been no structural change in ACP merchandise exports, this data shows that even when we

Table 2.9(a) **Structure of Merchandise Exports**

(% merchandise exports)	Fuels, minerals, metals		Other primary commodities		Machinery & transport equipment		Other manufactures	
	1970	1993	1970	1993	1970	1993	1970	1993
Mozambique	10	14	80	66	5	3	5	18
Ethiopia	2	1	97	95	0	0	2	4
Sierra Leone	21	45	17	28	0	0	61	27
Burundi	4	0	95	70	0	3	1	27
Uganda	9	0	91	99	0	1	0	0
Malawi	1	0	96	94	0	0	3	6
Madagascar	9	8	84	73	2	2	5	18
Nigeria	62	94	36	4	0	0	1	2
Togo	25	52	69	42	2	1	4	5
The Gambia		0		63		0		37
Ghana	13	25	86	52	0	0	1	23
Mauritania	88	52	11	47	0	0	1	1
Zimbabwe		16		48		3		33
Côte d'Ivoire	2	15	92	68	1	2	5	15
Senegal	12	25	69	54	4	2	15	19
Cameroon	10	51	82	35	3	8	6	6
Papua New Guinea	1	52	94	37	0	10	6	2
Dominican Republic	8	6	88	41	0	2	5	50
Jamaica	31	12	23	22	0	0	46	65
Mauritius	0	2	98	32	0	2	2	65
Trinidad & Tobago	78	58	9	8	1	3	12	32
Gabon	56	85	35	12	1	0	8	3
mean ¹			83.0	59.8			7.1	24.2
s.d			19.7	23.0			11.8	21.0

Source: Adapted from *World Development Report, 1995*.

Note: 1 Excluding Sierra Leone, Nigeria, Mauritania, Cameroon, Trinidad and Tobago, Gabon

exclude the main exports of fuel and minerals (where large shifts in the price and volume would exaggerate the change in the share of 'other primary products'), the dependence of the remaining 16 ACP countries on exports of primary products, excluding fuels, ore and metals, has declined from an average share of 83% to 60% of total exports, while the share of manufactures has increased from 7% to 24%.

Table 2.9(b) provides a comparison for 1980-92 with similar results, in particular a doubling of the share of manufactures as a result of diversification by Benin, Central African Republic, Barbados and Fiji.

Care must be taken in interpreting these statistics. First, the instability around a falling trend

in most commodity prices may affect a comparison of the share of primary products in total exports, with falling prices exaggerating the 'true' degree of export diversification. Second, there is a large degree of variation around the average share and this is particularly true of 'other manufactures' where the standard deviation has almost doubled and is almost as large as the mean value. Nevertheless the shifts, particularly in the share of manufactures, are such as to demonstrate that an increasing number of ACP countries have been able to engage in vertical and diagonal diversification.

Table 2.10 presents this information in a slightly different way for 1970-1992 and shows exports of manufactures as a proportion of non-oil

Table 2.9(b) **Structure of Merchandise Exports**

(% merchandise exports)	Fuels, ores, metals		Other primary commodities		Manufactured goods		GNP per/c \$ US	Pop 1993
	1980	1992	1980	1992	1980	1992		
Benin	5.3	7.3	86.8	70.8	3.4	21.9	420	5.2
C. African Republic	0.0	0.2	71.0	40.5	25.2	35.8	390	6.0
Guinea-Bissau	0.3	0.0	87.1	92.9	8.2	2.9	220	1.0
Guyana	38.0	20.4	49.8	52.5	11.0	7.4	350	0.8
Togo	66.2	26.3	23.2	37.9	10.6	7.9	330	4.0
Barbados	52.7	0.1	47.1	32.3	7.1	50.7	6240	0.3
Belize	0.0	0.0	82.0	78.4	17.6	14.9	2440	0.2
Fiji	0.1	0.2	92.8	61.8	1.4	37.5	2140	0.8
Solomon Islands	0.0	0.0	98.7	92.7	6.0	2.4	750	0.4
Tonga	0.0	0.5	96.5	69.0	3.5	7.5	1610	0.1
mean			73.5	62.9	9.4	18.9		
s.d			25.3	21.9	7.3	16.9		

Source: *Small States: Economic Review and Basic Statistics, Commonwealth Secretariat, 1995*

exports for 39 ACP countries. Of these, 22 countries recorded an increased share of more than 5% and in almost all of these cases, manufactures accounted for over 20% of non-oil exports.

A more complete picture of export diversification is revealed by changes in the overall export concentration index. Table 2.11 provides details of the Hirschmann concentration index for 1970, 1980 and 1992 calculated for the 239 three-digit SITC Revision 2 classification of products. As before, the statistics have to be interpreted with care to avoid a 'false' decrease in export concentration simply because of falling world prices of commodities and/or a temporary decrease in export volume. In addition, while the three-digit level of classification is generally used to distinguish between different products, in the case of some products, differences in three digit headings occur for closely related products. In this case it may be questioned whether this is 'true' export diversification in the sense of a wider portfolio of products leading to greater stability in export earnings. For example, Mauritius records a two-thirds fall in the level of concentration of exports. However, almost all of these new exports are clothing, where differences between three-digit classification are finely drawn (for example,

SITC 841 and 842 cover, respectively, male and female garments not knitted or crocheted, whereas 843 and 844 cover knitted and crocheted garments, while 845 covers knitted or crocheted garments for either men or women). Thus, while Mauritius has been the most successful ACP country in engaging in diagonal diversification out of a dependence on in this case sugar, the degree of diversification is somewhat exaggerated by the change in the concentration index.

Analysis of changes in the concentration index and the number of products exported over the period 1970-94 produces a rather less optimistic picture to that previously outlined on the basis of shares of particular groups of products. Countries such as Colombia, El Salvador, Sri Lanka, Guatemala, Tunisia, Uruguay and Morocco all have concentration ratios less than that of Tanzania (with the lowest ratio of the ACP countries of 0.248) and considerably less than the median value for the ACP countries listed in Table 2.11 of 0.491. Also, of these 42 ACP countries, only 17 countries have recorded a decrease of 20% or more in the concentration ratio over the period 1970-94 or 1980-94. This is partly due to the increased

Table 2.10 Proportion of Manufactures in Non-Oil Exports

(Rank by Concentration Index 1994)	% of Manufactures in Non-oil Exports	
	1970	1992 ¹
Nigeria	1.7	28.6
Angola	24.9	82.9
Zambia	0.2	9.0
Kiribati	0.1	0.1
Gabon	15.7	12.4
Seychelles	1.8	0.8
Malawi	0.2	
Burundi	0.8	10.0
Congo	29.3	40.0
Burkina Faso	4.4	6.4
Mauritania	0.8	0.2
Sierra Leone	61.0	30.0
Tonga	1.3	12.9
Uganda	0.4	0.7
Djibouti		
Ethiopia	1.6	20.1
St Lucia	6.5	26.8
Rwanda		2.9
Solomon Islands		
Guyana	3.2	25.6
Togo	5.7	7.7
Cameroon	8.5	25.8
Vanuatu	1.5	13.3
Ghana	0.5	15.1
Papua New Guinea	9.0	16.7
Belize	7.2	20.6
Dominica	11.2	29.0
Trinidad & Tobago	56.1	80.9
Fiji	2.1	38.8
Jamaica	47.6	22.0
Dominican Republic	3.6	48.0
Sudan	0.1	0.4
Zaire	6.8	16.2
Cote d'Ivoire	6.0	18.8
Mauritius	1.8	70.0
Zimbabwe	37.9	38.1
Kenya	14.2	19.7
Granada		22.4
Madagascar	7.5	19.2
Haiti	23.7	84.3
Senegal	19.4	25.0
Tanzania	13.6	18.5

Source: UNCTAD Handbook of Trade and Development Statistics – various years.
Note: 1 Latest year available.

importance of oil and minerals increasing the ratio for eight ACP states (Nigeria, Angola, Gabon, Burkina-Faso, Sierra Leone, Cameroon, Papua New Guinea) and the increased importance of tobacco exports in the case of Malawi. However, it is also noticeable that only in the case of Papua New Guinea has the *number* of products exported increased; in all other cases the number of products exported has been more or less constant, or decreased (Nigeria, Angola, Malawi, Burkina Faso, Cameroon). Further research would be required to identify the causes of this, but from a theoretical perspective we could expect this to result, for example, from 'Dutch Disease' effects and a progressive devalued increase in the CFA franc, causing an appreciation of the real exchange rate and a consequent decline in the competitiveness of tradable products. Of the 17 countries recording a decrease in export concentration, only 10 countries recorded a significant decrease in the ratio over the period 1980-94 (Congo, Uganda, Vanuatu, Ghana, Dominica, Trinidad and Tobago, Fiji, Jamaica, Mauritius and Grenada). It is also worth noting that 11 of the 17 countries are very small economies with populations of less than 3 million and it might be argued that it is easier for these economies to record a decrease in the concentration ratio because it involves a comparatively small absolute increase in the export of 'new' products.

The conclusions we can draw from this analysis of export diversification by the ACP states over the period 1970-94 is that, contrary to the image of no structural change and unchanged dependence on traditional primary products, a substantial number of countries have diversified their exports. However, only 8 of the 47 ACP countries (for which there is adequate data) have experienced a sufficient degree of export diversification as to record a concentration ratio in 1994 which was at least 20% less than in 1970 and to have sustained that decrease over the more recent period of 1980-94. A wealth of empirical evidence strongly suggests that 'for successfully developing economies, export

Table 2.11 Concentration of ACP Exports 1970-94

Countries (by Rank Order of Concentration Index)	Number of Products			Concentration Index		
	1970	1980	1994	1970	1980	1992
Nigeria	34	147	130	0.583	0.948	0.934
Angola	75	22	28	0.365	0.732	0.912
Zambia	22	49	73	0.952	0.717	0.787
Kiribati	2	15	5	0.859	0.507	0.767
Gabon	21	46	45	0.500	0.763	0.743
Seychelles	7	11	8	0.619	0.571	0.721
Malawi	23	47	35	0.473	0.490	0.704
Burundi	11	26	9	0.826	0.594	0.667
Congo	18	29	26	0.486	0.890	0.636
Burkina Faso	14	43	30	0.441	0.476	0.623
Mauritania	14	24	26	0.864	0.661	0.605
Sierra Leone	20	39	22	0.543	0.441	0.586
Tonga	9	12	9	0.626	0.411	0.564
Uganda	28	22	25	0.596	0.950	0.561
Djibouti			24			0.560
Ethiopia	29	30	19	0.603	0.636	0.557
St Lucia	12	28	32	0.628	0.423	0.556
Rwanda	7	13	14	0.639	0.668	0.505
Solomon Islands	8	17	19	0.628	0.484	0.496
Guyana	22	38	31	0.582	0.545	0.495
Togo	16	51	49	0.482	0.468	0.491
Cameroon	61	90	53	0.371	0.409	0.485
Vanuatu		11	9		0.668	0.469
Ghana	24	55	65	0.752	0.729	0.465
Papua New Guinea	24	60	74	0.379	0.485	0.465
Belize	14	76	19	0.524	0.421	0.446
Dominica	12	9	37	0.729	0.675	0.445
Trinidad & Tobago	87	119	124	0.678	0.636	0.422
Fiji	30	44	66	0.696	0.801	0.413
Jamaica	59	93	114	0.460	0.769	0.406
Dominican Republic	36	94	37	0.519	0.345	0.383
Sudan	19	63	59	0.639	0.388	0.373
Zaire	34	62	34	0.656	0.450	0.371
Côte d'Ivoire	81	154	130	0.422	0.383	0.368
Mauritius	9	55	128	0.930	0.688	0.332
Zimbabwe	78	87	172	0.324	0.257	0.329
Kenya	76	143	124	0.336	0.383	0.305
Granada	4	22	25	0.610	0.399	0.294
Madagascar	64	53	69	0.321	0.501	0.285
Haiti	32	68	44	0.386	0.215	0.266
Senegal	82	113	80	0.311	0.271	0.258
Tanzania	49	83	70	0.225	0.286	0.248

Source: UNCTAD Handbook of International Trade and Development Statistics – various years.

concentration ratios decline over time' (Colman and Nixon, 1994, p. 145) and the central challenge facing a future Convention is to help to create the conditions in which the ACP countries can be integrated more fully into the international economy and to nurture and develop the nascent export industries which have developed in recent years.

2.4 Export Diversification to the EU

Diversification 1975-88

It has been emphasised that an analysis of the extent to which the ACP countries have utilised preferences available under the Lomé Convention cannot be based on total exports but on a much more closely defined group of products in which Lomé provides a competitive advantage to the ACP through exemptions from EU tariff and non-tariff barriers to trade. The theory of preferences would then predict that, other things being equal, this should lead to the export of 'new' products (as well as increased exports of existing products for which preferences were available) to the EU. This form of analysis was first carried out by Stevens and Weston (1984) for the period 1975-80 and subsequently by McQueen and Stevens (1989) for the period 1976-87. The latter study initially reviewed 179 items at the 4 and 6 digit Nimex level of classification with a total value of Ecu 956 million in 1987. From this the study focused on 70 items grouped under 8 product categories – canned tuna, leather and leather products, wood products, yarns and fabric, clothing, processed tropical products, fresh flowers, vegetables. Altogether, 28 ACP countries recorded some new exports over the period 1976-87 and although many exported only a small number of products, one-third exported six or more new products and five countries exported more than 15 products. Furthermore, the range of ACP countries exporting these products included both more developed countries, such as Kenya, Zimbabwe, Côte d'Ivoire, Mauritius and Cameroon, and poorer countries at lower levels

of economic development such as Ethiopia, Sudan and Ghana. It was also noted that although the total value of the 179 products represented only 7.9% of total ACP non-oil exports to the EC, this was equivalent to almost three times the level of EDF 6 disbursements in 1987 and 26% greater than the combined disbursements from EDF 5 and 6, emphasising that the trade regime of Lomé is infinitely more important as a source of foreign exchange than the aid provisions. McQueen and Stevens emphasised that these were often nascent exports, but drew the tentative conclusion that, in contrast to the pessimistic conclusions of most other studies, these results indicated a basis for future diversification.

Diversification 1988-94

Table 2.12 provides a summary of exports to the EU from 1988-94 for the products covered by the 1989 study. The total value of these products in 1994 was ecu 1,856 million or 13.5% of ACP non-oil exports to the EU, representing a substantial increase in value and a significant increase in the processing of primary products and diversification into 'new' products. The number of countries has also increased, for example, 34 ACP countries exported more than ecu 100,000 of clothing to the EU (see Davenport, Hewitt and Koning, 1995, Table A4). Fisheries are now the most important group of products, with clothing second in importance, and these two groups together account for 60% of the products listed in Table 2.12. The highest growth rates have been recorded for fishery products (with the exception of shrimps and prawns, and frozen yellowfin tuna), clothing, cotton yarn, fruit and vegetable products (excluding pineapples) and parquet flooring. It is interesting to note that processed traditional primary products, however, have generally not performed well, with low or negative growth rates for cocoa butter, cocoa paste, coffee extracts, veneers and plywood, laminated wood and woven fabrics of cotton. This serves to emphasise that although domestic value added can be significantly increased by vertical integration into processing

and manufacturing (for example, the implicit unit price in 1994 for cocoa beans was ecu 1.15 per kg, while the price of cocoa butter was ecu 2.51 per kg; coffee beans were ecu 1.86 per kg, while the price of coffee concentrates, extracts etc. were ecu 6.60 per kg), it may simply produce a once-and-for-all gain and not necessarily increase either the long term growth or stability of export earnings. For example, the growth in the ecu unit price over the period 1988-94 of cocoa beans was -7.5% p.a. and of cocoa butter was -4.4% p.a.; for coffee beans it was -6.4% p.a. and for coffee concentrates, etc., was 17.2% p.a. The coefficients of variation (which may be regarded as a measure of instability) in both volume and value were similar (around 2.0) for cocoa beans and cocoa butter, but was substantially *higher* for coffee concentrates, etc. The latter may reflect production difficulties in the ACP countries rather than market instability, but this does not alter the fact that the costs and benefits of utilising resources in vertical integration must be carefully examined in exactly the same way as for any other investment project.

There should be no automatic assumption that because an ACP state exports a raw material, it is *necessarily* in its best interests to diversify into the processing and manufacturing of that raw material. Horizontal diversification may offer a better use of resources. For example, a recent report (UNCTAD, 1995) draws attention to the fact that non-traditional agricultural exports from Sub-Saharan Africa were now third in value behind coffee and cocoa, while Zimbabwe had increased its exports of non-traditional agricultural products from less than \$1 million in 1985 to more than \$50 million in 1994. Production of high value crops can also generate a substantial amount of employment, both in production (the UNCTAD study reports that a joint venture between Kenyan and French firms to export canned green beans generated employment for 20,000 poor farmers in West Kenya) and in packaging, transport and distribution, and in associated suppliers of goods and services.

Diversification is often on a fragile base and the margin of preferences is falling

The variation in the export experience of non-traditional products is reflected in the change in EU import share. Table 2.12 shows a substantial increase in share by the ACP countries for veneers, cut flowers, fresh and chilled fish, lobster, with a smaller increase for fresh fruit. In terms of the value of exports, however, this has been outweighed by declining shares for tuna, coffee concentrates, oil extracts, cocoa butter, fresh and chilled pineapples, and frozen shrimps and prawns. With the exception of tuna, these decreases have been associated with zero or negative growth rates and underline the fact that preferences by themselves do not guarantee the success of ACP exports and should be considered simply as one of a number of factors assisting export diversification. They also illustrate the vulnerability of new ACP exports and this, together with the often significant degree of variation in export volume, and dependence on one or two ACP countries for a large proportion of these products, *demonstrates the need for concentrated action to strengthen ACP export capacity and competitiveness.*

Equally, although preferences do not guarantee success in exporting to the EU, their presence can be important in offsetting the cost/competitive disadvantages of the ACP countries. This is most clearly illustrated in the case of the textiles and clothing (see the case study on Mauritius, below), where the ACP are exempt from the EU's quantitative restrictions of the Multi-Fibre Arrangement (MFA) limiting the exports of most non-ACP countries. These import quotas will be phased out in stages ending in 2005, and will mean a substantial loss of preference, since 67% of the ACP exports of textiles and clothing are in MFA covered products (see Davenport, Hewitt and Koning, 1995, Table A3). To some extent, this may be offset by increased access to other, protected, markets such as the US, but this will have to be achieved in competition with other highly competitive countries whose exports

Table 2.12 Exports of Processed and Non-Traditional Products to the EU

	Value 1994 Ecu m	VOLUME 1988-94		Share in Extra-EU Imports	
		Growth in % p.a. ¹	Variation in Growth ²	1988	1994
Coffee extracts, etc.	32.0	-1.7	9.5	18	19
Cocoa butter	96.3	2.5	2.2	59	43
Cocoa paste	34.6	-0.1	2.1	74	75
Fresh/chilled beans	50.4	5.2	1.0	51	56
Avocados	8.6				
Mangoes	14.0				
Citrus (oranges, grapefruit)	17.1				
Strawberries, raspberries etc.	26.7				
Fresh/dried pineapples	76.1	-2.0	1.5	84	62
Pineapples, prepared, preserved	44.0	3.4	2.0	18	19
Cut flowers	76.3	11.4	2.2	24	36
Tuna	252.5	9.1	1.0	48	45
Frozen yellowfin tuna	17.2	-26.0	9.0	45	18
Fresh/chilled fish	65.2	25.6	4.4	7	25
Frozen fish fillets	138.3	19.8	3.2	6	13
Frozen lobster	22.3	1.4	5.7	26	42
Frozen shrimps & prawns	182.5	0.5	3.4	22	11
Veneers & plywood	101.0	0.2	1.3	41	41
Parquet flooring	19.9	13.6	0.8	4	8
Laminated wood	22.5	-5.2	2.4	2	1
Cotton yarn	54.7	11.9	3.5	3	7
Woven fabrics of cotton	36.8	-2.9	1.3	7	6
Clothing	466.5	11.8	1.7	n/a	n/a

Source: Computed from Eurostat, 1995.

¹ Growth rate computed from the formula $\log x = a + bt$

² Variation in the growth rate is the standard error of the coefficient b and shows the typical % deviation around the estimated trend growth rate.

have been constrained by quotas. Also, there is no guarantee that the industrialised countries will not, at least to a limited extent, replace the protection of the MFA with con-

tingent protection measures. EU preferences on industrial products will then be limited to tariff preferences and although tariffs have been reduced to an average of 4% (a decrease of 38%

VALUE 1988-94		Share in Extra-EU Imports		Main Exporters (% ACP Exports)
Growth % p.a.	Variation in Growth	1988	1994	
-18.9	10.7	38	22	Côte d'Ivoire (98%)
-1.9	1.7	60	41	Côte d'Ivoire (58%), Ghana (25%), Nigeria (11%)
-4.4	1.3	75	78	Côte d'Ivoire (70%), Cameroon (21%)
8.3	1.1	74	68	Kenya (59%), Burkina Faso (13%), Senegal (11%)
7.4	1.4	6	9	Kenya (83%)
7.8	1.2	18	21	Côte d'Ivoire (34%), Mali (16%), Burkina Faso (13%)
-5.0	0.8	3	3	Swaziland (68%), Zimbabwe (19%), Mozambique (6%)
21.1	2.4	4	10	Madagascar (77%), Kenya (7%), Zimbabwe (6%)
-5.2	1.5	85	65	Côte d'Ivoire (84%)
1.7	2.4	22	22	Kenya (89%)
14.2	2.4	17	29	Zimbabwe (31%), Kenya (55%)
6.7	1.8	51	45	Côte d'Ivoire (46%), Senegal (21%)
-25.4	8.9	40	17	Seychelles (43%), Côte d'Ivoire (26%)
19.7	1.9	13	25	Senegal (68%), Namibia (14%)
20.0	1.7	11	12	Namibia, Mauritania, Somalia, Senegal, Kenya,
6.7	7.0	28	50	The Bahamas (86%)
0.4	2.2	22	14	Mozambique (22%), Madagascar (19%), Nigeria (16%), Senegal (15%)
2.3	1.5	47	28	Côte d'Ivoire, Congo, Cameroon, Ghana
12.6	1.4	8	8	Côte d'Ivoire (70%), Ghana (15%),
-4.2	2.6	2	2	Gabon (51%), Côte d'Ivoire (33%), Cameroon (12%)
11.6	3.6	2	6	Zimbabwe (32%), Zambia (26%), Nigeria (14%), Tanzania (13%)
-5.5	1.6	5	4	Côte d'Ivoire (31%), Madagascar (19%), Cameroon (17%)
9.5	1.6	n/a	(2.0)	Mauritius (76%), Zimbabwe (4%), Jamaica (7%), Madagascar (2%)

on pre-UR rates), tariffs on sensitive products such as footwear, clothing, leather goods and some simple manufactures have generally been decreased by much smaller proportions to a range of 17% for footwear (previously 20%), through 12% for textiles and clothing (previously 13% to 14%) to 9% for leather goods and cutlery.

The effective margin of preferences for the ACP countries, however, should be evaluated in terms of the EU's other preference schemes. In terms of the GSP, this will reduce tariffs on most sensitive products by 15% to 30% (for example, to 12% on footwear and 10% on textiles and clothing) and by 65% in the case

of cutlery (i.e. to 3%). Also, for the 9 non-ACP least developed countries and the 10 Latin American countries covered by the EU's enhanced GSP scheme, tariffs are, in most cases, zero. In addition, the EU has signed 26 free trade agreements since 1990 (Greenidge, 1996) which provide for duty-free entry for industrial products. In practice, therefore, the effective margin of preference on industrial products available to the ACP countries is at best less than 10% on a limited range of products and very low or 0% on a wide range of goods and 0% in relation to the 45 non-ACP countries with which the EU has preferential arrangements which go beyond the standard GSP.

Changes in the complex system of EU agricultural protection are discussed in detail in Chapter 7. As has been the case for sensitive industrial products, reductions in tariffs have been less than the average of 38% for all products and have typically been of the order of 20% or less (to between 8% to 14%). The exception, as far as all ACP exports are concerned, are flowers, where both peak rate and off-peak rate tariffs have been reduced by 50% (to between 8.5% to 12%). Also, agricultural and fisheries products are subject to only limited preferences in the GSP, both in terms of product coverage and are subject to only a 15% reduction in the MFN tariff rate. The exception (of relevance to Mauritius) is orchids, where the post UR rate of 8.5% (pre-UR rate of 17%) received a GSP reduction to 3%. The EU's enhanced GSP scheme for agricultural products is discussed in Chapter 7 and, while it is difficult to generalise, preferences are generally less generous than those under the Lomé Convention.

Objective assessments of the role of preferences, however, invariably lead to a qualified acceptance of their role in increasing exports. Where domestic production conditions encourage exports, then preferences can act as a useful *additional* incentive to sourcing imports from a preferences receiving country. But more important determinants of demand, as compared to the margin of preference, for both industrial goods and agricultural and fisheries products, are

non-price factors such as the quality of the product and the reliability of suppliers. Similarly, analysis shows only a small empirical positive relationship between the growth of ACP exports and the margin of preferences. A more important factor than the margin of preference is invariably the growth of the market. This equally implies that the erosion of ACP preferences should have only a limited adverse effect (though this may be significant for particular ACP countries) which could be more than offset by the growth of world trade, and that ACP negotiation resources for a new agreement should be much less concerned with trying to obtain new or increased preferences and much more concerned with radically improving export capacity.

2.5 Implications for a New Agreement

The ACP countries have recorded a declining share of world commodity markets and of EU imports from the non-oil developing countries and this has been interpreted as resulting from the failure of ACP trade policies. Closer examination of the trade statistics, however, reveals a large degree of variation between ACP countries and a more complex picture underlying broad aggregates of trade flows. Declining shares of world markets in traditional products such as cocoa beans, palm oil and palm kernels can largely be explained by very substantial increases in production by Malaysia and Indonesia. The excess of world production in relation to demand has led to large decreases in prices. Also, variations in ACP export earnings of primary products have been greater than variations in export volumes (with the exception of sawn hardwoods) indicating that price instability is a larger problem than variations in production. ACP countries must therefore decide whether increased production of primary products is in their long term best interests, or whether it would simply be 'investing in decline'. Conversely, downstream production into the processing of commodities, where unit values are twice to three times those of the raw material, could be of

substantial potential benefit to the ACP countries. However, although in some cases the price of processed products has been rising (in contrast to falling commodity prices), in a number of other cases, for example, cocoa butter, prices have been falling. Also, this study has found that export instability in both volume and value has been similar or higher for processed products as for the raw material. The causes of this require further research, but *in view of the limited extent of downstream production and the potential importance of processing, marketing, transport and distribution to many ACP countries, it would seem sensible to target this as a priority for a future agreement rather than simply, as in the present Lomé Convention, mentioning PMTD as an objective among many other objectives of the Convention.*

This report has examined the apparently high level of dependence of the Sub-Saharan African countries on the EU market and found that while this is true in general terms, a more detailed analysis of individual ACP countries shows substantial variation in the level and trend of export market dependence. Nevertheless, SSA exports to the EU have grown more slowly than exports to other markets for all categories of goods and the erosion of ACP preferences as a result of the Uruguay Round and the extension of EU special preferences to a wider range of countries can be expected, if anything, to increase this trend. This underlines the importance of the ACP countries diversifying their exports to non-EU markets. Trade liberalisation, by removing the bias against exports, should assist this process, but *it is important to ensure that financial and technical assistance from the EU to increase the export capacity of the ACP countries (the key elements of which are analysed in Chapters 4 and 5) is directed at global markets and not simply at the EU market.*

The large concentration of ACP exports in primary products has limited the value of preferences which ACP countries have been able to receive from the EU, and the anti-export bias of past trade policies of many ACP countries has retarded their ability to diversify into products where there has been a significant margin of pref-

erence. Nevertheless, it would be quite wrong to assume that no progress has been made. In 1987 just under 8% of ACP non-oil exports to the EU were in non-traditional products and by 1994 this had increased to nearly 14% of non-oil exports, while over the period 1970-93 the share of manufactures in total merchandise trade increased from 7% to 24% in a sample of 16 ACP countries, and from 9% to 19% over the period 1980-92 for a further sample of 10 ACP countries. Overall product concentration ratios in exports are still, however, substantially higher than for comparable developing countries. Also, only a few countries have seen a significant decline in their concentration ratios and only eight countries have increased the number of products exported over the last 25 years. The export diversification that has occurred is also on a fragile base, with one or two ACP countries accounting for a large proportion of ACP exports of any given non-traditional product and with substantial annual variations in export volumes. The erosion of ACP preferences, and particularly the phasing-out of the MFA (even if this does not entirely occur in 2005) will make progress in export diversification more difficult. On the other hand, ACP trade liberalisation should assist this process, and recent empirical evidence shows a modest positive relationship between trade liberalisation and economic recovery (including export performance) and that this relationship is stronger the greater the degree of implementation of the reforms (Kirkpatrick and Weiss, 1995). A recent study (Bach-Nuakoh, *et al*, 1996) of the limited revival of industrial and manufactured exports from Ghana also emphasises the negative effects of a limited degree of deregulation and uncertainty about policy direction, but it also emphasises a reluctance by the private sector to invest and modernise and ends by stating that 'firms concede that exporting would be one way to use spare capacity, but the majority also either find the domestic market sufficient or are simply not interested in exporting. This is not a dynamic picture' (*ibid*, p.90).

One explanation for this situation compared

to other developing countries could be differences in the cultural factors which create an entrepreneurial environment. The difficulty with this view is that similar sentiments were expressed about S. Korea in the 1950s! The alternative view is that governments have not only to create the necessary macroeconomic, physical infrastructure, educational and legal environment conducive to private sector initiative. They must also engage in joint public/private sector initiatives to build a comprehensive network of support for the private sector, and particularly for small and medium and micro-sized enterprises (SMEs) to enable them to absorb, adapt and modify new technologies and facilitate the flow of technical know-how both within the country and from abroad. Weaknesses in financial markets and in the provision of export promotion also appear to be a major problem in most ACP countries. *A central recommendation of this report is therefore that the trade, industrial, financial and regional co-operation provisions of a new agreement should be closely integrated to assist the development of a diversified export capacity of the ACP*

countries as a central objective of a new agreement. This co-ordinated strategy involving both the public and private sectors should seek to strengthen existing production where this is viable (and reduce the variability identified in this report); support vertical, horizontal and outward oriented industrialisation into simple manufactured goods; and help develop new markets within the EU, with countries with which the EU has a special trade relationship (such as the CEEC), with other industrialised countries, and with rapidly industrialising countries in Asia and Latin America. The instruments for achieving this will vary from one ACP country to another. Some of the more developed ACP countries will largely need technical support targeted at particular sectors, with financial resources coming from the local economy. Others will need long term financial and technical support both to build up the physical and human infrastructure of the economy as well as the capacity of particular sectors. Chapters 4 and 5 of the report provide a detailed analysis of how this could be implemented.

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Options for Trade Co-operation

Summary

The Commission Green Paper exaggerates both the difficulty of obtaining a renewed WTO waiver for the Lomé Convention after 2000 and the possibility of challenge from non-ACP countries. At the same time, the ACP states need to carefully consider whether or not it is in their interests to extend Lomé trade preferences on industrial products to a wider group of developing countries to enable the Convention to be more easily defended in the WTO. The advantages and disadvantages of a renewal of the Lomé Convention and the alternative of a Free Trade Agreement with the EU are considered. The analysis emphasises that an FTA is inferior to trade liberalisation bound in the WTO by the ACP countries unless the FTA enables the ACP states to go beyond WTO disciplines and obtain concessions from the EU not otherwise obtainable and sufficient to compensate for the costs associated with an FTA. Possible additional concessions are discussed and considered to be difficult to obtain in the light of the EU's 'Europe Agreements' and free trade agreements with the Mediterranean countries. The Green Paper proposal for regional free trade agreements is considered unworkable given the heterogeneity of existing regional groups. It would also weaken the negotiating position of the ACP group and, by creating a 'hub and spoke' system of trade, create barriers to trade between ACP countries. Reliance on the GSP and the enhanced GSP (for the least developed, Andean and Central American countries) would represent a significant loss of security of preferences and, especially in the case of the standard GSP, a reduction in the margin of preferences compared to the Lomé Convention. The conclusion is that the ACP should concentrate either on a renewal of the Lomé Convention, but

focused on a limited range of objectives and in particular on increasing the export capacity of the ACP states and with improved terms of access; or an 'umbrella' agreement which enabled ACP countries to select the appropriate form of trade agreement with the EU, combined with a focused and well integrated package of aid and technical assistance. Variations in trade arrangements within the umbrella agreement, however, should be kept to a minimum, otherwise additional barriers to trade will be created between ACP countries.

3.1 Introduction

There are basically five options available to the ACP countries in relation to trade with the EU:

- ❖ renew Lomé as a non-reciprocal agreement;
- ❖ negotiate free trade agreement(s) with the EU;
- ❖ limit trade co-operation to the GSP (because of incompatibility of Lomé with GATT rules) and have a separate agreement covering technical and financial co-operation;
- ❖ a combination of any or all of the previous options under an 'umbrella' Convention;
- ❖ trade liberalisation by ACP states and bound in the WTO (included because it affects the evaluation of the other options).

3.2 Renewal of the Lomé Convention

The challenge to the Lomé Convention

In order to discuss this question we have to set out the reasons why, after twenty-two years of operation, the future existence of the

Convention after the year 2000 is being questioned. The contention is that it is incompatible with the basic principles of the General Agreement on Tariffs and Trade (GATT) since it discriminates between developing countries (violating Article I, the principle of non-discrimination) and offers non-reciprocal preferences (violating Article XXIV, on free trade areas and customs unions).

First, it is important to remember the origins of Lomé. Before joining the EC, the UK offered Commonwealth preferences to its ex-colonies while the EC offered preferences to the ex-colonies of the six original member states in Sub-Saharan Africa under the Yaoundé Conventions I and II. The latter preferences were on a reciprocal basis with the EC. The accession of the UK in 1973 required a new agreement. The US had previously objected to reciprocal preferences being required by the EC because of their potential to exclude the US from important markets and this had resulted in the Casey-Soames¹ understanding. Under this, the US would not challenge EC trade agreements while the EC would not seek reverse preferences with the developing countries nor negotiate preferential trade agreements outside of the African Caribbean and Pacific group of countries and the Mediterranean countries.

In presenting the first Lomé Convention to the GATT², the EC claimed that Lomé I had not been made a reciprocal agreement because of the development needs of the ACP countries, and for this reason was compatible with the principles of Part IV of the GATT. Part IV of the GATT on Trade and Development was added in 1965 (just after the establishment of UNCTAD in 1964) and contains no legally binding obligations on members but sets out principles and objectives, commitments, and areas of joint action, in relation to trade and development. For example, Part IV Article 36.8 states that 'the

developed contracting parties do not expect reciprocity for commitment made by them in trade negotiations to reduce or remove tariffs and other barriers to the trade of less developed contracting parties'. The EC also argued that Lomé should be considered in the light of Article XXIV (on Free Trade Areas and Customs Unions) and Article XXXVI (the principles and objectives of Part IV) taken in conjunction.

Other members of the GATT working party set up to consider Lomé I and subsequent Conventions have questioned this view and pointed out that Part IV referred to special treatment for *all* developing countries. In addition, the working party on Lomé IV reported the view of several members that the Convention would only be GATT compatible if a waiver were obtained to Article I (principle of non-discrimination) under Article XXV, which states that:

'In exceptional circumstances not elsewhere provided for in this Agreement the Contracting Parties may waive an obligation imposed upon a contracting party by this Agreement; provided that any such decision shall be approved by a two-thirds (now three-quarters) majority of the votes cast and that such majority shall comprise more than half of the contracting parties'. The Contracting Parties may also by such vote (ii) prescribe such criteria as may be necessary for the application of this paragraph'
(Art.XXV.5).

Previous working parties had also failed to reach agreement on the Lomé Convention but this opinion was given additional impetus both by the objective of reinforcing the GATT as the basis for a rule based system of international trade and by the two disputes panels set up in 1993 to consider the banana issue (for further details, see Chapter 8). This arose because high cost ACP

1 The authors are grateful to Dickson Yeboah of the WTO for this information.

2 The authors are grateful to Edwini Kessie of the WTO for guidance on this section. Any errors are, of course, entirely the responsibility of the authors.

exporters of bananas (relative to Latin American producers) required and obtained preferential access to their traditional markets in the UK, France and Italy under a special Protocol of the Lomé Convention, and the application of Article 115 of the Treaty of Rome (permitting trade restrictions by individual EC member states) by these three member states. The completion of the single European market in 1992 meant that Article 115 could no longer be applied and it was therefore impossible to segment the EC market in this way. To implement the Protocol on bananas, the EU instituted Community-wide import restrictions procedures in July 1993, and this resulted in a request to the GATT in February 1993 by Colombia, Costa Rica, Nicaragua and Venezuela to establish a disputes panel to examine the EU import regime for bananas policy. The EU sought to justify the banana import regime on the basis of its obligations under the Lomé Convention, and so this inevitably led the panel to consider the broader issue of the compatibility of Lomé with the GATT, as well as specific issues concerning the import regime (which the disputes panels in 1993 and 1997 also considered incompatible with the GATT and GATS). The GATT panel found that the arrangement for bananas was not GATT consistent, firstly, *because Part IV was not intended to subtract from other GATT obligations (for example Article I), and secondly, the arrangement was not covered by Article XXIV, or Article XXIV in conjunction with Part IV.*

It should be remembered (see Chapter 1) that the findings of the WTO disputes panels now have much more authority than in the past. If member countries involved in the dispute cannot agree with the findings of the panel, the dispute goes to a final appeal body whose decisions are not open to challenge and whose report is automatically adopted unless the Disputes Settlements Body (DSB), which administers the agreement on disputes rules and procedures, decides by *consensus not to adopt* the Appellate Body Report. Since, in practice, this would

undermine the recent strengthening of the authority of the WTO and its disciplines, this is unlikely to occur and so the findings of the disputes procedures have very much greater weight than in the past.

In the light of these events and the change in attitudes in the WTO towards strengthening the GATT as the foundation for a rule-based system of international trade, the EU sought and obtained in December 1994 a waiver from Article I.1 under the provisions of Article XXV until 29th February, 2000.

Implications for the renewal of the Lomé Convention

These events form the basis for the view in the Commission's Green Paper which calls into question the future existence of Lomé. It can be argued, however, that this pessimistic view exaggerates and misinterprets the purpose and significance of the dispute in the WTO. The EU defence of Lomé was undermined in 1993 because one of the important advances of the Uruguay Round was to strengthen the General Agreement as a means of providing a rule-based system of international trade. The EU defence of Lomé on the basis of the combination of Article XXIV with Part IV was not credible. Article XXIV applies to customs unions and free trade areas and since Lomé was a non-reciprocal agreement, it clearly fails to qualify under this heading. Equally, Part IV applies to all developing countries and cannot be used in a discriminatory fashion. The Convention had to conform to GATT rules by obtaining a waiver under Article XXV.5 from the provisions of Article I in the same way in which the US obtained waivers for its preferential agreements with the Caribbean and the Andean countries and the Former Trust Territory of the Pacific Islands, and Canada obtained a waiver for its preferential agreement with the Caribbean countries. Equally, there would appear to be good reasons to expect the EU to obtain a further waiver for the Convention for the period 2000 to 2010 if it so wished. In this context it is worth

noting the history of the US Caribbean Basin Initiative.

The Caribbean Basin Initiative (CBI) originated in the Caribbean Basin Economic Recovery Act of 1984 and was implemented by the US under a waiver to Article 1 of the GATT on 15th February, 1985. The Act allows the US President to grant duty-free treatment for certain goods imported from particular countries and territories in the Caribbean Basin. The CBI was intended to be a temporary programme, set to expire in 1995, but due to the success of the programme, it was made permanent in 1990 and in November 1995 a further waiver was granted until December 2005. This waiver allows the US to continue to provide duty-free treatment for imports of a list of products from the Caribbean Basin countries without being required to extend the same duty-free treatment to similar products from any other WTO member. The waiver, among other conditions, provides for consultation to take place upon the request of a WTO member with respect to any difficulty or matter that may arise as a result of the implementation of the trade related provisions of the Caribbean Basin Economic Recovery Act (WTO Annual Report 1996).

The CBI demonstrates that the objections to the Lomé Convention were not against its discriminatory and non-reciprocal provisions, *per se*, but against the way in which the EU had tried to justify them in the WTO. Indeed, the recent disputes panel on bananas has accepted that the waiver for the Lomé Convention allows the EU to provide preferential treatment for the products originating in the ACP states as required by the relevant provisions of the Fourth Lomé Convention and their objections related to specific aspects of the import regime for bananas. In order to strengthen the rule bound systems of international trade, the EU had to conform to WTO disciplines in the same way as the US and Canada had to conform for their non-reciprocal preferences, namely, by obtaining a waiver from the provisions of Article I. Once this was obtained, the issue was settled.

Advantages of renewing Lomé

First, unlike the GSP, Lomé is a *contractual* relationship lasting for ten years under Lomé IV and based on the principle of a partnership. This is given effect by the institutional arrangements for the joint management of the Convention, the policy dialogue between the EU and the ACP states, and the mechanisms available to negotiate improvements and extensions to the Convention.

Second, the trade arrangements are, in total, superior to any of the other preferential agreements of the EU. All industrial products are allowed into the EU 'free of customs duties and measures having equivalent effect' (Article 168) and in practice (apart from a short-lived attempt by Britain and France to impose VERs on Mauritius in 1979) the ACP countries have not been subject to the use of, or threats of, non-tariff measures restricting imports of industrial goods. The trade provisions of the Convention, in conjunction with the Protocols, also provide the most generous concessions on CAP products. Rules of Origin are also superior in Lomé in that they allow cumulation of origin between all of the ACP states and provide for derogations from the rules of origin (though only under onerous conditions which mean that they are rarely used).

Third, the financial and technical provisions are the subject of greater negotiation and discussion both in their design and implementation than other aid programmes and include features such as STABEX and joint institutional arrangements such as the Centre for Development of Industry and the Trade Development Project, which are unique to the Convention.

Fourth, renewal of Lomé would preserve as much as possible of the 'acquis' obtained in successive negotiations of the Convention from Lomé 1 to Lomé IV, both in terms of its contractual relationships and in terms of the individual components of the twelve areas of cooperation in the convention.

Fifth, being non-reciprocal, the renewal of Lomé would leave the ACP free to pursue their

own trade and industrialisation strategy on a multilateral basis without any trade distortions or other adverse effects arising from granting preferences to the EU.

Sixth, renewal of Lomé would maintain the momentum for building the cohesion of the ACP as a group, contribute towards reducing tensions between the member countries, and enable them to most effectively negotiate with the EU and other developed countries, as well as within international bodies such as the WTO.

Disadvantages of renewing Lomé

First, the European Commission's Green Paper states that 'one of the shortcomings of this option is that being differentiated (i.e. not offered to all developing countries), it will continue to require a WTO waiver which needs to be reviewed every year. As a result, the security of the preferences, one of the main assets of the Lomé trade package, will be severely undermined' (p.40). This overstates the situation. Once a WTO waiver is granted, it lasts for the period agreed (in the case of the CBI this will last for the agreed 10 year period 1995 to 2005) and the annual reviews which are required as part of the waiver process are simply a reporting formality. The Green Paper may be confusing the formality of the annual reviews of a waiver with the one-off '*Extension of the Waiver*' which was obtained in October 1996. This 'extension' was required as a result of the '*Uruguay Round Understanding in Respect of Waivers of Obligations under the General Agreement on Tariffs and Trade 1994*' which meant that all waivers in effect on entry into force of the Marrakesh Agreement lapsed two years thereafter (i.e. on 1 January, 1997).

Renewal of Lomé could of course, be challenged by a WTO member country, but which countries would gain by such a process? The US is most unlikely to challenge, since they have relied on such a waiver for the CBI since 1984. This will expire in 2005 but President Clinton has already proposed improvements to the CBI as partial compensation for the reduction of EU banana preference as a result of the WTO panel

ruling. Objection to the renewal of the Convention would also push the ACP countries towards a free trade area with the EU, and the US has long opposed the EU requiring reverse preferences, since these would discriminate against US exports to the ACP. Similarly, by voting against the renewal of the waiver for Lomé, other industrialised countries would also effectively be pushing the ACP countries towards a WTO compatible free trade area under Article XXIV and this would inevitably produce discrimination against their exports to the ACP. The success of the Latin American banana exporters in challenging the EU may, it is thought, encourage these countries to challenge a renewal of Lomé in order to obtain compensatory trade measures from the EU. But the damage to their exports would have to be proved and (unlike the banana case), it is difficult to see how such a case could be substantiated. Also, as discussed by Hallam and Preston (1997), the banana challenge had much more to do with the global strategy of a small group of multinational companies than the trade interests of the particular Latin American countries concerned. A challenge by the Latin American countries to a Lomé waiver could also be viewed unfavourably by the US and act as an obstacle to their growing trade with the US (for the reasons given above) and with the EU, while producing little or no offsetting gain in their exports either to the ACP or to the EU.

Second, the Green Paper also emphasises the adverse effects of what it assumes would be the diminished security of preferences of a renewed Lomé Convention on foreign direct investment (FDI) in the ACP countries. The above arguments, however, cast doubt on the assumption of diminished security of preferences. If, however, the counter-factual is a free trade agreement with the EU then, *provided this was compatible with Article XXIV* (see the following section), such an agreement could provide greater security of access than Lomé and thus make the ACP a more attractive destination for foreign direct investment (through the investment creating and

investment diversion effects of preferences). Article XXIV, however, defines a free trade area as covering 'substantially all trade' yet the EU's free trade agreements invariably exclude or severely limit concessions in agricultural products in order to maintain the integrity of the CAP. As explained in Section 3.3, and in Chapter 7, the Uruguay Round has radically changed the likelihood of the EU being able to maintain such agreements without being successfully challenged in the WTO, in which case a free trade agreement would be no more secure (and perhaps less secure) than a renewed Lomé Convention, especially if the trade provisions of the latter covered a wider group of developing countries than the existing ACP and it was therefore less discriminatory between developing countries. Also, as discussed in Chapter 6, the destination of FDI is generally determined by much more important factors than reciprocal or non-reciprocal preferences.

Third, Article 174.2(a) of the Lomé Convention states that 'in their trade with the community, the ACP state shall not discriminate among the member states and shall grant to the community treatment no less favourable than most favoured nation treatment'. This raises the issue of how the EU would react to an ACP country or group of countries entering into a customs union or free trade arrangement with a developed country (e.g. Caribbean countries with the US and Canada; Pacific countries with Australia, New Zealand, or Japan). The use of the term 'most favoured nation' suggests that the agreement need only treat EU goods in accordance with Article I.1 of the General Agreement, but as stated in the Green Paper, at a political level it seems likely that the EU would challenge the continued free entry for imports from an ACP country which offered preferential access for other industrialised countries' exports, while denying such access for imports from the EU. Such ACP countries would then have to choose between remaining within Lomé, or leaving the Convention and relying on GSP preferences in order to join another regional arrangement involving reciprocal preferences with a non-EU developed country.

Fourth, the most important question is whether a continuation of the Convention would enable the ACP countries to participate more fully in the world economy. This report has emphasised the need for ACP countries not only to diversify by product but also by market, particularly towards the rapidly expanding markets in South and South-East Asia, Latin America, and the Central and East European countries. The continuation of the Lomé arrangements could be regarded as a 'soft option', continuing with familiar relationships but with the expense of maintaining a dependence on a slowly growing EU market and a continued level of product and market concentration, which would be detrimental to the growth and diversification of ACP exports. The 'soft option' of renewal of the Convention may be even more detrimental to ACP countries if it induced them to neglect necessary trade liberalisation and structural adjustment of their economies.

Fifth, the negotiation of successive Conventions is generally recognised to have led to a proliferation of policy instruments at the expense of development strategies (see Chapter 6). This has reduced the effectiveness of technical and financial assistance and created a lack of co-ordination between different aspects of the Convention. In the context of this study, it has led to an absence of strategies aimed at increasing the export capacity of ACP countries and enabling them to take advantage of the preferences offered. The renewal of the Convention in its present form would perpetuate these potential problems. In this sense the *status quo* is an inferior option, but there is no reason why the existing (or improved) market access provisions of the Lomé Convention could not be combined with much more focused and co-ordinated aid provisions.

3.3 Free Trade Areas

Trade creation and trade diversion effects

Multilateral or unilateral trade liberalisation offers the possibility of efficiency gains, especially

where it involves the removal of indiscriminate protection. A free trade area (FTA), by removing barriers to imports from the partner country (EU) also offers efficiency gains (trade creation), but by removing barriers to trade against the partner country (EU) but not against third countries, it also leads to the replacement of cheaper imports from third countries with dearer imports from the partner country (trade diversion). In this important sense, an FTA is always inferior to unilateral or multilateral trade liberalisation. The size of these trade creation and trade diversion effects on an ACP country critically depends on the structure of the economy and the patterns of trade, and few valid generalisations can be made about any country or group of countries. What we can do is outline the fundamental factors which would determine these effects in an EU-ACP free trade agreement.

The trade creation rise in imports from the EU will be larger the greater:

- (a) the initial level of imports from the EU;
- (b) the pre-agreement level of tariffs plus the tariff equivalent of the non-tariff barriers to trade removed as a result of the agreement;
- (c) the extent to which imports from the EU substitute for ACP produced goods in production and consumption. For some (small) ACP countries at higher levels of economic development (e.g. Mauritius) this could be quite high, whilst for other ACP countries most goods may be of a price, quality and design specific to a low income and less industrialised economy, or may be protected by poor channels for marketing and distribution, and so substitution between domestic production and imports is low; and
- (d) the preference for imported goods from the EU in production and consumption.

It will be appreciated that the estimation of (b) and particularly (c) is a matter of judgement rather than precise measurement, yet the interaction of the three parameters will substantially

alter the magnitude of the trade creation rise in imports.

Table 3.1 ACP Imports from the EU

(a) Greater than 40% of total imports

Angola, Burundi, Cameroon, Cape Verde, C. African Republic, Chad, Congo, Côte d'Ivoire, Ethiopia, Gabon, The Gambia, Ghana, Guinea-Bissau, Madagascar, Mauritania, Niger, Nigeria, Senegal, Sierra Leone, (S. Africa), Sudan, Uganda, Tanzania, Zaire.

(b) 20%-40% of total imports

Bermuda, Burkina-Faso, Dominica, Grenada, Kenya, Kiribati, Liberia, Mali, Mauritius, Rwanda, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Seychelles, Somalia, Surinam, Togo, Trinidad and Tobago, Vanuatu, Zambia, Zimbabwe.

(c) Less than 20% of total imports

The Bahamas, Barbados, Belize, Dominican Republic, Fiji, Guyana, Haiti, Jamaica, Papua New Guinea, Samoa, Solomon Islands, Tonga.

Source: UNCTAD 'Handbook', 1995.

Table 3.1 summarises the substantial differences in the share of imports from the EU in total imports, even for countries in the same regional grouping. The countries in category (b) import around one-quarter to one-third of their goods from the EU while some of those in category (a) import more than twice this proportion from the EU.

Table 3.2 Simulations of Trade Creation Increases in Imports

	Initial share of imports from the EU		
	20%	40%	60%
$e = -0.5, t = 10\%$	0.9%	1.8%	2.8%
$e = -1.5, t = 20\%$	5.0%	10.0%	15.1%
$e = -3.0, t = 30\%$	13.9%	27.7%	41.6%

e = price elasticity of demand for imports

t = trade weighted average tariff + tariff equivalent of non-tariff barriers removed by FTA

The simulations in Table 3.2 suggest that with a reasonable degree of substitutability of imports for domestic production and preference for EU imports ($e = -1.5$) and protection ($t = 20\%$), the once and for all trade creation rise

in imports is quite modest even with a high initial share of imports from the EU. But, with a higher level of import protection ($t = 30\%$) and a doubling of the import elasticity of demand ($e = -3.0$), imports increase substantially, depending on the initial share of the EU in imports.

The increase in imports from the EU as a result of lower cost imports from third countries being replaced by higher cost imports from the EU (trade diversion) depends on the extent to which ACP importers are willing and able to substitute in favour of EU suppliers. We could expect this to be lower for Caribbean and Pacific countries than for African countries, given their respective patterns of trade and distance from the EU. Even in the case of Sub-Saharan Africa, however, the small size of the domestic market in many ACP countries, together with the costs of servicing the market, can also be expected to reduce the extent to which EU exporters seek to displace exporters from the rest of the world. Also, EU goods may not compete with imports from the rest of the world, especially where these consist of imports from other developing or newly industrialising countries.

The conclusions from the analysis are:

- ❖ Even where a decrease in import prices leads to a more than proportional rise in the volume of imports ($e = -1.5$), levels of protection are significant ($t = 20\%$) and there is a high degree of dependence on the EU for imports (60%), the once and for all trade creation rise in imports would appear to be manageable, both in terms of the necessary re-allocation of domestic resources (adjustment in the face of increased competition from the EU) and in the balance of payments.
- ❖ Increased imports from the EU as a result of trade creation only appear to be substantial where import barriers are high (30% or more) and EU goods compete to a significant degree with local production ($e = -3.0$ or more).
- ❖ Given the dissimilarity of the economies of

the EU and the ACP countries, increased imports from the EU as a result of trade diversion will probably be greater than those resulting from trade creation. This does not create an adjustment cost to the ACP countries but does create a loss of welfare, since a lower cost source of supply (rest of the world) is being replaced by a higher cost source (the EU). The magnitude of the trade diversion effect fundamentally depends upon the elasticity of substitution, and this can be expected to be lower the greater the proportion of imports from other developing countries, the smaller the size of the ACP market and the higher the costs of servicing the ACP market.

- ❖ The increase in imports from the EU as a result of trade creation and trade diversion will lower Government revenues from import duties, which, for ACP countries such as Benin, Madagascar and Mauritius account for 37% to 42% of revenues and for a number of other countries account for 20% or more of revenues. Compensating for the loss of revenue as a result of an FTA with the EU by increasing duties on imports from the rest of the world will not only increase distortions in the allocation of resources in the economy and lower growth rates, but will exacerbate the problem because it will raise the trade diversion component of the increase in imports from the EU. It may appear counter-intuitive, but lowering tariffs and other duties on imports may be expected to *increase* revenues since it will reduce the extent of trade diversion and increase dutiable imports and, if import elasticities of demand are greater than unity, further increase revenues.

The case for a free trade area with the EU

Given the costs of an FTA with the EU, such an agreement has to offer advantages not otherwise obtainable. These are largely potentially strategic or dynamic advantages.

First, as discussed in Chapter 1, the Sub-Saharan African countries have generally declared bound tariffs at very high levels and in many cases well above actual applied levels. An FTA, it is argued, would help to overcome this resistance to essential trade liberalisation and complement structural adjustment policies acting on the supply side of the economy. For example, an FTA would enable governments to overcome the resistance of special interest groups seeking to maintain existing levels of protection. It is also argued that by 'locking in' structural adjustment reforms, an FTA with the EU would enable the ACP to obtain the same benefits as multilateral trade liberalisation. However, this assumes that the FTA leads to imports entering the ACP at world prices whereas if in fact EU exporters use their market dominance to charge substantially above world prices (Yeats, 1990, shows that EU exporters charge 20% to 30% above world prices), then an FTA will largely transfer import revenues to EU exporters, with little in the way of efficiency gains to the ACP countries. Also, if trade diversion costs out-weigh the trade creation gains, then there will be a net loss of welfare. Taken together, these factors could decrease the credibility of the reforms, while the negotiation and implementation of an FTA could very well divert attention and resources from the more important area of general trade liberalisation.

Second, an FTA could cover areas not covered by the WTO or where WTO disciplines are relatively weak, for example:

- ❖ guaranteeing market access against contingent protection (anti-dumping, use of safeguards, etc);
- ❖ offering a wider coverage of protected products which, compared to the Lomé Convention, would be agricultural products;
- ❖ 'national treatment' of foreign investment and business services;
- ❖ EU investment promotion schemes, for

example similar to the AL-Invest and EC Investment Partners (ECIP) schemes for Latin America, and the investment promotion schemes in the Europe Agreements. EU investment guarantees on foreign direct investment could be given in exchange, for example, for the right of establishment of EU firms and 'national treatment' for EU firms;

- ❖ additional assistance in complying with the regulatory and administrative requirements of the EU, for example, health and safety regulations, phyto-sanitary regulations, industrial standards, etc, combined with guarantees (underwritten by the option of independent arbitration binding on both parties in cases of dispute) that compliance will ensure that these regulations will not be used as a non-tariff barrier;
- ❖ agreement covering the liberalisation of trade in cross-border services enabling the ACP both to obtain these services on more favourable terms and to regulate the activities of EU service providers; and
- ❖ competition measures which could seek to prevent anti-competitive behaviour by EU firms.

Third, the EU's free trade agreements invariably include financial and technical resources specifically aimed at increasing export capacity and export promotion opportunities. The ACP could seek to utilise these resources, not only for export promotion in the EU market, but also in markets in which the EU already has preferential agreements, for example, the Central and East European Countries (CEEC).

Fourth, the guarantee of access to both the ACP and EU markets may induce investment creation and investment diversion by EU and non-EU firms. For example, Mauritius has benefited from FDI from firms in the EU, Hong Kong and a variety of other countries. Some Caribbean countries have attracted significant amounts of

US investment (investment creation) attracted by their US, and to a lesser extent, EU preferences.

Fifth, the Uruguay Round undoubtedly strengthened the rule of law in international trade relations, but a proliferation of regional integration arrangements could still undermine the multilateral trading system. A recent example which has concerned the EU has been the case of Mexico which, faced with a financial crisis and the impossibility of increasing tariffs on imports from the US because of the NAFTA agreement, increased duties on imports from third countries, including the EU. As a result of this and the deepening of preferences between the ASEAN countries, the EU has requested the WTO to review the content and operations of all free trade agreements. An FTA could act as an 'insurance' against a reversal of the move to a more liberal multilateral trading system.

Sixth, NAFTA and the general Enterprise of the Americas Initiative may pose a particularly acute policy dilemma for a number of the Caribbean countries where exports to the US account for 50% or more of total exports. Estimates of the static trade diversion effects of NAFTA on the Caribbean countries produce relatively small amounts (Davenport 1995) with much larger effects coming from loss of preferences as a result of the Uruguay Round. Much more important are the unquantifiable long term effects in terms of future market access and foreign direct investment. The CBI is a unilateral offer by the US under a GATT waiver (see Section 3.2) and there is no guarantee as to how long this will be continued after 2005, while even if continued, there is always the possibility of protectionist measures by the US. NAFTA also allows for safeguard measures to be applied on imports, but the existence of the agreement makes their imposition subject to closer scrutiny while, subject to these measures, access to the US market is guaranteed indefinitely. This guarantee of market access can be expected to attract foreign direct investment to utilise the lower costs of production in those countries with stable

economic and political systems, and transparent and relatively straightforward regulations. Such investment is a crucial element in diversifying the exports of small economies. FDI brings a package of benefits (as well as costs) to host countries, including access to importers, knowledge, and technology. If the Caribbean countries stay out of NAFTA or are not offered 'NAFTA-parity' in their trade relations with the US, then at least for some countries there could be investment diversion towards NAFTA members, affecting not only current industries such as clothing but a whole range of future industries. As discussed previously, NAFTA membership may well mean that these Caribbean countries would have to offer an FTA with the EU as well. Having done that, they will have effectively engaged in multilateral trade liberalisation and permanently removed the power of protectionist lobbies in their own countries.

Potential areas of difficulty in negotiating a free trade agreement with the EU

A free trade agreement would have to be in conformity with Article XXIV of the General Agreement which, *inter alia*, requires the removal of 'tariffs on the regulations of commerce for a substantial part of the trade' (Article XXIV.2) and for 'substantially all the trade' (Article XXIV.8 (b)) between the countries concerned. This raises the first potential area of difficulty for an EU-ACP free trade agreement.

The EU has consistently limited its offer on sensitive products, most notably in agricultural products, by means of product exclusions and limited access for products through partial reductions in tariffs, tariff quotas, calendar restrictions and high minimum entry prices. The Europe Agreements (association agreements) for example, exclude agricultural products, the Mediterranean FTAs provide only limited concessions on restrictions on agricultural products, and the proposed trade agreement with South Africa excluded 40% of its farm exports and was referred back to the EU for further negotiation. As will be explained in Chapter 7, the wide-

spread use of exclusions by the Commission in EU free trade agreements has led the Council of Ministers to question the ability of the EU to maintain such agreements within WTO rules.

More generally, these product exclusions illustrate one of the fundamental weaknesses of Article XXIV. The EU has argued in the past that 'substantially all trade' should be interpreted as quantitative requirements applying to *existing* import protected (and therefore distorted) flows, in which case a free trade agreement which does not include such protected products would still be compatible with Article XXIV. The EU has also argued that 'substantially all' should be interpreted as meaning at least 80% of actual trade. It could equally be argued, however, that this is special pleading and stretches the language of Article XXIV beyond its original intention, which was clearly directed at ensuring that no major *sectors* were excluded from such agreements. GATT working panel examinations of EU agreements have not, in the past, limited the EU's freedom of manoeuvre, despite their repeated criticisms of the exclusion of whole sectors. Our reading of the UR 'Understanding or the Interpretation of Article XXIV of GATT 1994', however, strongly suggests that this freedom of action will be much more limited in the future. The fourth introductory paragraph of the Understanding states that the contribution of free trade areas to the expansion of world trade 'is increased if the elimination between the constituent territories of duties and other restrictive regulations of commerce extends to all trade, and diminished if any major sector of trade is excluded'. The Understanding on the evaluation under Article XXIV:5 of the general incidence of the duties and other regulations of commerce applicable before and after the formation of a customs union or free trade area states that it should be based upon an *overall assessment* (our italics) of the weighted average tariff rates and customs duties. The Understanding also states that the dispute settlement procedures can be invoked with respect to any matters arising from the application of the provisions of Article XXIV,

including interim agreements leading to free trade areas. It should be recalled that the change in the UR from a 'consensus to accept' to a 'consensus to reject' means that the EU has effectively lost any power of veto which it previously had over an adverse disputes panel decision.

Taken together, this strongly suggests that the EU's interpretation of Article XXIV would be at least as much open to challenge in the WTO as a renewed Lomé Convention and undermines the assertion in the Green Paper that a free trade agreement would enhance the security and predictability of preferences and lend credibility to ACP trade policies. In order to be *confident* that an ACP-EU free trade agreement would be WTO compatible, then *all* sectors of trade, including sensitive sectors such as agriculture would have to be included in the FTA. This is unlikely to be acceptable to the EU and may also be unacceptable to the ACP countries.

The second area of potential difficulty in negotiating a free trade agreement with the EU concerns the length of the transitional period. Under Article XXIV.5(c) this has to be achieved 'within a reasonable length of time' and this was clarified in the GATT 94 Understanding as 'exceeding 10 years only in exceptional cases'. In one sense, the low level of industrialisation of most of the ACP countries implies that there are relatively few industries competing with EU imports and so the adjustment cost to most of the ACP countries of liberalising trade with the EU would be correspondingly small. Secondly, the neo-classical (World Bank) 'shock approach' emphasises that the quicker an economy is opened up to international trade, the smaller are the adjustment costs. The reasoning behind this is that it gets the 'pain' over quickly, helps to overcome vested interest in protection, and enables consumers to benefit sooner rather than later from a wider range of goods and at lower prices, thus establishing the credibility of and therefore support for the programme. Chapters 4 and 5 of this report, however, emphasise that the ACP countries have infant economies which require government intervention not simply in

the World Bank sense of neutral 'market friendly' intervention, but also strategic intervention in order to create a learning environment between related activities. If the logic of this argument is accepted, then a transitional period to free trade with the EU which would be WTO compatible would probably be too short a period of time for many ACP countries.

Thirdly, the EU agreements with Morocco and Tunisia (which could be taken as a model for the trade provisions of an ACP-EU agreement), which are to be implemented over a twelve year period, do not provide a good example of a free trade agreement going substantially beyond WTO disciplines and deepening free trade relations. Only a very limited range of agricultural products are included in the agreements and concessions are limited (see Chapter 7) despite the importance of the agricultural sector to these countries, particularly as a source of employment. The EU has also insisted on safeguard clauses in addition to the right to impose anti-dumping and countervailing duties in ways which go beyond those permitted in the General Agreement, allowing 'substantial opportunity to intervene if the political willingness to do so exists' (Hoekman and Djankov, 1996). The authors also point out that 'anti-dumping remains applicable to trade flows between the partners despite the agreement of Morocco and Tunisia to apply EU competition disciplines' (p.399). These and other factors lead the authors to conclude that 'the European Mediterranean agreements do not go significantly beyond existing multilateral (WTO) disciplines'.

With regard to financial co-operation in the Mediterranean Agreements, although the volume of aid is expected to increase, no commitments are given in terms of real flows. It is also worth noting that the previous protocols on financial co-operation have not been renewed, and instead, there is a total sum available to *all* Mediterranean countries, with individual applications depending, at least in part, on country performance (as determined solely by the EU). This is interesting as it would seem to come close

to the proposals discussed in Chapter 6 of the Green Paper.

If the Mediterranean Agreements are taken as representative of EU free trade agreements, then it is difficult to escape the conclusion that the motivation of the EU for such an agreement has more to do with 'locking in' countries into the EU sphere of influence and capturing markets for EU exports at the expense of third countries through the trade diversion effects of such agreements than it has to do with a widening and deepening of WTO trade disciplines.

3.4 The Generalised System of Preferences

The third possible option is to separate the trade provisions of Lomé from other areas of co-operation and to replace these trade provisions by the EU's generalised system of preferences (GSP).

All industrial and agricultural products imported from the least developed countries (as defined by the UN) covered by the GSP enter the EU duty free and thus similarly defined least developed countries in the ACP group would receive identical treatment to Lomé for these products. This 'enhanced' GSP also applies to imports of industrial products from the Andean and Central American States, with some exceptions in the case of the Central American States and with concessions on agricultural products (for further details see Chapter 7).

For non-least developed ACP countries a reliance on the GSP would mean a significant erosion of their preferences, as guaranteed market access for industrial products free of 'duties and measures having equivalent effect' would be replaced by what the EU refers to as 'tariff modulation'. Very sensitive goods (all textiles, clothing, ferro-alloys) only receive a 15% decrease in tariffs, sensitive products (such as footwear) only receive a 30% decrease, semi-sensitive products a 65% decrease, and only non-sensitive products enter duty free.

The small reduction in tariffs on these products, combined with the decrease in

post-Uruguay Round tariff rates (albeit small cuts in the case of sensitive products), means that for most products of potential relevance to the ACP countries, the margin of preference is so low (for example, 5.1% for footwear on the final Uruguay Round rate) that it would not be worth the administrative cost of applying for preferences.

In the case of agricultural products there are concessions on the tariff rates on some temperate products such as fruit, flowers, peas and beans, but in most cases the reduction in the MFN rate in the standard GSP is only 15% or 30%, giving GSP rates of 6.8% for peas, through to 10.2% for most flowers in the peak season and 12.2% for frozen beans.

The rules of origin in the EU's new GSP were improved to include as 'originating products' imports from the EU of intermediate products used in the production of the exported good ('donor country content' provision), but there is no general 'cumulation' of origin among beneficiaries and only limited cumulation allowed among certain regional groupings.

The GSP is also a unilateral offer given by the EU and is not negotiable, nor is it contractual and this, combined with the limitations of the scheme, suggest that it will have little effect in stimulating domestic or foreign investment in recipient countries.

The safeguard clauses in the new GSP are also more restrictive than in the old GSP. For example, the previous scheme referred only to the possible implementation of the safeguard clause where there was any difficulty to the *Community* as a whole or to one of its *regions*. Now, the safeguard clause can be implemented if there is simply an economic difficulty to an EU *producer*. In addition, the least developed countries are no longer exempt from the re-imposition of tariffs under these provisions.

The GSP also includes a complex formula for the exclusion of product/country combinations which are deemed to be competitive and no longer requiring preferences. Further analysis would be required to determine the effects of this formula on individual ACP countries, but it

would seem unlikely that it would apply to any except, perhaps, some exports of clothing from certain countries such as Mauritius, Jamaica and Zimbabwe (and perhaps not even in these cases).

The GSP would seem to be of some value to the least developed ACP countries, provided there were improvements to the rules of origin and to the safeguard clauses to upgrade them to Lomé standards, although there would still not be the same degree of certainty and contractual relationship of the Lomé Convention. For the remaining ACP countries, the replacement of Lomé by the GSP would represent a decrease both in their level of preferences and in their security of access to the EU market.

3.5 Choosing between the Options

The permutations of 'variable geometry'

The options of a renewed Lomé Convention; integration into the GSP and a free trade agreement can be combined in various permutations negotiated with individual ACP countries, regional groupings, and ACP countries defined by different levels of economic development (with the added modification of 'vulnerability' defined in terms of small size of the economy, specialisation in a very few exports, geographical isolation from markets, etc). The Green Paper presents some of what are an infinite series of possibilities. No one, however, can imagine how such complex variations could be negotiated, and an assessment of their impact on the ACP countries concerned, other ACP countries and third countries, with such endless possibilities, is an impossible task. The permutations of 'variable geometry' may be an interesting intellectual exercise, but it is difficult to see how they could form the basis for practical policies. On the other hand, the possibly divergent interests of some ACP countries need to be recognised. Countries in the Caribbean and Pacific may see their future increasingly involving closer integration into regional trade, and if they were unable to achieve this through other means, for example NAFTA-parity in the case of

the Caribbean countries, then a simple renewal of Lomé may conflict with such an objective. Also, ACP countries vary widely in their levels of development, from the poorest countries in the world like Rwanda (per capita GNP \$80) to Trinidad and Tobago and Gabon (with per capita GNPs of just under \$4000).

Guidelines for deciding among the options

This conundrum is best approached using guidelines for decision taking.

First, ACP preferences are now of relatively minor and diminishing importance compared to 1975 when Lomé began. Preference margins have been eroded by tariff cuts and as a result of the Uruguay Round the EU's trade weighted GSP tariff average in tropical agricultural products has decreased from 15% to 9.4% (tropical non-agricultural products are 0%); natural resource based products have decreased from 3.4% to 3.2%, textiles and clothing are 9.3%³ and leather and leather footwear has declined from 0.2% to 0.1%, while other industrial products have declined from 5.1% to 3.5% (Greenaway and Milner, 1995). There are probably further opportunities for utilising preferential access to the EU for some temperate agricultural products and fisheries, but the possibilities here seem limited. In the case of textiles and clothing, the market is highly competitive, already well developed and non-price factors are more important than the margin of preference (although they may be useful at the margin when importers are choosing between competing sources of supply). Import quotas under the MFA (from which the ACP countries were exempt) are scheduled to disappear by 2005, and although it is questioned whether this timetable will be adhered to (given that most sensitive categories of clothing are scheduled to have quotas removed in that year, as well as the possibility of using contingent protection measures), ACP countries can only rely in the future on a margin of preference equal to

exemption from duties (10% to 12% on GSP/MFN rates, but 0% with respect to the country/product coverage of the enhanced GSP) and will have to compete in a free (or relatively free) market with low cost producers in Asia. In addition, ACP preference margins have been eroded by the proliferation of the EU's special preferences for countries in Europe and in the Mediterranean region.

This leads us to two important conclusions. First, the ACP countries could consider opening Lomé tariff preferences to an appropriate group of non-ACP countries, since the costs in terms of further erosion of existing preferences would be small and the benefits could be a greater degree of acceptance of Lomé in the WTO (this is explored in more detail in Section 3.6). Second, the benefits in terms of exemption from tariffs of an FTA with the EU are likely to be small and insufficient in themselves to outweigh the costs of granting free entry for imports from the EU (although, as we have discussed, there may be other intangible benefits).

Second, the aid and technical co-operation provisions between the EU and the ACP group may well be separable from the trade co-operation provisions of a new agreement so that if an ACP country did not wish to obtain EU preferences under Lomé or an FTA, it could still participate in the non-trade provisions of a new ACP-EU agreement.

Third, free trade agreements are inferior to MFN trade liberalisation *unless* they include benefits which could not be obtained through other means. These may be intangible or tangible benefits. Intangible benefits include a fear that the multilateral world trading system could break down into competing regional groups. This is always possible, but it seems unlikely as it would lead to a return to the situation similar to the depression of the 1930s and it was this disastrous experience of 'beggar my neighbour' policies which led to the General Agreement on Tariffs

3 Stated as 0% by Greenaway and Milner, but this appears to be incorrect and so we have calculated the average GSP rate.

and Trade being established to avoid a repetition of this disaster.

Tangible benefit could include exemption from the use of 'contingent measures' of protection and other non-tariff barriers to trade, not at present covered by Lomé: for example, anti-dumping investigations; countervailing measures; the application of safeguards or standards (technical, health, safety, etc.) to imports; and government policies which directly or indirectly adversely affect trade. Preferential agreements could also include additional trade and investment measures available only to members of the preferential area.

Fourth, the analysis of the EU's trade agreements with other groups of countries suggests that the EU operates a 'hub and spoke' system through the use of regional trade agreements, both to capture as much as possible of the market and to minimise the adjustment costs to itself of reciprocal preferences. Sensitive products are omitted from the trade agreements, safeguard provisions are more onerous than those under the WTO, and compliance with EU competition rules and protection of EU investment is demanded without compensatory concessions, such as exemptions from contingent protection measures.

Fifth, all of the above suggests that great skill will be required in the negotiations to maximise the benefits from a trade agreement (and the additional benefits required if a free trade agreement with the EU is included in the trade options). This strongly points to the need for the ACP countries to pool resources and to negotiate as far as possible as a group.

Sixth, the number of alternative arrangements forming a new agreement ('variable geometry') should be kept to the absolute minimum. This is essential, not only to maintain the common objectives and cohesion of the ACP group, but also because the greater the variation in the content of ACP-EU trade provisions, the stronger will be ACP-EU ties, and the weaker will be the incentives for ACP regional trade. A range of different ACP-EU trade agreements will make it much easier and

less costly for either an EU or third country to service an ACP market from the EU than from an individual ACP country. This arises, firstly, because where duties have to be paid on imports of intermediate products from the EU in an ACP country, manufacturers will be at a competitive disadvantage compared to manufacturers in a neighbouring ACP country with a free trade agreement with the EU, and will resist moves towards regional free trade. Secondly, if the product coverage of agreements between the ACP countries and the EU differs, then EU rules of origin under different agreements will be strictly enforced to maintain the integrity and differentiation of the two agreements and this will inhibit regional trade.

3.6 Viable Options for Negotiation

Of all the many possibilities open to the ACP countries regarding trade co-operation with the EU, only the following seem viable (not ranked in order of merit):

- 1 Renewed non-reciprocal Lomé preferences under a WTO waiver with a more focused range of policy instruments and objectives (as discussed in Chapter 6).
- 2 Non-discriminatory trade liberalisation in the ACP countries with a more focused ACP-EU development co-operation agreement.
- 3 A free trade agreement or agreements subject to:
 - (a) obtaining benefits not otherwise obtainable and sufficient to outweigh the costs of such agreements;
 - (b) minimising the variations of such agreements in terms of product coverage, lengths of transitional period (long transitional periods limit the usefulness of such agreements as an 'anchor' for economic reforms, decrease the credibility of these reforms for domestic and foreign investors, and encourage protectionist pressure groups) and rules of origin;

- (c) reducing the cost of free trade agreements by simultaneously decreasing barriers to trade with third countries, and binding reduced tariffs in the WTO;
- (d) obtaining a new and more focused development co-operation agreement.

Strengthening the acceptability in the WTO of a renewed Convention

We have argued that the Lomé Convention could be renewed on the basis of a further waiver from Article I in the WTO if there is sufficient political will to do so on the part of the EU. Nevertheless, a further waiver would probably be subject to closer scrutiny in the WTO than the present waiver, given the change in attitudes of the Contracting Parties reflected in the Uruguay Round negotiations and agreements towards arrangements which did not conform to the GATT and which clearly discriminated between member countries. Discrimination between developing countries, in particular, combined with the greatly strengthened dispute settlement procedures also, as the banana case has demonstrated, substantially increase the possibility of challenge and panel litigation even when a waiver is granted; and this reduces the confidence of exporters and investors in receiving preferential treatment. It is therefore in the interests of the ACP countries and the EU to consider placing Lomé trade preferences on a less arbitrary and discriminatory basis than the present regional grouping. As we have pointed out, the substantial erosion of Lomé preferences since 1975 implies that the extension of trade preferences to a wider group of comparable developing countries would impose very little additional costs to the ACP countries in terms of a further reduction in their margin of preferences. Generally applicable criteria for Lomé preferences would also imply that such preferences were 'time bound' and therefore of additional compatibility with WTO procedures.

The precise form of such criteria is clearly a sensitive issue which would have to be acceptable both to the ACP countries and to the member

states of the EU. One obvious extension of Lomé preferences would be to extend them to the least developed countries (UN definition). This would be consistent with the poverty-oriented focus of EU development co-operation, as stated in the Maastricht Treaty, and with the aid policies of a number of the EU member states. The least developed countries already have benefited from the EU's enhanced GSP and the only potential cost in terms of preference erosion for the ACP countries would be in certain sensitive textiles and clothing goods exported by Bangladesh. Extension of preferences could also include the Andean and Central American countries under the terms of preferential entry covered by the enhanced GSP. Table 3.3 lists these three groups of countries.

Table 3.3 Countries Covered by the EU's Enhanced GSP

Least Developed
Yemen, the Maldives, Myanmar (Burma), Bangladesh, Nepal, Bhutan, Afghanistan, Laos, Cambodia
Andean Countries
Bolivia, Ecuador, Colombia, Peru, Venezuela
Central American Countries
Panama, Costa Rica, Nicaragua, El Salvador, Honduras, Guatemala

The Andean countries have tariff-free entry for industrial products and the Central American countries have tariff-free entry for non-sensitive industrial products and additional preferences over the standard GSP for sensitive products. Agricultural products are subject to a more complex regime in which there are five lists of agricultural products (for further details, see Chapter 7) in which the least developed countries have duty-free access for the products in all five lists. The other two groups of countries only have duty-free access for the products in the fifth list, with tariff concessions of varying depth on the products in the other four lists. Given the sensitivity of agricultural products in the EU, the most that could be expected

would be an extension of Lomé preferences on industrial goods to these countries with the consolidation of enhanced GSP agricultural preferences into Lomé. The advantages to these non-ACP countries would be to place their preferences on a more secure contractual and negotiable basis than the EU's unilateral GSP offer and to extend to them the benefits of regional cumulation in Lomé's rules of origin. The costs to the ACP countries in terms of erosion of preferences would (with perhaps the exception of certain sections of clothing from Bangladesh, and this would have to be quantified) be minimal.

This enlarged regional grouping to include non-ACP countries would still be arbitrary and therefore open to the charge of unjustified discrimination against non-member developing countries. A bolder step would be to place the EU's special preferences, at least for industrial products, on a more rational and therefore more easily defended basis, which could be recognised by the WTO. The basis for such a scheme could

be founded on the fundamental rationale for preferences, namely that developing countries have *infant industries* which require preferential access to a protected market to enable them to 'learn-by-doing' and achieve minimum efficient scale of production. The authors of this report would enlarge on this traditional analysis by emphasising that the analysis should be extended beyond the level of the firm and recognise the importance of externalities, the absence or limitations of which create *infant economies*. The limitations or absence of internal and external economies of scale particularly apply to developing countries with a relatively small size of domestic market, and this suggests a criterion which combines low per capita income levels with low levels of GDP.

Table 3.4 should be regarded only as illustrative of one result of such an exercise based on the simple criterion of Lomé preferences being granted to developing countries having a GDP of less than \$50,000 million. The countries excluded under such a criterion are intuitively those which, given the large size of their domestic markets and/or their level of economic development, seem least in need of preferences beyond the GSP. The major advantage of this proposal is that it would not only place the EU's special preferences on a more rational basis than the present complex hierarchy of preferences, but also simplify the hierarchy so that, for example, there would be a simple unified scheme for industrial products covering the non-candidate (for entry into the EU) Mediterranean countries as well as countries in Asia and Latin America comparable to the ACP countries. As we have emphasised, given the EU's existing structure of tariffs, preferences, and imports from these countries, we would not expect the costs to the ACP countries (in terms of erosion of preferences) and to the EU to be significant (though this requires more detailed analysis). Equally we would not expect this, or a similar proposal, to be able to be agreed by 2000. A commitment to liberalise trade in this way, however, would fulfil the WTO's objective of regional trade agreements acting as a stepping stone for future global liberalisation,

Table 3.4 Excluded developing countries if Lomé preferences applied to countries with a GDP less than \$50,000 million (1994) and to countries eligible for the EU's enhanced GSP (in rank order of per capita GNP, 1994)

India
Pakistan
China
Indonesia
Philippines
Thailand
Venezuela
Iran
Brazil
Malaysia
Mexico
Argentina
<i>plus:</i>
Rep. of Korea
Singapore
(Hong Kong)

overcome the pessimism of those who regard regional integration as acting as a force opposed to multilateral liberalisation, and automatically generate a large measure of support in the WTO for a further waiver for a new Convention. Special preferences based on an objective criterion would also mean that they were time bound and recipients would, as their economies developed, move from Lomé preferences to GSP, and finally graduate out of the GSP to receiving MFN treatment. Within this framework, countries could, if they so wished, opt out of special preferences and negotiate WTO-compatible free trade arrangements.

Accommodating the divergent interests of the ACP Group – an umbrella agreement

The ACP countries comprise a heterogeneous group with the ten poorest countries in the world with a per capita GNP of \$200 or less, compared to over \$3,000 for Gabon, Mauritius and Trinidad and Tobago. Similarly, shares of agriculture in GDP range from over 50% for the poorest countries to under 10% for the richest, while shares of manufacturing range from under 5% for some of the poorest countries to up to one-quarter for the more developed. *These large structural variations could be accommodated within an 'umbrella agreement'.*

This could take the form of the least developed ACP countries renewing the Lomé Convention (this would make it easier to obtain a WTO waiver and would be less subject to subsequent challenge), while the remaining ACP countries would negotiate a free trade agreement with the EU but with varying transitional periods, depending on their ability to adjust to free trade with the EU and reduced barriers to trade with the rest of the world.

Alternatively, individual ACP countries could elect *either* to join a renewed Lomé type arrangement *or* to join in the negotiation of a free trade agreement, having decided for themselves the costs and benefits of these two alternatives.

The third possibility is that the least developed ACP countries could enter into a non-reciprocal

Lomé-type agreement; the more economically advanced ACP countries could (possibly self-elected) negotiate a free trade agreement with the EU, while the less economically advanced ACP countries (excluding the least developed) could obtain their trade preferences from the GSP. For the reasons given when discussing the option of the GSP, we do not regard the latter as a useful option. GSP preferences are of limited value and unlikely to have the potential benefits for export or foreign direct investment either of Lomé or a free trade agreement, and to try and improve the GSP solely for a group of ACP countries would, almost certainly, be successfully challenged in the WTO.

The practicalities of negotiating an 'umbrella agreement' and its detailed content require discussion between the ACP countries, but it could broadly take the form of the free trade agreement incorporating a general timetable for trade liberalisation. The Community would offer free access to the EU market at the beginning of the agreement, with the ACP countries concerned agreeing to liberalise trade over a period of somewhere between 10 and 15 years (probably the maximum acceptable to the WTO). A commitment would be made to liberalise $x\%$ (e.g. one-third, or one half) of tariff headings by the mid-point of the agreement and all tariff headings by the end of the transitional period, and each ACP country would undertake to submit a binding schedule of trade liberalisation measures to the EU by an agreed period of time (e.g. three years) after signature of the agreement. This time period would be necessary because the drawing up of the schedule would be very demanding on the limited resources of many ACP countries and they would probably require technical assistance. In view of this, it would probably be necessary to obtain a waiver covering all ACP countries for an extension of Lomé past the year 2000 until the year set for the beginning of the transitional period of the free trade agreement. Aid and technical assistance provisions would be closely linked to the phasing of the transitional period.

For those ACP countries not joining the free trade arrangement, Lomé would be renewed broadly on its existing terms, but with improved coverage for agricultural products of interest to the ACP countries.

For both a renewed Lomé and a free trade agreement, the ACP could seek to improve on the present, Lomé, *rules of origin*. The stringent process rules require ACP countries to add value to non-originating (i.e. non-ACP or EU) inputs which is often beyond their manufacturing capabilities. The exclusion of 'simple processing' and 'simple assembly' discriminates against the least developed countries, while rules on fisheries are prohibitive (see McQueen, 1982). Some minor concessions have been made over the years, but the rules remain highly restrictive and discriminate in favour of EU as against non-EU suppliers. Unfortunately, improvements are even less likely in the future as the Green Paper indicates that rules of origin for all preference schemes are to be harmonised and this will make it more difficult to liberalise the rules for the ACP.

All ACP countries would participate in a Financial and Technical Assistance Agreement focusing on particular areas, notably building export capacity, with different instruments tailored to the needs of ACP countries at different levels of development (this is explored more fully in Chapter 6).

An alternative structure for negotiation, and one which would appear to be favoured by the Commission (following the pattern set for the CEEC and Mediterranean countries), is to negotiate new agreements on a regional basis. The difficulty is that the ACP countries do not conform to homogeneous geographical regions. In Sub-Saharan Africa, for example, the most obvious regional groupings are the 23 ACP members of COMESA (Common Market for East and South Africa), the 7 members of CEAO (Communauté Economique de l'Afrique de l'Ouest), the 3 members of the MRU (Mano River Union), and the 6 members of the UDEAC (the Customs and Economic Union of

Central Africa). This still leaves a number of countries not covered by these regional groupings – Ghana, Nigeria, Togo, Cape Verde, The Gambia and Guinea-Bissau. In theory, these countries, together with the members of the CEAO and the MRU, could be covered under ECOWAS (the Economic Community of Western African States) but in practice, the economic, political and cultural differences between the member states have meant that the ECOWAS Treaty is 'a dead letter' (Faroutan, 1993). These groupings also omit Zaire, Sao Tomé and Principe, and the Seychelles. Levels of economic development, structures of the economic and future development strategies all differ substantially within these groupings and it would therefore be extremely difficult, if not counter productive, to arrive at a common negotiating position with the EU. The Caribbean countries also exhibit substantial differences in per capita incomes, sizes and structures of the economy and future development strategies (particularly the vulnerable Eastern Caribbean countries). The economic interests and levels of development of the Pacific countries also show large variations and therefore substantial differences in their objectives in a new agreement. An 'umbrella agreement' negotiated between the EU and the ACP group would avoid the need to accommodate the conflicting objectives of countries within a regional grouping and the problem of how to cover ACP countries outside regional groups, and would most effectively utilise the negotiating capacity of the ACP.

In conclusion we would emphasise the following. First, we believe that the Lomé Convention could be renewed with a WTO waiver in the same way that the US renewed the Caribbean Initiative, provided the political will is present on the part of the EU. Second, a free trade arrangement is inferior to unilateral and multilateral trade liberalisation *unless* it enables the ACP countries to obtain EU concessions and assistance *not otherwise available*. In any case, most ACP countries would have to engage in trade liberalisation if they are to minimise the

potential costs of an FTA. Third, the most important policy objective for the ACP countries is to integrate their economies much more closely into the world economy, and preferences are now of relatively minor importance (and may be counter-productive) in accelerating this process. Much more important are the domestic policies of the ACP countries which rationalise and reduce barriers to imports in a

non-discriminatory manner as between trading partners, and policies which enhance the export capacity of the country. A new agreement could be useful in providing preferences in 'sensitive' goods and providing some degree of guarantee of unhindered market access, but its most valuable potential role is in supporting and reinforcing domestic policies in the ACP countries.

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Improving Supply Responses in ACP Countries

Complementarities Between Government and the Private Sector, with Particular Reference to SMEs

Summary

The conventional wisdom regarding structural adjustment is that to 'get your prices right' is both a necessary and sufficient condition for growth. This report takes the view that 'getting prices right' is necessary but not sufficient. It suggests that some interventions are also required. These can be divided into two categories functional and selective (Lall 1994a). The former are those interventions which address market failures without favouring any specific activity (e.g. provision of infrastructure, institutional capacity, education), whereas the latter 'are designed to favour individual activities or groups of activities in order to remedy specific failures or externalities that would lead to sub-optimal resource allocation either in a static or dynamic sense' (Lall, 1994b p.65). Selective interventions address market failures concerning the creation of a dynamic capacity within an economy in particular information and technology upgrading, and skills formation.

Governments also have important roles to play in the co-ordination and timing of policies. This ensures that the skill creation, technological capacity and know-how are developed in line with requirements. However 'government failures' exist in developing countries, and assistance is required to help overcome resulting problems.

An example of this approach is seen in Taiwan ROC where the complementarities between market mechanisms and government interventions have been very successfully exploited. The case study of Taiwan provides many

important lessons for other developing countries.

Increased globalisation means that growth must be private sector led. This requires greater emphasis being placed on micro, small and medium-sized enterprises (SMEs).

The second part of this chapter examines the importance and potential benefits of small firm development in developing countries, and stresses the need for a strategy rather than ad hoc development. This is particularly important since small firms experience greater efficiency when they operate in clusters or groups. Under such conditions horizontal and vertical links develop between enterprises. These, together with subcontracting, result in a network of formal and informal relationships which greatly enhance flexibility and speed of reaction time.

Any post Lomé agreement needs to target assistance towards overcoming 'government failure', and to provide assistance to support small enterprise development.

4.1 Introduction

The discipline imposed on economies by globalisation and liberalisation requires countries to adopt forward looking and outward oriented policies. However many developing countries are characterised by low growth, political instability, weak and fragmented industrial bases, and low and unstable export earnings that are highly concentrated in primary products. Under such conditions economies are vulnerable to both exogenous and endogenous shocks. Their problems are exacerbated when governments pursue weak macro policies which result in inflation,

4 The authors would like to thank Mr. Carl Greenidge for his helpful comments on Chapters 4 and 5.

low levels of private and public savings and investment, overvalued exchange rates, and balance of payments problems.

Faced with such problems governments often engage in indiscriminate protection, the results of which resonate throughout the industrial and manufacturing sectors, causing increased costs and uncompetitiveness, low levels of productivity, and rent seeking behaviour. Under these conditions countries are clearly unable to meet the levels of efficiency required for successful participation in world trade. Adherence to a sound macro policy, together with the rule of law and a degree of political stability are necessary conditions for participation in the global economy, and for economic growth and development.

Many ACP countries, through structural adjustment programmes, are implementing macro policy reforms in terms of financial and trade liberalisation, exchange rate policies, and reductions in public sector expenditure. Some still have a way to go.

The conventional wisdom, however, is that this 'getting your prices right' is both necessary and sufficient for growth. The alternative view put forward in this report is that 'getting your prices right' although a necessary condition for growth is not in itself a sufficient one. Efficient selective intervention in both product and factor markets to facilitate market entry, to support industrial and export expansion and the formation of a technological capacity, and to create new markets, is also necessary for sustained growth.

To understand this controversy it is necessary to understand the implicit assumptions of the conventional approach to structural adjustment. This assumes:

- 1 Goods markets will provide the correct signals for investment if allowed to operate freely.
- 2 Markets for factors of production are free to respond to these signals.
- 3 As a result, the economy will make the

most efficient use of the country's resources. The 'guiding hand' of the market with its constant flow of information can never be improved upon by government.

- 4 The acquisition of technological capabilities and knowledge does not enter into this analysis because it is assumed to be available throughout the world and can be easily obtained by a developing country. Indeed, it is often claimed that latecomers can grow more rapidly because they can acquire the hard won knowledge of today's more developed countries. Increasing the technological capacity of a country is therefore seen as an engineering problem, not an economic one.

In this view of the world, the role of government is solely to provide basic public institutions and a legal framework and pursue macro policies which will ensure a stable and predictable economic environment. It may be accepted that some factor and product markets may not operate efficiently where there is a public goods issue. An example would be education, where the social benefit may be greater than the private benefit captured through increased lifetime earnings and where the time horizon of individuals may be less than that of society, in which case there will be private under-investment in education. Similarly, firms may under-invest in training workers because other firms may 'free ride', not train workers, and simply poach them away with higher wages. In these cases the conventional wisdom would be that government intervention is potentially beneficial provided the intervention is *general* and *neutral*, that is it is not selective between different economic activities or economic agents (for example policy should be neutral as between foreign and local firms). Also, such limited interventions should be *indirect*, utilising the market, for example, through a system of taxes and subsidies. The general conclusion of the conventional structural adjustment approach is that there is no need for policies to support, protect, and induce the acquisition of

technological capabilities and knowledge in developing countries (Pack and Westphal 1986), or to create new industries and upgrade existing industries from which new dynamic comparative advantages will result (Biggs and Levy 1990), and that where governments have done so, for example in the NICs, these policies have had few positive structural effects (as discussed for example, in World Bank 1993. This conventional view is also largely implicit in the thinking underlying the policy prescriptions of the Commission, as outlined in the Green Paper.

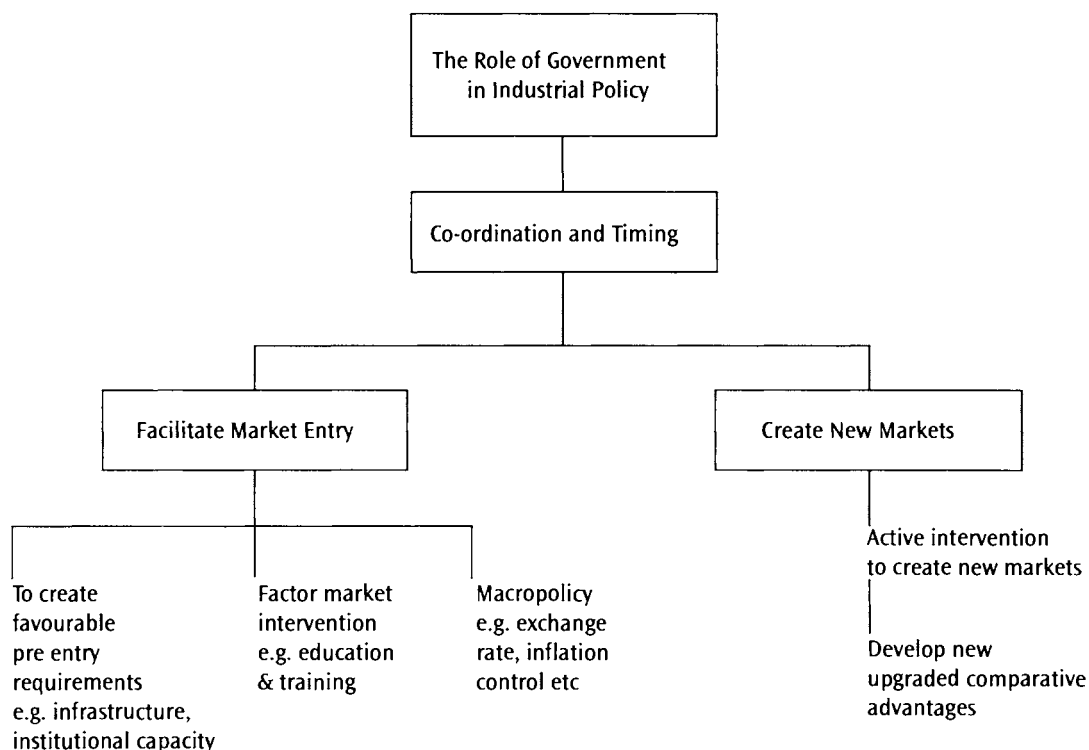
The alternative view, forwarded by this report, strongly supports Lall's analysis (1994a and 1997), and that discussed in the Industrial Development Report (UNCTAD 1996). As stated earlier, globalisation means that countries must adopt outward oriented policies, this has necessarily resulted in the need for governments to adopt the discipline of appropriate macro policies. This approach strongly endorses the conventional view that sound macro policy and

structural change are fundamental prerequisites for industrial and export-led growth. It also recognises that globalisation has changed, and to some extent reduced, the role of governments in formulating economic policies. However, this report advocates that the development of sound and efficient industrial and trade sectors, which are capable of acting as a platform for export-led growth requires that further interventions be undertaken. The nature of such interventions will be discussed in subsequent paragraphs. Within this approach we can distinguish clear and decisive roles for governments in co-ordination, the timing of policy executions, and in planning and implementing interventions designed to assist the development of industrial and trade sectors.

4.2 The Role of Government

The role of government in this approach is outlined in diagram 4.1 below.

Diagram 4.1 **The Role of the State in Industrial Policy**



Consider first the role of government in policy co-ordination. As countries begin to develop, industries and markets do not necessarily develop in a well co-ordinated and logical manner. Pockets of economic or entrepreneurial activities may arise, but their future development may well be thwarted by insufficient physical and business infrastructure, and under-developed financial markets or export channels. The timing and co-ordination of policies aimed at developing these support systems is crucial. Similarly in the early stages of industrialisation, output consists primarily of low-tech, labour-intensive commodities such as wood manufactures, garments and footwear, together with agricultural output. In order for industrialisation to proceed smoothly the development of strategic processing and heavier industries must be planned for and not merely allowed to develop in an ad hoc fashion. Future skill requirements need to be anticipated so that education and training keep pace with industrialisation. The conventional approach relies heavily on market mechanisms to provide the necessary stimulus for new industries to develop. However, the private sector in general, and entrepreneurs in particular, are motivated by profits. Profits act as a signal to entrepreneurs attracting new investments in relatively high performance industries. These profits arise out of the differences between private costs and private returns, and accrue to individual firms. For an economy as a whole however, the focus must be on social costs and social returns. Given externalities, private sector investment may, in some areas, be sub-optimal and poorly-timed.

Also, as economies develop some industries will naturally decline whilst new industries will spring up. There is a critical need to forecast, with some accuracy, both sunrise and sunset industries, and formulate policies both to mitigate the impact of shutdowns, and to train workers in the necessary skills and techniques required for the new sunrise industries (UNCTAD 1996).

The second, and equally important, role of

the state involves intervention. Lall (1994) stated that interventions can be divided into two categories – functional and selective. ‘Functional interventions’ are those interventions which address market failures without favouring any specific activity over another whereas ‘Selective Interventions’ are designed to favour individual activities or groups of activities in order to remedy specific failures or externalities that would lead to sub-optimal resource allocation either in a static or dynamic sense (Lall 1994b p.65). Examples of functional interventions can be seen in the provision of transport, telecommunications, education and health services. Other general interventions may also include supporting and restructuring the private sector, regional policies, and policies aimed at increasing overall export competitiveness.

Selective interventions address the more subtle types of market failure described by Stewart and Ghani (1991) concerning the creation of dynamic capacity within an economy. This has particular importance with respect to information and technology upgrading and skill formation. In the neo-classical model, from which the conventional approach is derived, knowledge and technology are freely, instantaneously, and costlessly available to all. In practice, in developing countries, nothing is further from the truth. One of the problems of Sub-Saharan Africa is the weakness of its technological capacity, a problem that does not appear to be abating. Also it is not sufficient for a nation or a firm to have knowledge of or acquire a technology; they must also be able to use it efficiently and adapt it effectively to their best advantage (Fransman 1986). However in developing countries local managers may not be familiar with, or fully understand the skills that are required to use imported techniques or technologies effectively, or the skills available to them in the workforce may not match those required for new technologies. These problems need to be addressed.

An integral part of developing long-term technological capacity is the need, as industrial-

isation proceeds, to develop an indigenous R&D capability. This takes time and must be carefully planned for in terms of skill developments and specialisms in specific areas such as engineering, material science and bio-technology. Most R&D undertaken in developing countries is informal and incremental, and generally falls into the 'development' category – but in order to incrementally upgrade both products and processes, firms must have a firm grasp of underlying technology. Research institutions can help adapt and develop appropriate industry-specific techniques and technologies so that firms can in turn utilise them as they stand, or modify them to suit their particular market demands. While some techniques and technologies may be mastered quickly and relatively costlessly, others may involve substantial outlays in both monetary and resource terms, and involve long time lags.

Under such conditions there are large potential social returns to be gained from the development of research institutes and programmes which, once operational, will provide an important channel through which firms and industries can upgrade. Without intervention these channels will simply not develop in sufficient numbers. However, most ACP countries do not have the capacity for such development, and there is a critical need for assistance in this area.

Another related, and well known, cause of market failure lies in the under-provision of education and training. Primary and secondary education may, to a large extent, be viewed as general training. Further education and skill training may be regarded as more specific. As has already been mentioned, there is a critical need for education policy to be co-ordinated with industrial development thus ensuring that skills are matched to requirements. Whilst primary and secondary education provide many of the skills required for shop floor supervision, many technologies are industry specific or process specific. With the ever accelerating pace of technological change the need for ongoing training is heightened. Individual firms, for reasons

discussed earlier, have on aggregate a lower propensity to invest in training employees than is socially optimal, and therefore intervention is required to ensure its provision.

When developing technological capacity governments also have a role to play in decisions involving licensing agreements and joint ventures. In Japan, the Republic of Korea and Taiwan ROC, the state played an active role in searching for and introducing new technologies (Amsden 1985). It also played a key role as a regulatory body, and took the lead role in bargaining with TNCs (Taylor 1993).

Ongoing industrialisation requires a level of institutional capacity which is lacking in many ACP countries, and governments have a key role to play in expanding and co-ordinating its development.

The final role of governments in the area of intervention concerns market creation. Twenty five years ago Kaldor (1972) distinguished the allocative function of markets from the second, less frequently focused-on function, which he called the creative function:

'a creative function – as an instrument for transmitting impulses of economic change.'

Here intervention focuses on the creation of new markets. This can be done, for example, via the state taking the lead in the creation of key upstream enterprises if the private sector is not forthcoming in their provision. The establishment of such large enterprises acts as a catalyst for the development of a host of smaller, downstream firms. This can be done either as a joint venture or, if necessary, as a state-owned enterprise. As industrialisation proceeds, or once such firms are well established, it is important that ownership and control are divested to the private sector. Such a policy, as will be discussed later, proved to be very successful in South Korea and in Taiwan ROC in the 1970s and 80s.

The case for selective interventions is strengthened if, following Bruton's analysis (1989), which may be viewed as an extension of the standard infant industry argument, developing countries in

general, particularly the least developed countries, may themselves be considered to be infant economies, and need to be protected whilst they undergo the transition period of industrialisation. This argument is heightened in a global world as these infant economies have little or no experience as global players and their fragile economies are extremely vulnerable when exposed to world markets. Under present WTO rules countries with per capita income less than US\$1000 are exempt from regulations regarding selective subsidies. However some countries, e.g. Mauritius, do not fall into this category but, because of their small size and narrow range of export commodities, still need support as they attempt to upgrade and diversify.

It is worth noting that the distortions of government policies in Sub-Saharan Africa were no worse than many other developing countries and that levels of protection and weaknesses in macro policies were probably worse in Latin America. What has made the Sub-Saharan African situation so serious is the combination of these problems with a very weak technological and skill capacity in these countries, and this will not improve significantly without government intervention, both generally in factor and product markets, and selectively in clusters of related activities, increasing collective efficiency.

4.3 Government Failure

As has already been mentioned, a great deal of government failure also exists in developing countries, both in terms of failing to eliminate market failures, and in failing to create new markets and market capacity. For example, attempts by governments of developing countries to fill the gaps in financial markets with specialist development and finance institutions have a poor record of achievement both in financial terms and in terms of poverty relief (Hulme and Mosley, 1995). If governments actively engage in promoting credit to 'favoured' industries, e.g. by subsidised interest rates, distortions can be very large. Similarly if governments do not have enough information to calculate the

true relative social costs/benefits of the formation of different industries, or of undertaking various projects, or enough knowledge of the existence of certain technologies, then they cannot play an effective role in co-ordinating industrial and private sector development.

Given the high potential for 'government failure' in ACP countries, there is a need for EU policy to be aimed at attempting to overcome this by concentrating their efforts in specific areas.

The present EU mandate here is wide. By reducing it, the Commission's strength and EU funds have the potential to be used more effectively. This is particularly important at this time when Europe is increasingly concerned with value for money, and when the percentage share of EU funds appropriated to ACP countries is being squeezed as Europe is expanding and strengthening links with the transition economies. The opportunity cost of not undertaking the required selective interventions is high, and more work is needed to establish priorities in these areas.

4.4 The Development of SMEs

This section will focus, using examples from Taiwan ROC, on the development of SMEs, and the role of governments in supporting their ongoing proliferation. If successfully implemented, such a policy has the potential to reduce dependence on primary commodities and help integrate an economy into the world trading system without heavy reliance on TNCs. However, the growth of manufactures by SMEs does not provide an 'easy quick-fit solution' for low income countries, and attempts to minimise the problems facing countries undertaking such an approach must be avoided. Nevertheless small firms offer potential entrepreneurs the opportunity to enter business activities without being faced with prohibitively high initial levels of investment and skills.

Traditionally, small firms have been viewed as less efficient than their large counterparts. Indeed

neo-classical economic theory only considers large firms which have the potential to benefit from scale economies and to produce under conditions of constant returns. However, industrialisation led by large-scale, assembly-line technology, together with its highly developed division of labour and stratification, is not always optimal in a developing country. Large firms, and in particular MNEs, have their place in industrialisation in developing countries, but the role of SMEs has not always been fully recognised and exploited. Over the last decade, increased awareness has led to changing consumer tastes and the need for differentiated products, and it is here that small firms are able to capitalise on their flexibility and fast response times.

Small scale production has many advantages including the potential to:

- (i) combat rural depopulation and migration, thus reducing the problem of dualistic development;
- (ii) enable firms to set up and develop in sectors and industries not suitable for large production i.e. in sectors where there are few scale economies;
- (iii) have a large and positive effect on the distribution of income;
- (iv) provide local employment, particularly for women, and give them the opportunity to enter the labour market either as employees or entrepreneurs;
- (v) induce potential entrepreneurs to start up businesses on an on-going basis;
- (vi) turn local savings into local investments;
- (vii) absorb and adapt technology, particularly when backward linkages between larger national firms and MNEs are established, (under such conditions small enterprises are able to incrementally upgrade using appropriate technology); and
- (viii) upgrade and enhance skills over a wide range of production activities.

With the help of government, support agencies and other private organisations these small firm advantages can be harnessed to play a major role in creating a manufacturing base. However, small size means that individual firms are vulnerable. Inexperienced entrepreneurs do not have the range of skills or the knowledge or information available to larger enterprises. If they are to operate successfully in global markets they need to have channels through which to sell their exports and acquire knowledge and technology.

Internationalisation and changing consumer tastes have resulted in the creation of niche markets which SMEs, with their enhanced flexibility and fast response times, are able to exploit. Deregulation has also, in some areas, had a positive influence on market penetration for SMEs, but many small firms still have problems in identifying new markets.

The gains from small-scale production are amplified when individual firms form part of a 'cluster', or co-operative, both in terms of employment and information flows (Pyke 1992). Industries such as footwear, clothing, furniture and mechanical and electrical engineering all lend themselves to small firm production, and by operating and interacting at differing levels the industry can together achieve what Schmitz (1995) called 'collective efficiency'. Collective efficiency may thus be viewed as the competitive advantage that agglomerations of small firms within a sector can derive from interaction and from local external economies. Such agglomerations are usually referred to as 'clusters', and can be both sectorally and geographically concentrated. Probably one of the most widely discussed European examples of the successful development of a cluster is the Italian footwear industry. Less well known, and more pertinent to the requirements of developing countries, is the ongoing and very successful development of industrial clusters in the Asian NICS, and particularly in Taiwan ROC, during the 1970s and 80s.

4.5 The Case Study of Taiwan ROC

No blue print for industrialisation exists. Different countries require different policies at different stages to cope with changing economic conditions. But the example of Taiwan ROC provides a host of important messages for developing countries. It demonstrates quite clearly that a manufacturing sector comprised almost entirely of SMEs can successfully lead the industrialisation process via its export success.

Taiwan ROC, is a small island located in the South China Sea. It has relatively few natural resources, and yet achieved such high levels of growth during the 1970s and 80s that many authors referred to Taiwan's growth as an 'economic miracle'. The SME sector, which accounted for over ninety five percent of Taiwan's manufacturing outlets in the 1980s has been described as the backbone of Taiwan's manufacturing and export industries. Yet, contrary to what was first believed by Western scholars and institutions in the 1980s, Taiwan's 'economic miracle' was not achieved solely by the operation of market forces, or 'get your prices right policies', but by a subtle mix of market forces and efficient and flexible government intervention.

Under the auspices of an entrepreneurial, and somewhat authoritarian government, Taiwan's industrial development was achieved via flexible planning undertaken by the government using a series of four and ten year development plans which were modified and changed in line with changing economic and political climates (see Wade 1990, Phillips 1994). Starting with the targeting of simple labour intensive exports in the 1960s, new, more advanced target industries and technically sophisticated ones were introduced over time, and comparative advantages established in the fields of electronics and computer technology. As industrialisation proceeded, the proportion of government-owned enterprises declined, and that of agriculture as a percentage of GDP gradually, yet substantially, reduced. The authoritative nature of the state enabled the government to pursue a sound and flexible macro policy and develop markets and

infrastructure – thus overcoming market failures.

In the 1950s Taiwan adopted import substituting policies but, unlike so many developing countries at that time, these were relatively light, and post 1960 a vigorous outward-oriented policy has been pursued. Nevertheless some I-S industries were developed alongside export industries, this was particularly so in the post-oil shock years when export and import industries were developed in tandem, primarily to counter negative exogenous forces, and to deepen their industrial base, thus reducing outside dependence. In the 1970s, the first of currently over seventy industrial parks and three export processing zones was developed along with the establishment of science and technology research centres. These provided a major stimulus to the industrial upgrading process and, ultimately, to Taiwan's export success. This success was augmented by the government's policy with respect to foreign direct investment (Amsden 1985, Haggard 1993). The Government restricted foreign investment to key industries where the technology was vital to industrial development.

Indeed although FDI was welcomed in designated areas such as electronics, chemicals, textiles and optical instruments, other areas were screened from foreign influences (Amsden 1985). Where large scale investment was deemed necessary, and FDI unforthcoming, the government itself set up large up-stream enterprise (which it subsequently divested, partly or fully, to the private sector). These large upstream plants provided the incentive for the proliferation of smaller, downstream enterprises. At the same time there was heavy investment in education and training and latterly in research and development, to support the upgrading process. Over time Taiwan's industrial base widened and deepened and during the 1970s, 1980s and 1990s more complex technologies have been introduced, existing industries upgraded, and new ones developed. This has resulted in the creation of new dynamic comparative advantages, and export successes that are the envy of many developing and industrialised countries.

Taiwan's experience sheds light on the importance of the government in providing systematic, planned, yet flexible policies, and the need for long and medium term goals and strategies. During its developing years macro policy was tight – for example interest rates and energy prices were swiftly and substantially raised in response to the two oil price shocks (see Kuo 1983 for details). Massive investment in education was undertaken. However, expenditure on further education was co-ordinated and targeted to development needs. For example during the period 1960-69 the average percentage of students in higher education enrolled in engineering was 18%; this rose to 33.2% during 1980-89 (MOEA 1989). The number of students in social sciences followed a similar trend until 1983 when, due to a shift of emphasis, there was a dramatic fall in numbers. The late 80s and 1990 show increases in the number of students undertaking management training; there has also more recently been a re-emphasis on agriculture.

A similar involvement by government in creating technological capacity can also be observed. At the beginning of 1980 government spending accounted for 60.4% of total expenditure on R&D; by 1987, as firms and private institutions began to undertake more of their own R&D (with particular emphasis on development) this figure had fallen to 50.8% (MOEA 1989).

The government also set up research institutes, and encouraged the development of both public and private organisations to support developing and upgrading industries and entrepreneurs including: The Metals Industry Development Centre (1963), The China Youth Career Organisation (1979), the Industrial Design and Packing Centre, the China External Trade Development Council (which now has offices all over the world), the China Productivity Centre, and many more.

However, perhaps the most remarkable achievement of the Taiwanese government was their ability to recognise the complementarities between government intervention and market mechanisms. This is nowhere more apparent

than in their policies directed at supporting SME development. Selective intervention may be said to have been a necessary condition for Taiwan's industrialisation and export success; it was not a sufficient one. Market forces have played a crucial and dominant role in the development of the manufacturing sector.

For historical reasons many Taiwanese businesspeople have a dislike of too much government interference, and a strong desire for independence. Cultural factors mean that strong loyalties exist between families and friends. These factors together with the lack of employment opportunities in the 1960s and the targeting of exports, provided the potential for the growth of entrepreneurship.

The role of the government here can best be described as that of facilitating, supporting and guiding market forces. By providing the necessary physical and business infrastructure, it helped create an environment in which enterprises could flourish. However selective interventions were also employed, for example, the government played an active role in creating new industries by investing in upstream enterprises and thus facilitating the development of small downstream firms, and ensuring that certain key or target industries were developed. Skill centres were developed to provide training and the changing skill requirements as industries and firms upgraded.

An array of support agencies and supply and export channels were provided by the government and the private sector enabling clusters of small firms to develop. Over time networks developed and strengthened. The government also actively engaged in promoting target industries via the provision of subsidised product development research, training, finance, and by assisting with factory designs and upgrading. Support for SMEs operating existing target industries was reduced as they developed, and new, more sophisticated industries were developed and targeted. The development of firms operating in non targeted industries was generally left to market forces, and most

of these SMEs received no specific government assistance.

Taiwan's policy towards SMEs is, however, not unique. South Korea and Japan operate a similar strategy in terms of the support systems and networking services they provide for small enterprises.

4.6 Lessons for ACP Countries

Taiwan ROC ensured that policies affecting the growth of manufacturing and exports were well co-ordinated and anticipated future needs. The government adopted an entrepreneurial attitude. It prioritised export growth and sought out and established new markets where future dynamic comparative advantages could be developed. Conditions were established, and constantly upgraded, so that the private sector could thrive. Any long term planning was flexible, allowing for upgrading and changing international conditions. The key element in Taiwan's success is that markets were allowed to work efficiently – but their establishment was managed. In short, the market sector and the government worked together in a complementary way.

4.7 Summary and Conclusions

This chapter has discussed the important and complementary roles of ACP governments, the private sector and the EU in ACP countries. It has presented the case for efficient intervention by governments, which rests on the belief that the existence of market failures means that the private sector will not develop, in the medium and long term, without some form of selective, as well as functional intervention. Globalisation has increased the pressure on ACP countries to

establish a thriving private exporting sector to act as an engine of growth. This has led to changing, and to some extent reduced roles for governments and public sectors. But governments still have a vital role to play in the co-ordinating and timing of policies, particularly in education and skill training, in the development of infrastructure and institutional and technological capacity and in creating new markets. However, in many ACP countries 'government failure' also occurs, and there is a need for support in this area to overcome market failure. A new convention may wish to examine ways in which specific support can be developed for individual countries. One of the criteria for developing such capacity is the establishment of an equal working partnership between ACP governments, the Commission and the private sector. This would enable a policy framework, binding to all parties, to be jointly established and agreed on. Policies need to be forward looking and flexible, and geared towards ensuring that the private and public sectors assume their correct role in industrial development. To do this priorities must be established and targeted. Under the 'alternative approach' forwarded by this report, selective interventions would assume a high priority. However regardless of the approach taken by different countries it is necessary to target assistance, as was done in Taiwan ROC, so that SMEs can develop in sufficient numbers as to lead export growth. Policy instruments that have a high potential to facilitate small firm growth need to be employed. To achieve the greatest effectiveness, the number of policy instruments must be limited and bureaucratic procedures minimised.

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Improving Supply Responses in ACP Countries

Private Sector Development with Particular Reference to SMEs

Summary

Governments and the EU need to demonstrate visible commitment to private sector development. ACP governments must be steadfast in their commitment and not capitulate when faced with inevitable adverse exogenous shocks. To create a workable partnership a minimum set of governing rules and procedures, that are acceptable to all parties, will need to be developed, and adhered to by all parties.

At present the CDI is responsible, within the EU, for assisting ACP countries with industrial development. It has produced a sound plan for private sector development. Its effectiveness is currently hampered by having to operate, at times, under cumbersome, centralised, bureaucratic procedures. Ways of reducing these need to be investigated. Potentially there is much to be gained by ensuring other organisations are also included, and by increasing and targeting funds towards projects particularly in areas such as financial sector development and institutional support for SMEs.

More research is required into the development of environments conducive to business growth. For example, there is a need to link the shortcomings in infrastructure with the ability to produce and market goods at internationally competitive prices, match skills with needs, and balance general and vocational training. ACP policymakers require more information. In order to obtain this, links between public and private sectors need to be strengthened.

Private sector led growth requires the development of a sound financial sector. In many ACP countries financial sectors are plagued with market failures. Increased dialogue is needed to find appropriate solutions. Foreign direct investment, technology and know-how agreements are

important for the creation of an indigenous research capacity. Centre-satellite systems are a means of diffusing skills, knowledge and technology, and creating employment opportunities. More research into their potential in ACP countries may prove useful.

There is much to be gained from the development of micro, small and medium-sized enterprises. Under the correct conditions they have the potential to act as an engine of growth for a manufacturing section. A co-ordinated policy for their development is required to ensure their sustained proliferation. The challenge of any post Lomé arrangement is to ensure that:

- (i) SME development must be given priority (European Commission 1996a);
- (ii) legal and regulatory frameworks need to be upgraded to meet the requirements of SMEs; and
- (iii) an efficient support system is required for ongoing, large-scale, small firm development. This includes the provision of a large range of private and public of institutions and agencies and the development of financial, supply and export channels in research institutes, and training programmes.

5.1 Introduction

The 1996 Green Paper highlights the need to stimulate economic growth in ACP countries through competitiveness and private sector development. The importance of the private sector has been heightened by the accelerating pace of globalisation. To operate in global markets, private sector companies must be

competitive in all spheres of business operations, particularly in areas of productivity, quality and the ability in order to identify and meet market requirements. However, as has been stressed throughout this report, the ACP countries are a diverse group not only in terms of economic and industrial development and geographic location, but also in terms of cultures and socio-economic environments. Whereas globalisation offers opportunities to some, it represents major challenges for others. Policies will be required to be both country- and sector-specific, and allow for gradual upgrading of both over time.

5.2 Industrial Co-operation

The current Lomé agreement attempts to address the problems facing ACP countries in their attempts to industrialise by encouraging industrial co-operation between the EU and ACP countries. Article 78 states the objectives of industrial co-operation:

‘Industrial co-operation, as a key instrument for industrial development, shall have as its objectives:

- (a) the creation of the basis of and framework for effective co-operation between the Community and the ACP states in the fields of manufacturing and processing, mineral resources development, energy resources development, transport and communications;
- (b) the promotion of conditions conducive to industrial enterprise development, and local and external investment;
- (c) the improvement of capacity utilisation and rehabilitation of existing industrial undertakings which are potentially viable, in order to restore the productive capacities of ACP economies;
- (d) fostering the creation of and the participation in enterprises by ACP nationals, especially those of a small and medium-size nature that produce and/or use

local inputs; the promotion of new and the strengthening of existing enterprises;

- (e) support for the establishment of new industries to supply the local market in a cost-effective manner and ensure the growth of the non-traditional export sector in order to increase foreign exchange earnings, provide employment opportunities and an increase in real incomes;
- (f) promoting increasingly close relations in the industrial field between the Community and the ACP states, and in particular further encouraging the speedy establishment of ACP-EEC industrial joint ventures;
- (g) promoting business associations in ACP states as well as other institutions for industrial enterprise and business development.’ (Lomé IV Convention)

In order to achieve these objectives, Articles 79-86 pledge EU assistance to ACP states in terms of :

- ❖ improving their institutional frameworks, financial institutions, industry-related infrastructures, and training;
- ❖ establishing key industries, joint ventures, SMEs and their support networks;
- ❖ the exchange of information, research, scientific and technological development;
- ❖ marketing products and stimulating trade.

In short, the current Lomé undertakes to assist all ACP states in almost all stages of industrial development. However, this umbrella approach has failed to produce the desired partnerships or results in many countries. Given the constraints on funds and other resources the EU is clearly not in a position to provide support in all areas to all ACP countries. Priorities must be agreed on. The EU must decide exactly where best to target assistance.

5.3 A Partnership Approach

Governments need to develop workable partnerships with the private sector, civil society in general and CDI representatives. By augmenting their knowledge and developing skills of delegation of decisions to the private sector, governments can enhance private sector development. At the same time private sector representatives must realise their responsibility to keep the government informed of their actions. A-symmetric information leads to incorrect decisions and mistrust between partners.

Given the typical differences in the approach of the private and public sectors towards business practice, the development of the channels necessary for information flows cannot be left to chance. A minimum set of governing procedures and responsibilities of the various parties needs to be formulated. Such a set of guidelines must be jointly developed and agreed, clearly stated and easily understood. What is not required is more bureaucracy and the slowing down of decision making processes.

At the present time, under the existing arrangements of Article 98, organisations like the CDI are required to ask recipient governments for permission to undertake any study or project regardless of size or cost. This is done via government channels without private sector involvement. Major problems can be encountered if the short term priorities of government are critically constrained by lack of finances. Under such circumstances it is difficult for government officials to give high priority to the allocation of funds to the private sector for ostensibly long-term projects. The introduction of a simple set of rules could act to free-up the system. For example if the CDI were required to seek permission in principle for a type of project for the development of a particular region or industry but that, once obtained, approval at each stage was left to the private sector, then decisions could be made and acted on more swiftly and there would be no conflict of interest. The private sector and CDI would need to keep officials up to date with new developments via the information channels.

Any major shift in emphasis would be a matter of government involvement.

There are also other areas of potential difficulties. The allocation of funds and success of initiatives depends on a number of authorities and/or people. For example 'coal face' knowledge and skills, market expertise, development skills, funding control, and awareness of specific countries' needs and funding priorities tend to reside within different parts of the chain of potential beneficiaries – the CDI, EIB or similar bodies, experts and consultants, and the ACP governments. It is clear from the above that each group is likely to have its own priorities and, in addition, will not have or be fully aware of the skills and expertise of the other parties.

If the various cross-party steering groups each had all the expertise and authority necessary to identify, specify, fund and subsequently monitor and manage an initiative from start to finish, many of the conflicts would disappear. In this way all involved parties would agree the terms and share accountability for their group's initiatives. In addition, the communications referred to above as being so important would be greatly simplified as individuals from all factions would be represented and would be better able to implement the communication guidelines and feed the communication channels.

5.4 Visibility and Commitment

Industrial and private sector development are ostensibly long and medium term agenda items. Whilst not advocating rigid long term development plans it is important that governments do engage in planning, are steadfast in their commitment to the private sector and that the correct signals are given to the business communities, both nationally and internationally, and to civil society in general. A visual commitment to change and planning, and to private sector development signals the potential for investment first nationally and, ultimately, from international companies. The path of industrialisation is not always smooth – endogenous and exogenous shocks can result in major setbacks. If

governments do not show steadfast commitment to the private sector, but capitulate at the first major obstacle, the process will come to an untimely halt. The same analysis may be applied to the Commission and other international agencies. If the Commission and member states are earnest in their desire for partnership and private sector development in ACP countries, they must demonstrate and signal their commitment so that others can see, and act on it. Individual member states must publicly promote the ACP countries as potential markets for investment, and as suppliers. They must also encourage joint ventures with ACP countries.

5.5 The Centre for the Development of Industry (CDI)

Past constraints on industrial co-operation

The EU has three main organisations which are responsible for co-operation and industrial assistance – the Commission, the Centre for Development of Industry (CDI) and the European Investment Bank. These organisations, though fully aware of the need for ongoing and dynamic change in a global world, have been severely constrained by the nature of the existing Lomé arrangement. As an example of this The Committee on Industrial Co-operation, under Article 87c, has the authority to organise ‘on the request of the Community or ACP states’ a review of industrial policy when conditions dictate. In reality industrial policies must be flexible and continuously reviewed. Procedures are currently too bureaucratic, cumbersome and centralised to be sufficiently fleet of foot to execute instructions within a dynamic commercial environment. These issues must be addressed to enable the CDI to continue to improve its effectiveness.

Also, in the early years of the IVth Lomé Convention, industrial co-operation between the Commission, the CDI and the EIB was not always what it could be. As part of ‘The Halfway Revisions’ the new Article 89 stipulated that co-operation between these institutions be intensified. Since 1995 there has been definite progress and the CDI and EIB are more active in industrial forums

and planning (European Commission, 1995).

Project funding

Before looking at some of the important aspects of the CDI’s current and future roles it is useful to look at past fundings.

In 1994 the number of ACP beneficiaries of CDI assistance was 545, and the total number of projects handled was 192. This represented a 24% increase over the previous year and approximately one third of total admissible applications. All accepted projects were subject to pre-selection criteria by the antennae and the CDI.

The geographic and sectoral spread of these projects are shown below.

Geographic Location	1994%	1993%
East Africa	25	18
Southern Africa	22	20
West Africa	22	24
Central Africa	7	14
The Caribbean & the Pacific	24	24
Sectoral Breakdown in 1994		
Agro-industry	35	
Building material	32	
Clothing	15	
Others	18	

In 1994, the agro-industry accounted for 41% of the budget. Overall 34% of CDI interventions were aimed at new enterprises and pilot projects, 35% at expanding and diversifying existing enterprises and 31% at rehabilitating or consolidating existing projects. Interventions fell into two categories: technical interventions on the floor (56%), and those which could be classified as feasibility studies, diagnoses and expert and commercial assistance (44%). During the same year 31.3% of the projects supported by CDI were small 18 business projects, whilst 68.7% were medium-sized. Approximately 50% of assisted enterprises were joint ventures (oppcit).

Sector and key industry development

The 1994 figures demonstrate the importance of the agro-industry and the focus on project, rather

than sector, assistance in the CDI policy framework. This is not surprising as one of the first stages of developing a manufacturing base is to diversify into processed agricultural commodities, thus utilising prevalent basic skills and techniques. However, it is also important that the least-developed countries develop new, labour-intensive manufactures which are suitable for export, and that the more developed ones upgrade, deepen and widen their industrial bases by establishing more technologically-dependent industries. To do this, it is necessary to adopt a more sector-based approach to complement project-based assistance. Whilst projects need to be selected on the basis of their potential for success and profitability, it is also important to select projects which have the potential to generate a long term multiplier effect, and ones which can be viewed as key industries which have the potential to spawn further industrial development. In this way, long-term goals may be sought while meeting short-term imperatives, as recognised in more recent CDI plans.

Such key industries have historically been established by the public sector and divested over time as industrialisation proceeds. However, where the public sector is under-equipped to take on such a role, joint ventures with foreign firms or with the public sector can also be used to establish such industries. Focus on private sector development should not result in the exclusion of the public sector, nor should the public sector monopolise industries which are more suitable for private sector development. Investment by foreign firms can, under the correct conditions, provide the necessary technology, know how, management and marketing skills which are such key components in any individual firm's success. The benefits from joint ventures are amplified when the resultant organisation can become part of a centre-satellite programme⁵. When selecting joint venture projects for funding it is important, therefore, to ascertain the potential of each joint venture enterprise to act as a centre firm from which downstream medium-sized and small satellite firms can develop.

Such development has been demonstrated in Taiwan ROC, to lead to strong backward and forward linkages and the establishment of business networks. As will be discussed later in this chapter a formalised centre-satellite programme needs a co-ordinating body experienced in private sector development to help start up, train and upgrade small firms in all aspects of business development, and also to set standards and monitor both centre and satellite performance. This ensures the quality of output and, ultimately, exports. In Taiwan this role has been, and still is, performed by the China Productivity Centre which is a privately-owned, government-sponsored organisation. The centre-satellite programme in Taiwan has been a resounding success over the years. It has helped to establish many new industries, and upgrade traditional, labour-intensive ones, launching them into export production. There is a great deal of potential for using a similar programme within the ACP countries, particularly in those countries where the private sector is beginning to become established.

The development of more information and resource-flow channels

The CDI antennae system and the follow-up procedures in the aforementioned mentioned report show that information and resource-flow channels from grass root enterprises to fundholders and policymakers are becoming established, but there is still room for more work in this area. At the present time the CDI has over 60 antennae, together with national and regional correspondents and specialist consultants. The CDI has a wealth of technical experts who are active both in industrial development and the co-operation process, but their resources are stretched. There is a need to evaluate the possible ways of targeting, expanding CDI budgets and involvement, and the inclusion of other agencies, institutions, groups and individuals to assist the CDI with private sector development.

5 Centre-satellite systems will be discussed in more detail in subsequent paragraphs.

5.6 The Need For Entrepreneurial ACP Governments – Ways in which the CDI and Commission Can Help

One of the key players in the private sector is the entrepreneur, but it is often difficult for government officials and private sector employees to relate to such individuals, or to become more entrepreneurial themselves. However economies like the Asian Tigers have industrialised through a combination of entrepreneurial and authoritarian governments. Article 110 states that 'fostering of ACP entrepreneurship is crucial... 1.(vi)'. In most ACP countries entrepreneurial skills within government and the public sector are very scarce. This has the potential to produce problems which could resonate throughout the industrial and export sectors.

Firstly, if entrepreneurs and government officials do not hear the same tune there will be no harmonisation of policies and actions. This problem is exacerbated if entrepreneurs are not involved at the policy planning stage.

Secondly, a related problem may emerge at a more decentralised level. Regional or local officials may misinterpret the essence of rules and procedures for the private sector or, even more catastrophically, they may believe, given their mindsets, that a policy is not appropriate and deliberately block or slow its implementation at grass root levels. This calls for:

- ❖ documentation to be clear and simply presented with the minimum potential for misinterpretation;
- ❖ dialogue between the private and public sector and the CDI at all levels;
- ❖ the use, where at all possible, of officials who have at least a working knowledge of the private sector; and
- ❖ some basic training of government officials in the mechanisms underlying successful business practice.

Thirdly, if governments themselves are not entrepreneurial they will not respond to market

signals, resources will not be channelled appropriately, and opportunities will be lost.

However, governments cannot become entrepreneurial overnight. There is a clear role here for the EU to provide some assistance. The CDI, with their comparative advantage in business practice, are in an ideal position to (i) help governments understand the importance of being entrepreneurial (ii), provide support for them to become so. However the scope for CDI involvement is limited by its budget, and other organisations could also play important roles.

Until now the CDI's role had focused primarily on stimulating and maintaining growth in the private sector, but it could be expanded to include more initiatives to improve public sector awareness of business. Alternatively other organisations could provide such a role. This approach would only work if both parties recognise the added advantages of co-operation and openness. Ultimately they would be better placed to understand each other's priorities, positions, and constraints, and to develop complementary skills and procedures.

5.7 Creating an Economic Environment Conducive to Private Sector Growth

The ongoing proliferation of private enterprises depends on the creation of an environment which will encourage entrepreneurs to engage in market making activities. As has been previously mentioned, the first and most fundamental prerequisites for this are good governance, rule of law, a stable economy, and the existence of a sound macro policy framework. Similarly, institutional arrangements, infrastructure, and education policies must keep pace with industrialisation.

Infrastructure support

As a recent survey (Stern and Gugerty 1986) points out, it is easy to list the shortcomings in the supporting structure of the Sub-Saharan African countries – a weak legal system, poor telecommunications, lack of roads and well maintained ports, lack of appropriate human capital, a failure to

develop a variety of export support services. However, there is little research linking these shortcomings to the ability to produce and market goods at internationally-competitive prices, yet without this information it is not possible to rank the relative importance of these factors and design appropriate policies. A further difficulty in the context of physical infrastructure is an absence of information on the extent to which the poor infrastructure is due to under investment in capacity, compared to the lack of maintenance of the existing capacity. The need for information and research to determine the priorities for building infrastructure is underlined by the observation that most successful developing countries (and for that matter many industrialised countries) have many serious gaps in their infrastructures. It is therefore crucial to identify those deficiencies that really matter for achieving the objectives that the ACP have established for their economies. Close collaboration between public and private sectors has proved to be an essential element in providing information on which these priorities can be established. In the context of EU-ACP development co-operation, this requires an institutional mechanism enabling the private sector to participate much more actively in the policy dialogue and in the development of the NIPs. An increase in direct private sector participation in infrastructure projects is also probably essential in most ACP countries, because public resources are inadequate to meet the huge task of investment and upgrading. The methods by which this can be achieved will vary between countries, but in all cases will involve changes in the legal and regulatory framework to induce greater private sector participation by local and foreign companies. EU countries have developed a considerable expertise in this field and have been particularly active in providing advice to East European countries. ACP countries could usefully target this as a particular area of co-operation.

Investment in human capital

It is axiomatic that investment in human capital increases growth but, as discussed above, this observation is not useful to policymakers unless

translated into more precise statements at the individual country level. Is the problem one of a general lack of literacy and numeracy or is it that the skills developed through the education and training system do not match the needs of the economy? Is the balance between primary, secondary and higher education correct (given scarce resources)? Is the balance between general and vocational education correct? Again, there is very little information available to ACP policymakers in deciding such crucial issues and yet decisions on these matters lie at the heart of building a successful and internationally competitive economy. As with decisions on infrastructure in general, so decisions on education and training require a close and constant interaction between the public and private sector to determine the best mix of education and training and between formal and informal training (apprenticeships and in-service training) and between public sector, private sector and the joint provision of training. ACP countries could usefully obtain assistance in answering these questions and on the basis of this, determine priority areas for action in their NIPs.

A thorough analysis of training (Biggs, *et al*, 1996) based on panel data for two hundred firms and a series of case studies in eight Sub-Saharan African countries (Burundi, Cameroon, Côte d'Ivoire, Ghana, Kenya, Tanzania, Zambia, Zimbabwe) concluded that:

- 1 Because of the complexity of technology and many uncodified elements, learning by doing, trial and error and step by step incremental learning are all important for technology transfer. Accordingly, pro-active time consuming efforts must be made by firms to transfer new process and product technologies and these investments can be costly.
- 2 Successful absorption of a new technology is only the first step. After the initial learning is mastered, it is critically important for firms to develop the ability to adapt and modify the practices as circumstances change.

- 3 The leading source of technical learning in firms in all countries comes via private channels. When firms are unable to meet their technological needs internally, there will be a demand for technical support services of government, NGOs and donor agencies to fill the gap.
- 4 Learning by doing, on-the-job training and internal tinkering, adapting and modification are cited as the most important sources of technological capability and productivity gains over the lifetime of the firm. Such technical efforts are also occurring in African firms. The firms that we interviewed in Africa are engaged in training workers, rudimentary research and development activity, and development and use of technical documentation and technical offices.
- 5 Where African firms appear to differ from their Asian and Latin American counterparts is in the overall incidence and quality of internal technical efforts. Only a very few large firms, mostly multinational corporations, have in-house training courses. The same is often true of the other elements of internal technical effort.
- 6 The internal technical efforts of the firm will not amount to much if the environment within which the firm operates is not supporting these efforts with new inflows of know-how, new market connections and access to individuals with technical expertise. The availability and quality of business support services are crucial elements in the internal learning process. That these external support services, both private and collective, have been weak and missing in some cases has limited significantly the effectiveness of enterprises' internal technical efforts.
- 7 Where African firms have access to foreign flows of technical knowledge through technical assistance contracts, technical

licence agreements and foreign ownership, studies show that they were more productive. Such private external learning mechanisms increase average firm productivity by about 30 percent. The priority task for public policy at the firm level is first to ensure that the business environment facilitates – rather than obstructs – the development and functioning of the private-to-private flow of technical know-how at home and from abroad.' (Biggs, *et al*, 1996, pp.108-111).

The challenge for a new Convention is to learn from such empirical studies and to target and channel more resources and organisational effort, both by the ACP and the EU, into substantially upgrading the technological capacity of firms.

5.8 Financial Sector Development

The changing emphasis in ACP countries towards private-sector-led development means that financial sector development assumes even greater importance. In many African states, liberalisation has not progressed as swiftly as was hoped, and their financial sectors remain underdeveloped and plagued with market failures, rent seeking behaviour and inefficiencies. Central banks are often still government-owned or controlled, private sector banks operate under severe capital constraints, and there are few, if any, financial institutions which cater for business development needs. Private and public sector savings are low, and there are few mechanisms by which savings can be mobilised into efficient and socially-desirable investment projects. Banks in most ACP countries often appear to be inadequate in all functions not only for long term investment, but also for working capital and the provision of adequate and timely pre and post export finance. 'Banks typically are uninterested in adapting financial products to meet the needs of viable small or medium enterprises. The tendency is to try to mould the customer to an existing set of financial products. As a result,

bankable small and medium enterprises have a hard time accessing overdrafts and short term capital, let alone credit for expansion' (Biggs, *et al*, 1996, p.115).

Sources of financial services outside of banking are often even more limited or are non-existent, for example, equity markets, leasing, venture capital, and insurance.

Under the present arrangement the European Commission have played a very limited role in financial sector reforms and development in ACP countries, though they have provided technical assistance to banks in some ACP countries to help them provide services to small and micro firms, and they have also assisted in the creation of a private sector development bank in Mali.

With an ever-increasing emphasis on private sector development, there will be a far greater need for increased assistance in the late nineties. Awareness of this requirement prompted the CDI to propose a new strategy for financial sector development. The first stage of this strategy stresses the need for increased dialogue with ACP governments to find appropriate ways to ensure that financial institutions become autonomous and independent from political agenda. Other subsequent measures include support in strengthening the role of central banks in bank supervision, and in interest rate policies so that market rates are established or approached, providing technical assistance to establish new specialised financial institutions such as private development banks, venture capital companies, insurance and stock exchange organisations.

With regard to capital market development, the CDI report stresses that capital markets in ACP countries are both shallow and narrow, and that in most African states banking sectors are heavily concentrated with an absence of competition, and intermediate finance institutions are not developed. It recommends that restoring the viability of financial institutions and building competitive and efficient financial markets should be given priority by the European Commission.

As with all policies discussed in this chapter,

the success of financial sector development relies heavily on the adoption of sound macro policy, and the provision of an adequate legal and regulatory framework. Within this, the CDI report recommends that strategies be focused on rehabilitating viable, distressed banks through restructuring and technical assistance, refining credit and interest rates, promoting new instruments and establishing appropriate regulations and supervisory structures, which can promote stable competitive conditions within banks and capital market institutions. These are new areas of activity for EU-ACP co-operation and the ACP will have to decide on those areas in which the Commission, as compared with other donors and sources of technical assistance, could most effectively assist them in the development of the financial sector.

The ACP may also wish to review the effectiveness of the present division of responsibilities between the Commission, the Centre for Development of Industry (CDI), and the European Investment Bank. For example, is it sensible for the EIB to be involved in financial initiatives independently of CDI and the Commission, especially when they have little or no experience of operating in a developing country and have no locally-based staff in an ACP country? What delays and missed opportunities have arisen from these arrangements? What problems have arisen from the overlapping responsibilities of the Commission and the CDI? Are there alternative and more effective modes of delivery available, for example using private sector suppliers?

5.9 Foreign Direct Investment and Centre-Satellite Programmes

Technology can be simply and easily divided into

- (a) technology which results from inflows from abroad; and
- (b) indigenous, or domestic technological activities.

For developing countries the most important external sources of technology and product upgrading, are foreign direct investment (FDI) and joint licensing agreements. Other sources include technological publications, universities and the Internet (World Wide Web).

Under the correct conditions FDI can act as a major stimulus to the private sector, however it can also result in enclaves of development and have a negative effect in terms of dualistic development. The spread of globalisation and economic liberalisation has resulted in FDI playing an even more important role in technology transfer. It has the capacity for transferring capital, skills and brand names, and for providing access to international markets. It also has potential benefits in terms of spillover effects on local skill formation, technological learning and competition (UNIDO 1996). However, most ACP countries (with the notable exception of economies such as Nigeria), and especially the least-developed economies, have experienced only low or insignificant flows of foreign investment, and much of that which has occurred is concentrated in mining and extraction. The actual benefits of FDI to host countries depends on:

- ❖ the host country's ability to negotiate a 'fair' package in terms of the use of indigenous labour, raw materials and other inputs;
- ❖ the level of industrialisation within the host country; and
- ❖ the extent to which linkages and spillovers develop, and human capital is upgraded.

Under the correct conditions, then, FDI has the potential to enhance the performance and development of the small and medium sector. The establishment of large upstream firms acts as a catalyst for downstream small-scale firms to locate as their suppliers. In this way backward linkages and networks develop. However, given that TNCs seek global competitiveness, they will not locate without the pre-conditions of economic and political stability, simplicity and

clarity of domestic markets, infrastructure and competitively priced factor inputs and intermediates, (Greenaway and Milner 1996). This represents a major challenge for many ACP countries as MNEs will not locate even if offered the most attractive terms.

Even without FDI, ACP countries must attempt to develop indigenous, innovative capabilities. At higher stages of industrialisation this need is heightened. Countries such as Kenya, Mauritius, Nigeria and Zimbabwe have benefited from technology and know-how agreements as substitutes for FDI (UNIDO 1996). If FDI is not forthcoming, this is an important means of obtaining technology.

5.10 Centre-Satellite Programmes

An important way of harnessing the potential benefits is by implementing a centre-satellite programme. However, as is discussed elsewhere in this report, many ACP countries cannot rely on inward investment. A major advantage of a centre-satellite (C-S) programme is that it is also equally applicable for large domestic firms (private or public) and for joint ventures. If, as is discussed in Chapter 4, private investment in a key industry is not forthcoming, efficient public sector investment could provide the necessary stimulus for small downstream firms. By harnessing the development of small firms in a formal system rather than allowing ad hoc development, the benefits are greatly increased.

- ❖ Institutes and organisations can be developed to assist small firms in all areas of production.
- ❖ Small firms have a guaranteed market for their products.
- ❖ If, as is usually the case, the centre firm is an exporter it imposes the discipline of international quality standards on its suppliers.
- ❖ There is a potential for the development of management and other skills.

- ❖ Competition and co-operation develop simultaneously between SMEs as chains of subcontractors develop.
- ❖ Once experienced, centre employees may set up on their own as suppliers of components, and often retain strong links with the centre firms, which can provide training, or contribute to satellite development in some other way.

Firms recognise mutual dependence and trust and bonds develop. More so if members of extended families are involved in the chain.

From a policy point of view the goal of a centre-satellite programme is to promote more unified production between large and small enterprises, with small downstream firms developing from suppliers of raw materials to suppliers of component parts. For example:

Centre-satellites also provide opportunities for employment, homeworking, and new enterprise creation. For example one could visualise a chain of suppliers of component parts and assemblers in the bicycle industry. Small suppliers, themselves subcontractors, provide work for homeworkers (with the necessary quality control). If, as would usually be the case, the centre firm was a national or international exporter, further benefits in the form of the upgrading of technology, management and marketing may accrue to small firms. An example should serve to underline the advantages.

A firm designated as a centre (by some national authoritative board), would have to achieve a certain quality standard (e.g. world quality standards). This firm would then subcontract work to smaller firms. In order that the satellite firms' production was of the required standard, the centre firm would give advice on production techniques and training. What usually happens in Taiwan under such schemes is that local centre employees set up as entrepreneurs once they are experienced, and work is contracted out to them. Further subcontracting by satellite firms increases the diffusion and adaptation of knowledge, know-how and tech-

• Centre factory	–	an assembly industry
Satellite factory	–	manufacture of spare parts and accessories
• Centre factory	–	producer of intermediate materials
Satellite factory	–	processing firm obtaining raw materials from upstream
• Centre factory	–	bicycle or textile firm
Satellite factory	–	equipment, component supplier

(Adapted from Development Merit 1994)

niques, and clusters of small firms develop. From these clusters some firms will emerge, over time, as more dynamic enterprises, with the aspirations and potential to develop into centre-firms and/or exporters in their own right. However, whilst still infant, such enterprises have the security of supplying, at least part of their output, to the centre. Further development of these firms depends critically on the support systems available to them as they attempt to start up, and later as inexperienced exporters. In addition, traders form an important export channel for infant firms both in terms of information collection and dissemination, and market access. Over time, research, marketing and management centres will need to be provided either by the private sector or by joint private-state enterprises. Examples of domestic enterprises as centre firms can be seen in agro-industry, light manufactures, or when the informal craft sector is positioned to upgrade.

Under the present Lomé Convention, the CDI has been the main instrument for providing technology advisory services to SMEs. The development of centre-satellite systems would provide opportunities for the CDI, and other organisations to extend their work in this area and to co-ordinate and develop technological capacity, particularly in the higher income ACP countries, and basic manufacturing capacity in others. Technology transferred must be appropriate for any individual country, and 'imported technology' may need to be adapted to meet local needs and conditions. In Taiwan ROC, the China Productivity Centre,

monitored standards and requirements and co-ordinated with research institutes on adaptations required. In the early days of its industrialisation, research institutes consultants and engineers from abroad all played a critical role in adapting basic technologies.

5.11 Small and Medium-sized Enterprise Development

Policies aimed at supporting the SMEs

Developing countries in general lack appropriate, effective policy frameworks to promote the growth of SMEs and, where they do exist, they are fragmented rather than fully integrated into macro-economic policies. Little attention is given to the specific fiscal and financial measures needed to promote SMEs. Article 97 refers to the development of financing schemes in favour of SMEs, but individual countries must also adapt their legal and tax systems to favour small firms.

In policy terms, as is stated in the discussion paper on Private Sector Development Framework (European Commission 1996a), any approach must be based on identifying a country's needs and the building of a private sector support system which tackles the country's main deficiencies.

Upgrading the legal and regulatory framework to meet the requirements of SMEs

Over time, legal and regulatory frameworks evolve within countries to regulate and govern the activities of large enterprises within the industrial sector. It is important that rules and regulations relating to business operations and performance are changed and updated to meet the needs and the requirement of small, medium, and micro enterprise operations. Deregulation and structural reform should ensure that SMEs are treated on an equal basis to that of their large firm counterparts, and that an appropriate policy mix is established. Business practice is frequently hampered by numerous regulations, and small firms find themselves encumbered with rules designed for larger enterprises that are not applic-

able for small firms. Lengthy procedures also impinge more heavily, in relative terms, on small firms. In a field study of micro-enterprises operating in seven countries, including Swaziland and Niger, Morrisson *et al* (1994) found that the major institutional problems relating to start-up of micro enterprises revolved around difficulties in obtaining authorisation to operate, and submitting to certain types of inspection. In contrast, established firm problems focused more on taxation.

Small firms also experience difficulties in their attempts to adhere to international and domestic regulations concerning environmental and labour related issues. The 1996 Green Paper states the need for industrial development to be in line with world environment standards and labour laws. Both still pose major problems for ACP countries.

Institutional capacity

As has been mentioned previously, in many ACP countries there is a need to expand the institutional framework to cover areas such as design and productivity improvements, as well as technical, managerial and marketing support. In their study of Mauritius, Lall and Wignaraja (1997) point out that SMEs are handicapped in terms of poor quality, management, rudimentary design capabilities and low incidence of technology contracts. More institutions which are involved in helping SMEs to achieve world standards such as ISO 9000 are needed. In Mauritius the Mauritius Standards Bureau and Diffusion System was set up as part of a World Bank competitiveness upgrading project.

Small and medium-sized enterprise sector development

SMEs are fundamentally different from large firms in terms of aspirations, management, operations and behaviour. The large enterprise, with its focus on scale economies, internalises to reduce transaction costs and achieve efficiency whereas small firms' advantages lie in their flexibility and speed of reaction. They rely on

product differentiation, economies of scope and niche market penetration. Whilst their small scale gives flexibility, it also heightens their vulnerability to changes in demand and supply, in both national and international markets. To overcome this small firms engage heavily in sub-contracting and need outside channels for marketing their products and for technology diffusion. A small firm sector, or cluster, operates by networking at all levels of business operations.

It is highly unlikely, in developing countries, that the on-going proliferation of small firms will occur spontaneously. The small firm sector cannot flourish without the development of an efficient support system, which adapts, upgrades and evolves in line with the needs of small firms. Without such support individual firms cannot develop the networking required for dynamic growth. Typical areas of specialisation and operations include private financial institutions to provide medium and long term loans to small enterprises, marketing institutions and organisations of trades, Chambers of Commerce, and industrialised development centres.

Problems facing micro, small, and medium-sized enterprises

Finance

Many small firms lack access to institutional funds. Successful rural revolving credit schemes have been developed by NGOs, but there is a need for increasing the numbers and availability of such schemes. Slightly larger new firms, and established ones seeking to expand, have higher funding requirements. These entrepreneurs often face insurmountable problems in trying to gain access to more formal lending channels. Unable to provide the collateral or business plans required by banks, these businesses are denied funds despite the small size of the loans they require and the fact that, on average, small firms in developing countries have been found to be no less creditworthy than large ones (UNIDO 1989).

Sufficient effective mechanisms for the delivery

of funding to enterprises still need to be developed. Small firms' competitive advantages are based on flexibility and fast reaction time – if opportunities arise they must be ready and able to respond. There is little point in applying for loans or grants if the bureaucracy is so great that the process takes several months – by that time market conditions may have changed and opportunities lost.

Related to this is the need for efficient institutions which are able to provide small, as well as large, amounts of credit. At the moment the EIB has a budget of 100mEcu for developing countries. However, the main thrust of the EIB operations is as a financing institution for European banks. Banks are, by nature, risk averse and do not have the facilities to execute many hundreds of small loans. Because of this, funds are not always taken up. What is needed is a re-think in terms of the distribution of loans with increased focus on the requirements of small firms and projects rather than large ones. 'Europe needs to take risks when looking for financial return' (Report on Europe's Development Aid, Wilton Park Conference, Feb. 1997).

Training

Shortages in training may arise because:

- ❖ individual managers/entrepreneurs are unaware of the need;
- ❖ there is a deficiency in the provision of finances, institutions, agencies and individuals for the provision of training;
- ❖ there is a mismatch in the training offered and that required by entrepreneurs at any given time;
- ❖ there is insufficient funding within enterprises.

As discussed earlier, insufficient training will be provided by the market and some form of intervention is required to make up the short fall.

However, small firms are not homogenous in their aspirations and abilities to grow. Many owners of family firms do not aspire to become large national or international traders, but desire

only a modest income. Other 'true' entrepreneurs are motivated by profit, growth and status. The most important aspect of training is, like all other features of private development, that it be targeted correctly and planned systematically. Given the limited resources available for training it is important that expensive training packages are not wasted on firms which do not require them.

Empirical studies can provide assistance in categorising and selecting firms for different types of training.

The CDI's 1995 discussion paper (aforementioned) states that 'Actions will be developed to provide professional management development in specific skills and continuous training at appropriate levels, both in the public and private sectors'. The development of a centre-satellite programme would enable small firm managers via their links with large enterprises to enhance their skills. Such schemes would be complementary to CDI practice.

CDI policy for strengthening trade links for the private sectors includes the development of more trade associations, programmes to support enterprises in specific sub-sectors which place emphasis on product quality improvement, market research, the strengthening of trade-related infrastructure and services, and the development of national or regional trade development programmes (European Commission 1996a). These policies require adequate funding and support if they are to achieve their goals.

Finally, as discussed earlier, educational requirements need to be anticipated, and training programmes co-ordinated to provide the skills needed by firms.

5.12 Conclusions

If ACP countries are to be integrated into the global economy, adequate policies to stimulate growth via private sector development and trade are required. Under Lomé IV, EU policy includes financial and technical measures to support structural reforms, and to promote support in areas such as infrastructure, agriculture, industry, ser-

vices, and human resource development, as well as direct support for private sector development, in the form of investments, trade and enterprise development, and financial and technical support provided by the EIB and CDI (European Commission 1996b).

Despite these efforts in many ACP countries, particularly the African states where liberalisation is still not complete, the desired growth has failed to materialise.

Any new arrangement must prioritise and target support, to ensure that a workable and equal partnership between the EU and ACP governments must be established. The Commission must address its bureaucratic procedures, decentralise, reduce the number of policy instruments available, and target them specifically.

Currently, the CDI has a wide mandate and limited capacity and resources. It has developed a sound range of strategies to stimulate private sector development, but cannot do so without increased funding.

Other organisations may be well positioned to augment CDI activities, ensure that there is no monopoly on industrial assistance, and allow CDI to focus on where they have a competitive advantage.

FDI is a potentially important channel, but is of limited importance in most ACP countries; and there appears little prospect of this changing in the near future. Mechanisms through which other channels of technology upgrading can evolve need to be developed, and steps need to be taken to develop indigenous technological capacity at all levels. Centre-satellite systems, which have proved so successful in Taiwan ROC, have the potential to do this and integrate large and small enterprises within an industrial sector or industry. Further work in this area may prove useful.

Under the correct conditions, SMEs have the potential to become the backbone of a manufacturing sector and of exports. However, their ongoing proliferation requires the establishment of a network of support systems, and the integration of policies aimed at SME development into

a general macro framework. A future agreement needs to target resources to these ends.

Similarly more channels through which small firms can access funds swiftly need to be developed. As highlighted by the CDI, priority must be given to the development of the financial sector and markets, and also to tackling the other problems facing small firms in the areas of training, management and marketing their products.

There is a growing weight of evidence to suggest that the most effective way for developing countries to improve their situations is through the promotion of SMEs. The reasons for this seem fairly straightforward:

- ❖ towns, villages and even families tend to relate more naturally to the 'small, family business' type of organisation;
- ❖ the resources (finance, expertise, people, R & D, technology, skills, infrastructure, etc) required by SMEs are by definition much less than those demanded by larger organisations, so they are quicker and easier to set up;
- ❖ SMEs are more fleet of foot and can therefore respond more rapidly to changing market requirements;
- ❖ they can also operate in market niches too small to be viable for larger organisations;
- ❖ as SMEs expand, they tend to favour an outsourcing approach (rather than the alternative of increasing their own cost base significantly, thereby providing work for other SMEs in related areas; and
- ❖ the need for (often scarce) management skills is kept to a minimum due to the small size.

If we accept that promoting the proliferation of SMEs is a sound policy, we need to be able to encourage individuals to set up as small time entrepreneurs.

This doesn't mean that MNEs should not be encouraged. Nor does it mean that there is no role for the government in providing public sector

organisations. Indeed quite the opposite is true.

SMEs operate most effectively in groups (or clusters). Under such conditions horizontal and vertical linkages develop between firms. This network of relationships leads to stability, strength and efficiency. Clearly in order for clusters to develop individual enterprises have to start somewhere and start-ups tend to involve an entrepreneurial spirit as a driving force. However, entrepreneurial talents are often latent or absent in many ACP countries, and steps are required to reduce the perceived risks, and to create an environment in which micro, small, and medium-sized firms can flourish. Existing and potential entrepreneurs need specific knowledge and/or skills (in products, markets, manufacturing techniques, etc.) which reduce the risks to manageable proportions.

Indeed if entrepreneurs are not risk takers, then, it follows that they will be encouraged to set up operations only when certain conditions are in place. These conditions will vary between individuals, companies, markets, and countries, but it is possible to draw up a basic requirements list:

- ❖ availability of appropriate funding and access to finance on an on-going basis;
- ❖ availability of appropriately-skilled people;
- ❖ ability to 'ship' output (i.e. suitable road, rail and sea links);
- ❖ access to new technologies;
- ❖ access to market knowledge;
- ❖ availability of raw materials (or sub-assemblies) of acceptable quality;
- ❖ assistance with legal, exporting, etc procedures;
- ❖ assistance with adherence to internationally-recognized quality standards;
- ❖ freedom from over-burdensome bureaucracy; and
- ❖ stability in terms of the economy in which

they operate, enduring policies, etc. i.e. If I set up now, will it be impossible to operate in the future if policies changes?

Individual ACP governments, therefore, face the challenge of, and the responsibility for, creating such a fertile environment. In terms of promoting specific industries, centre-satellite systems have been shown to be very effective elsewhere for encouraging the start-ups of SMEs in particular areas; a 'centre' firm may manufacture bicycles, but subcontract the manufacture of many of the components (spokes, wheels, brake assemblies) to 'satellite' firms.

In such situations it is the role of governments, the private sector and organisations like the CDI to work together to identify appropriate industries (from knowledge of local/international markets, technology requirements/availability, manufacturing requirements/capability, etc.) and 'incentivise' companies to set up in these areas through skill training, knowledge transfer, financial assistance and so on.

In the same way FDI can be encouraged. FDI has the added advantage, when correctly managed, of introducing new technologies and skills which are then transferred to other companies in the chain (or centre-satellite system).

In return for providing help in these areas, those involved in providing it are able to feed information back to the centre (the planning hub) that provides input to adjust or enhance the plan in the light of successes, failures, shortfalls, etc.

In this way such an integrated process is able to identify requirements, attach priorities, and devise responses in a constructive and cost-effective manner providing (or facilitating) appropriate training as differing needs arise, easing the route to funding in appropriate cases, creating partnerships where necessary, and easing the administrative/legislative burden where possible.

Governments have, or have access to via the EU (and other institutions and organisations), significant expertise in/knowledge of world markets, quality standards, appropriate technologies, exporting procedures and so on, and

they and the EU can contribute enormously by making such expertise readily (and cost-effectively) available. Institution capacity, a fundamental requirement for industrial development, needs to be expanded and developed in order to face the new and changing requirements of the small scale sector. There is a critical need to analyse both needs and weaknesses in physical and business infrastructure (roads, communications links, exporting support etc.), within individual economies, and many ACP countries require assistance here.

For maximum effect such initiatives to promote the private sector would need to form part of an agreed and integrated policy and be targeted at certain areas and/or business sectors, with decision-making ability being devolved to the local level so as to take account of regional variations and to provide the speed of response that entrepreneurial organisation thrive on (or die without). In addition to this, a network of support systems to include research institutes, training programmes, marketing institutions, financial institutions and packages, export agencies, design and engineering agencies, to support small firms, is required if the proliferation of firms is to be sustained. Such a network would consist of both private and public agencies, balanced in the appropriate proportions, according to priorities, needs, skills and finance. To ensure co-ordination, information flows, and appropriate timing and execution of policies, efficient channels of communications are crucial. At present a comprehensive range of support agencies and packages is lacking in most ACP economies, and where it does exist, problems often arise in co-ordination and communications between agencies or institutions, or between them and the enterprises they are trying to assist. In small economies, or where the SME sector is underdeveloped, much of the necessary support could be provided by or co-ordinated by an overall body, thus eliminating information breakdown and time-lag problems. This is of particular importance in the areas of upgrading, technology transfer and finance.

Small firms' competitive advantages result from their flexibility and speed of reaction time, and their ability to adapt appropriate technologies to suit local conditions and different markets. Without appropriate support, ACP entrepreneurs will not enter markets in sufficient numbers for

them to achieve these advantages, or to act as catalysts for sustained growth and development. The EU and the ACP countries face the challenge of finding the most appropriate ways for individual countries to provide the necessary environment and support systems.

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Aid and Foreign Investment in a New Agreement

Summary

The ACP countries rely on the EU for 47% of their aid, but budgetary pressures in the EU countries will mean that future flows of aid are unlikely to increase in real terms. It is therefore essential that the ACP countries look for ways to increase the efficiency of the financial and technical assistance they received. In the context of the Lomé Convention; this requires a recognition that Community aid comprises only one-fifth of EU aid and under the Maastricht Agreement, is required to be complementary to that of the member state. The present Convention has too many policy instruments and objectives, and this, combined with accountability to the 15 member states and the European Parliament, and pressures on staffing, has led to weaknesses in the efficiency of aid and pressures to downgrade the importance of partnership and joint responsibility between the Community and the ACP countries. What is needed is a more focused aid programme and given that trade is a wholly Community responsibility, this is the most obvious area for the Community to concentrate its financial and technical assistance. If aid were targeted in this way then the ACP countries would need to evaluate the existing instruments of the Convention. The report therefore argues for a decrease in the number of 'windows' which allocate aid for particular purposes and a greater emphasis on programme aid which, while concentrating on improving supply response in the ACP countries, would be more flexible in tailoring instruments to the specific needs of the ACP countries. We recommend that the present division of responsibilities between DG8, the Centre of Development of Industry and the European Investment Bank be removed in favour of an

integrated programme (comprising a substantial proportion of the financial protocol of a new agreement), administered by a joint ACP-EU Productivity Centre, and involving participation by the public and private sectors. It would be responsible for the development of the physical infrastructure, legal, financial, education and training, technology diffusion, marketing and institutional capacity which is necessary to increase the integration of the ACP countries into the world economy. It would also advise on measures to increase the flow of foreign direct investment into the ACP countries and measures which sought to increase regional integration. Foreign direct investment flows to the ACP countries have been disappointing in terms of both volume and in increasing the competitiveness of the ACP countries non-oil and minerals sectors, although there are significant variations in experience between ACP countries, especially in recent years. Proposals are put forward to improve the content of Title III Chapter 3 (on Investment) in the Convention, especially aimed at reducing the riskiness of investing in ACP countries, and additional measures are highlighted which could increase the attractiveness and ease of investing and which could benefit from the support of the EU in a new agreement.

6.1 Prospects for Future Aid Flows to the ACP Countries

EU bilateral and institutional aid to the ACP countries increased as a proportion of total OECD aid to these countries from an average of 40% in 1983-87 to an average of over 47% in 1988-93, representing an increase in an already substantial level of dependence on the EU for

aid. At the same time, total flows of aid, measured at constant prices and exchange rates (1993), by the OECD countries to Sub-Saharan Africa are approximately 10% less than they were in 1980 and have stagnated in real terms in the 1990s. A further disturbing factor is that while there has been a rising trend in the share of EU institutional aid to the ACP countries from an average of 18% of total EU aid for the period 1983-87 to an average of 21% for 1988-93 (and over 22% 1991-93), there was considerable difficulty in reaching agreement among the EU governments over the size of the EDF 8 covering the ACP countries for the period 1995-99. The final agreed increase was over 10% less than the amount required to maintain the real value of EDF 7, despite the accession to the EU of three new member states (Austria, Finland and Sweden).

Coinciding with these trends has been the large increase in aid to the Central and East European Countries (CEEC), Russia and the Newly Independent States (NIS). OECD aid to these countries increased from \$2.25 billion in 1990 to \$7.1 billion in 1991 and since then has more or less stabilised at this level. The EU has accounted for over 60% of this aid and this raises the question of whether aid to E. Europe has 'crowded out' EU aid to the ACP countries. In one sense this question is unanswerable since we cannot know precisely what EU aid to the ACP countries would have been in the absence of the transformation of the CEEC/NIS countries. We can, however, indicate whether increased aid to E. Europe has coincided with decreased aid to the largest member of the ACP group, namely Sub-Saharan Africa (SSA). OECD aid to the SSA decreased by 0.5% p.a. in real terms in the period 1991-94 while EU aid decreased by 3.5% p.a. Caution, however, is necessary in interpreting these flows. Aid disbursements vary from year to year and this period of time is too short to draw strong conclusions on trends. Also, when EU flows are examined in more detail we can see that EU aid declined largely as a result of a sharp decline in aid from Italy to SSA and this was

paralleled by a decline in Italian aid to the CEEC/NIS countries. Aid from France and the UK to SSA was more or less constant in real terms and interestingly aid from Germany to SSA increased in real terms, despite the fact that Germany has accounted for over half of EU aid to Eastern Europe. The tentative conclusion we would draw is that there is no evidence, as yet, of 'crowding out', but that equally it is too early to reach firm conclusions.

A more important factor affecting future aid flows than aid diversion to E. Europe is the general budgetary pressures which will increasingly affect EU budgets and make it very difficult significantly to increase aid flows in real terms from their present levels.

Aid budgets have come under pressure in the EU countries, partly as a result of the need to contain rising government expenditure and partly to stabilise and if possible reduce burdens of taxation in order to improve the competitiveness of their economies. Government expenditure has increased mostly as a result of the substantial increases in unemployment in the EU countries, generating higher social security payments whilst at the same time reducing the tax base of the economy. Initial optimism that this was largely a cyclical phenomenon has been replaced by a general view that the causes are, to a significant extent, structural and that Europe's 'natural' long term level of unemployment may have increased. Pressure on budgets has also increased as a result of the need for large scale reconstruction in the former East Germany, structural adjustment required in member states such as Greece, Spain and Portugal to enable them to compete in the EU, and financial assistance required in particular sectors of the EU such as agriculture and fisheries, coal, iron and steel. At the same time, the objective of trying to meet the maximum government borrowing requirements required by single currency provisions (a maximum budget deficit of 3% of GNP and a maximum level of public debt of 60% of GNP) of the Maastricht Treaty have forced governments to introduce policies aimed at cutting expenditure and increasing

revenues, thus further depressing their economies and raising unemployment. These are all difficulties and pressures which will not easily be reduced and can be expected to continue well into the next century.

These budgetary pressure can be expected to intensify with the future integration of the six CEE countries (Bulgaria, the Czech Republic, Hungary, Poland, Romania and the Slovak Republic) and the Baltic States (Estonia, Latvia, and Lithuania) into the EU. Integration will be phased over a period of time with some countries joining the EU substantially ahead of others, but the demands on the EU structural funds will be substantial. In addition, these countries have large agricultural sectors and even with a significantly reformed CAP (itself a very sensitive political issue), the pressure on the financial resources of the EU both from existing and from new member states, will be considerable.

The implication of these budgetary pressures is that EDF aid needs to be used as efficiently and productively as possible and this requires greater focus and targeting in a new agreement.

6.2 Weaknesses in EU Institutional Aid

Too many instruments and objectives

The Lomé Convention provides for 12 areas of co-operation:

- Title I: Environment
- Title II: Agricultural co-operation, food security and rural development
- Title III: Development of fisheries
- Title IV: Co-operation on commodities
- Title V: Industrial development, manufacturing and processing
- Title VI: Mining development
- Title VII: Energy development
- Title VIII: Enterprise development
- Title IX: Development of services

Title X: Trade development

Title XI: Cultural and social co-operation

Title XII: Regional co-operation

Successive conventions have increased the range of themes which cut across these twelve areas of co-operation. For example:

- food security;
- support for structural adjustment;
- integration of women into development;
- poverty, health and education;
- support for an increased role for the private sector ; and
- protection of the environment.

The 1991 Maastricht Treaty on European union established the objectives of EU development policy as:

- sustainable economic and social development, especially for the poorest;
- integration of developing countries into the world economy;
- the alleviation of poverty; and
- observance of human rights, consolidation of democracy and the rule of law.

The negotiation of successive Conventions has also increased the range of instruments and financial schemes. For example, in the Lomé IV financial protocol 1995-2000, of a total of ecu 14,625 million, ecu 12,967 million was allocated to the European Development Fund (EDF) and ecu 1,658 million to the European Investment Bank (EIB). Ecu 1,000 million of EDF resources were allocated to risk capital and of the remaining resources a further 48% were allocated as grant aid for the following:

- stabex ecu 1,800 m;
- structural adjustment ecu 1,400 m;

regional co-operation ecu 1,300 m;

of which:

regional trade promotion ecu 85 m;

institutional support ecu 80 million;

Centre for Development of Industry
ecu 73 million;

joint Assembly ecu 4 m;

sysmin ecu 575 million;

interest rate subsidies ecu 370 million;

emergency refugee assistance
ecu 260 million;

of which:

emergency aid ecu 140 m;

refugees ecu 120 m;

As a result, only 43% of EU institutional aid is freely available to finance programmes in the ACP countries. The prior allocation of aid for specific purposes means that unless the EU has perfect foresight, then there is either too much or too little aid for the designated purpose. Either way, it implies an inefficient use of aid.

This proliferation of objectives and policy instruments has not been the result of the evolution of a consistent development strategy for the ACP countries, but rather piecemeal, ad hoc, additions derived from changing fashions in development (primarily emanating from the EU countries) and the belief that the more 'windows' for aid there are the greater the volume of aid received by the ACP countries.

The changing fashions in aid (often vigorously advocated by influential NGOs) may have some merit in themselves, but they need to be carefully evaluated in the light of the main policy objectives of the ACP countries. Unfortunately, these policy objectives are often defined in the most general terms, both in the Convention and by most ACP countries, and are never prioritised.

This results in a confusion of means with ends, so that the overall efficiency of the aid programmes are reduced and conflicts between objectives emerge (although within the limitations of the Convention as a whole, the management of projects has probably been improved by the introduction of the 'logical framework approach' to project cycle management in 1992). It has also meant that the Convention comprises an incomprehensible mass of schemes and instruments of which few people have an overall understanding, and as a result many of the provisions of the Convention are either neglected or utilised in National Indicated Programmes (NIPs) in an arbitrary and unsystematic manner. At the same time, the focus on instruments *referred to* in the Convention may well lead to a neglect of more appropriate instruments *not contained* in the Convention, but which may be of potential value to an individual ACP country or groups of ACP countries. This danger may be compounded by an excessive attention to control and accountability by the Commission which stifles innovation (ECPDM, 1996) and adaptability essential to the effectiveness of aid in individual ACP states.

The idea that the more 'windows' there are for aid the more aid you obtain, has always been of doubtful validity. The reality is that the aid budget of individual donors are always the result of annual bargaining between ministries for limited resources and is conducted in terms of overall amounts, with only a limited reference to broad aid commitments and with no reference to the minutiae of individual policy instruments or 'windows'. This is all the more true in the present situation of severe pressures on the budgets of the EU member states and increasing aid commitments to non-ACP countries, particularly in Eastern Europe. The objective of the ACP should therefore be to concentrate on ways of *increasing the effectiveness* of Community aid.

Weaknesses in the main agreement of aid and aid conditionality

A recent report (Koning 1995) provides a useful analysis of the strengths and weaknesses in the

management of the EDF (an analysis which is, incidentally, largely absent from the Green Paper). The report concludes that while there is no obvious shortage of staff relative to other comparable donor agencies, specialist staff are concentrated in 'traditional areas and this creates a gap in priority fields. Although these gaps are generally filled by consultants, adequate supervision is required. The ratio of support staff to other staff is low, causing overburdening of professional staff with administrative functions both in Brussels and in the delegations' (Koning, 1995).

A particular feature of the EDF are the delegations located in ACP countries, but a recent study noted a lack of decision making authority in the delegations which led to delays and inefficiencies (Price Waterhouse 1992).

Similar conclusions were reached in a detailed study of EU aid to Ethiopia (Maxwell, 1996) which, *inter alia*, concluded that 'the capacity of the EU to implement an aid programme falls some way below its capacity to agree on overarching aid framework and establish aid instruments' and that there was 'an overriding impression of an aid programme that was bigger than the capacity to manage it'.

The Green Paper sees a significant cost of the partnership principle of Lomé in terms of a reduced efficiency of aid and 'in its eagerness to improve the efficiency of aid operations, the Community has tended to take the place of its weaker partner, adopting a more interventionist role that is hard to reconcile with the recognised need to encourage the recipient countries to take charge of their own development process' (p. 7). The downgrading of the principle of partnership and joint responsibility for the aid programmes has been most clearly seen in the use of conditionality in the disbursement of funds under the various instruments of the Convention, notably in the case of Stabex, and the use of these instruments to obtain leverage on ACP policies.

Now it is axiomatic that the efficiency of an aid programme depends on the social, political, and economic environment in which it takes place and the EU has a legitimate interest in

ensuring that the basic requirements for the success of aid financed projects are met. Earmarking funds for particular purposes, however, is a very inefficient way of achieving this object. Conditionality, properly conceived and adapted to the individual needs of a country (a particular objective of EU structural adjustment assistance), can be helpful in producing 'performance contracts' whereby aid flows are guaranteed provided certain agreed results are achieved, but it needs to apply to the whole programme of aid (not simply EU aid) to an ACP country and, furthermore, needs to be closely co-ordinated with other aid donors, otherwise conflicting and self-defeating requirements will be made of recipients. Focusing aid and simplifying the range of policy objectives and policy instruments will require the ACP to accept EU involvement in conditionality and to engage in a more general policy dialogue than occurs at present with the EU. ACP countries will also have to increase their institutional capacity to engage in such a policy dialogue. The benefits, in terms of a more flexible and efficient aid programme, better targeted to their needs, are however, very substantial.

6.3 Basic Principles for Restructuring the Convention

There is an overwhelming need to restructure the Convention so as to make it more workable and realistic by simplifying its content and concentrating on achievable objectives, both in terms of EU resources and in terms of the needs and development capacities of the ACP countries. How could this best be achieved?

The starting point is whether a new Convention is to be seen as a 'blueprint' for ACP-EU development corporation (i.e. the 15 member states plus the Commission), fulfilling the Maastricht objective of greater co-ordination between the members states in their development co-operation policies (at present limited to guidelines for common policies in poverty alleviation, health and education, and

food security), or whether it will be confined, as at present, to European Commission-ACP relations (with some degree of co-ordination with the actions of member states). The former is an attractive objective since it could lead to much better co-ordination and increase the effectiveness of the EU overall, and is implicit in the Commission's Green Paper which considers the objectives of EU aid and not just Community institutional aid. Aid, however, is very much viewed, at least by the larger EU donors, as serving their foreign and commercial policy objectives and the most that can therefore be expected is better co-ordination between the member states and the Commission, with the Commission acting as a clearing house, channelling information to the member states on each other's initiatives in the ACP countries.

One of the distinctive features of Lomé aid is the ideal of partnership and policy dialogue between the EU and the ACP. Community aid, also has the advantage of not being driven by the foreign policy and commercial interests of an individual member state and so is therefore potentially more development oriented than bilateral aid. At the same time, the Commission does not have the human and financial resources of big international institutions like the World Bank and UNDP, and only accounts for 18% of EU aid to the ACP states. The combination of these considerations with the need to simplify the Convention and concentrate on essential development objectives suggests that a *new Convention should be based on the areas in which the Commission has a particular contribution to make, as compared to other multilateral, institutions and bilateral donors.*

In view of the fact that trade is exclusively an EU responsibility, then this would be one of the most obvious areas for the Commission to concentrate on (though not necessarily the only area). This would also fulfil the Maastricht Treaty objective of integrating the developing countries into the world economy and is of vital importance not simply to the more developed ACP countries, but also to the least developed countries. Other objectives, such as the alleviation

of poverty and protection of the environment, would form an integral part of such a programme, while the means of achieving the objective of improving the trade performance of the ACP countries would encompass both direct measures to improve production, marketing and distribution, and indirect measures concerned with education and training, support for the private sector, institution building in the public and private sectors, and regional integration.

The ACP countries may also wish to consider other objectives of EU assistance such as food security. The important point is that these objectives should be kept to a minimum and EU assistance *focused* on these few objectives.

Similarly, the range of policy instruments needs to be simplified and focused (Maxwell 1996) and this requires the ACP countries to evaluate the effectiveness of existing instruments. For example, does Stabex (the largest single instrument of ACP-EU financial co-operation and allocated Ecu 1800 million between 1995-2000) serve the trade interests even of the relatively few ACP countries which significantly benefit from it? (Lingnau 1996, quotes a study by Ohlin 1993), that 'only a handful of countries have received three-quarters or more of the transfers, leaving over 60 countries to share the rest'). Some observers note, for example, that by providing aid based on exports of a specific list of commodities it may act as a disincentive to export diversification, while at the same time ensuring supplies of these commodities to EU multinationals. At the same time, it should be recognised that Stabex has a high degree of acceptability among ACP countries, presumably because it provides aid automatically to qualifying states. Despite its title, however, Stabex does not stabilise the export earnings of the ACP countries, but only the earnings from a list of 50 products, mainly exported to the EU. The scheme was devised in the 1970s, when it was expected that world commodity prices would be stabilised through international agreements and buffer stocks. This did not occur and so the funds available for Stabex have been inadequate to

stabilise commodity earnings against large fluctuations in world prices. Partly to deal with this situation, the formula for deciding whether payments should be made, arbitrarily excludes the highest and lowest level of earnings when calculating the average (reference) level of export earnings over a six year period. As a result, a rising trend (with the usual variability around the trend) of export earnings over the six year period, with a drop in earnings in the seventh year, will result in a much smaller Stabex payment than could be rationally expected on the basis of the differences between the expected value (based on the exponential trend value) and the actual value of export earnings. Thus, not only is the fund based on an arbitrary list of products (so that countries with balance of payments problems can receive payments while those with problems cannot claim), with inadequate funding to guarantee payment, but it also does not address the fundamental reasons why export instability creates harmful effects on the growth of the economy (the basic objective of Stabex as stated in Article 186). The funds allocated to Stabex could be used for other purposes and the ACP countries need to evaluate this opportunity cost of the scheme. If it is decided to retain the scheme then the objectives of the scheme need to be more clearly and realistically specified in the context of the funds available, and the rules and procedures of the scheme revised so that the scheme can meet these objects. For example, it may be decided that, given the limited financing of the scheme, it would be more appropriate to consider it part of a disaster relief operation than a stabilisation fund, in which case rules would be devised governing eligibility on that basis.

The same considerations apply to other funds earmarked for a specific purposes. More generally, the ACP countries need to consider whether it would not be more in their interests for the EDF to go back to its original form and greatly increase the proportion of programmable aid (not pre-allocated for specific purposes) from its present level of 43% of total financial resources.

A further strategic area for the ACP countries to consider follows from this discussion, namely, that if total EU aid becomes more programmed to the individual needs of ACP countries in exchange for agreement on a few key areas of ex-post conditionality, then the present system of five-year allocations of aid to individual ACP countries may lead to even lower levels of disbursement than at present. If a number of ACP countries consistently fail to meet the conditions of the grants (EDF 8 specifies that 70% of the overall financial envelope can be released and that the remaining resources may be allocated, depending on the progress achieved in the execution of the first tranche and the state of preparation of activities envisaged with the second tranche). At present, unspent sums allocated to an ACP country under one EDF are simply transferred to the country's allocations for the next EDF, but if these accumulate to a significant degree then there is a substantial opportunity cost to other ACP countries which could productively use these resources. The ACP may therefore wish to consider introducing a mechanism by which an unused proportion of aid above a certain threshold is made available to other ACP countries (analogous to the redistribution of quotas under the sugar and beef protocols).

6.4 Aid and the Integration of the ACP States into the World Economy

This report has emphasised in Chapter 1 the impact of the forces of globalisation and liberalisation which pose both a threat and an opportunity for the ACP countries. In order to take advantage of these opportunities, the ACP will essentially have to pursue a 'niche filling' strategy and the experience of rapidly growing economies indicates that a network of micro, small and medium-sized enterprises are fundamental to such a strategy because they offer the advantages of flexibility and adaptability to constantly changing market conditions. The analysis of the export record of the ACP states in Chapter

2 showed that, contrary to the general view, an increasing number of ACP countries had diversified their exports, but that this process needs to encompass a larger number of countries and has not extended to a sufficient group of products, or covered a sufficiently wide range of rapidly growing markets. The experience of ACP countries which had implemented structural adjustment policies has shown that these have improved export performance, but case studies indicate that although these policies are necessary for improved performance, they are not sufficient. They need to be complemented by detailed supply side policies which improve both the general economic environment of the country and provide a specific and targeted network of support for micro, small and medium-sized enterprises. In this way, the ACP states could achieve the objectives of 'growth with equity'. The policies and instruments necessary to achieve this have been analysed in detail in Chapter 4 and 5.

We have argued for a much more focused and targeted approach to the use of Community aid resources, and that supporting ACP export capacity building should be one of the main objectives of a new agreement. In order to give effect to this proposal, the financial and technical assistance of a new agreement needs to be closely co-ordinated and integrated within a joint ACP-EU organisation which replaces the existing division of responsibilities between the Commission, the European Investment Bank and the Centre for Development of Industry. To be effective it also needs to involve the active participation of both the public and the private sectors in the ACP and EU. This joint organisation, which could be called the ACP-EU Productivity Centre, would be wholly responsible for developing the export capacity of the ACP countries and would have at its disposal a substantial proportion of the financial protocol of a new agreement. It would bring together under one roof the resources necessary to development: physical infrastructure, legal, financial, education and training, technology diffusion, marketing and institutional development

(including building, for example, on the antennae systems of the CDI, linking local enterprises with fundholders and policymakers). It would advise on the structure of incentives in ACP countries, on the regulation and promotion of foreign investment, and on regional policies which could enhance export performance. It would also closely liaise and co-ordinate its efforts with other bilateral and multilateral aid donors, but its underlying philosophy would be to recognise the importance and significance of market failure and missing markets in ACP countries, and the need for intervention and institution building.

The instruments for meeting this overall objective would vary according to the needs and the level of economic development of individual ACP countries. Some of the more advanced ACP states may be considered largely able to finance their development through their own resources, foreign investment and borrowing, and indeed may be legitimately constrained in their access to aid finance in a new agreement. In these cases, the requirement would be largely for a substantial amount of technical assistance to organise and implement a strategy for improving export competitiveness. The majority of the ACP countries, however, will require a mix of financial and technical assistance with financial assistance including direct support for establishing and building up productive activities, supporting services, networks and institution building (including the establishment of National Productivity Centres in the ACP states). In all cases, counterpart finance would be required from the public sector and beneficiaries in the private sector in the ACP countries, and targets would be set both for performance and for the progressive transfer of ownership and responsibility for the enterprise to the ACP country. This co-ordinated package of support would be targeted at particular sectors of the economy, and, where appropriate, we would suggest the use of a suitably modified form of the Centre-Satellite system discussed in Chapter 5.

Additional financial and technical assistance

will be required if an ACP state decides to negotiate and implement a free trade agreement with the EU (as discussed in Chapter 3).

We have also discussed in Chapter 1 the need for EU assistance in enabling the ACP countries both to participate more effectively in the WTO, and in implementing and explaining the implications of the Final Act of the Uruguay Round and the Marrakesh Agreement to the private sector in the ACP countries.

It has also been suggested in this report that the EU could act as a channel of information and export promotion between the various geographical grouping of its special preferential trade agreements, and in particular between the ACP group and the CEEC/NIS countries. This could be organised through the ACP-EU Productivity Centre in collaboration with the appropriate organisations contained in the Europe Agreements.

We recognise that these proposals represent a major departure from traditional relations between developed and developing countries, but just as Lomé I represented a new departure and innovative thinking on North-South relations in 1975, so a new agreement needs to concentrate on one of the main issues of our time, namely to increase substantially the degree of integration of the ACP countries into the world economy.

6.5 Flows of Foreign Direct Investment to the ACP Countries

'Private investment in developing countries has shown a marked revival as a consequence of the widespread progress in stabilising macroeconomic balance in individual countries' (International Finance Corporation, 1995). In contrast, most African countries 'have improved, typically within structural adjustment programmes, their regulatory frameworks and they try to increase investor confidence through the conclusion of bilateral investment and tax agreement and are subscribing to multilateral agreements pertaining to FDI ... (however) for the continent as a whole,

FDI flows have not responded or, at best, responded unevenly' (UNCTAD, 1995). A similar conclusion is reached by the IFC in terms of trends in private investment in development countries 1970-74, 'an improvement in economic growth rates in Sub-Saharan Africa in 1994 was generally not accompanied by higher private investment. The overall trend of low and falling private investment rates continued'. (IFC, 1995, p.4). In Asia and Latin America, foreign direct investment is the largest component of net resource flows, whereas in Africa it comprises only 12% of these flows (UNCTAD, 1995).

A recent and more detailed study (Bennell, 1994) of UK manufacturing investment in 14 Sub-Saharan African countries (accounting for 50%-80% of all manufacturing FDI in these countries) paints an even gloomier picture of a trend of dis-investment in the 1980s *accelerating* in the period 1989-94. This dis-investment was greatest in intermediate and capital goods, with the result that manufacturing investment has become increasingly concentrated 'in the production of relatively low value added wage goods, bulky intermediate goods, and a very limited range of metal and electrical goods. Most of these activities use relatively simple and increasingly out-dated technologies' (p.7). The study records that in 1989, 90 UK companies had 336 equity involvements, in manufacturing. By mid-1994 this had fallen to 65 companies with 233 equity involvement in manufacturing and by the end of the decade this could be expected to have fallen to around 30 or 40 companies. The reasons for this were partly due to a world-wide phenomenon of MNEs concentrating on core activities, but interviews also showed that MNEs had become 'weary of dealing with all the problems of manufacturing in Africa' (p.12). MNEs were also highly critical of the structural adjustment policies in Africa which they considered were too simplistic and had been too rapidly implemented with the result that 'there may be "nothing left" (of manufacturing) in the medium to long term' (p.11). Also, while local currency rates of return on investments were substantial, £ sterling

rates of return were inadequate, reflecting the large devaluations of most countries over the period. Fears over foreign exchange problems are now widespread and the author concludes that unless these 'can be satisfactorily resolved, then the prospects for significant increases in manufacturing FDI, even among existing investors, remain bleak' (p.15).

As we have emphasised, however, it is very difficult to make valid generalisations about such a heterogeneous group as the ACP countries and a recent World Bank study (Bhattacharya, Montiel, Sharma, 1997) points out that while FDI flows have been stagnant or shown only a small increase for the CFA countries, and countries with negative per capita growth, other Sub-Saharan African countries have recorded significant inflows. These countries fall into three groups. Firstly, long term recipients such as Botswana, Mauritius, Seychelles, Swaziland and Zambia, where flows have remained constant or declined. Secondly, countries recording large increases, mainly in the oil and mining sectors, such as Angola, Cameroon, Gabon, Ghana, Guinea, Lesotho, Madagascar, Mozambique,

Namibia, Nigeria and Zimbabwe. Thirdly, countries where FDI was low and declining in the 1980s and early 1990s but where flows have now reversed, sometime to a spectacular degree, such as in Uganda.

In the case of the Caribbean and Pacific countries, some countries have experienced substantial net inflows over the period 1990-94, especially when standardised on a per capita basis or relative to GDP, and compared to major beneficiaries of FDI such as Chile, Mexico and Thailand (see Table 6.1).

Substantial net inflows, relative to the size of the economy have also been recorded for Antigua and Barbuda, Barbados and The Bahamas, though these countries may, to a certain extent, be regarded as special cases.

6.6 Measures to Increase the Flow of FDI

Most ACP countries, however, have received only modest inflows and this is disturbing in the light of the potential benefits of FDI in terms of technology transfer and access to markets, knowledge and information not easily available, or

Table 6.1 Net Inflows of FDI 1990-94

	Average 1990-94 \$m	\$ per capita	\$ per \$1,000 of GDP
Dominican Rep	166	21.3	16.0
Jamaica	121.6	48.6	29.0
Trinidad and Tobago	270.4	216.3	56.3
Fiji	46.6	60.5	20.3
Nigeria	1100	10.2	33.8
Swaziland	34.9	42.0	38.8
Chile	511.6	36.5	9.8
Mexico	5409.0	60.8	14.3
Thailand	1554.0	26.8	10.8

Computed from: International Financial Statistics 1996, World Development Report 1996.

- Note
- 1 Papua New Guinea not included in the table because substantial net inflows in 1990-92 became small net outflows in 1993 and 1994.
 - 2 Mauritius not included because net inflows of up to \$40m in 1990 became net outflows in 1991-93.

unavailable, from other sources. Moreover, a large proportion of FDI has been in resource based industries with little domestic processing and refining, or in tourist enclaves, so that the contribution to the ACP countries has been largely confined to the generation of government revenues, and in the case of tourism a (varying) degree of local employment. There is therefore a need for increasing substantially both the quantity and the quality (in terms of contribution to the development of the host economy) of MNE involvement in the ACP countries, for example, in manufacturing, infrastructure and tourism related goods and services.

International agreements

As we have mentioned, most ACP countries have reformed their authorisation and regulatory procedures for FDI and many are now signatories to the four major multilateral investment conventions⁶ and have concluded bilateral investment treaties with capital exporting countries. In addition, as discussed in Chapter 1, the ACP members of the WTO have also to conform to the agreements on Trade Related Investment Measures (TRIMS) and Trade Related Intellectual Property Rights (TRIPs). There would therefore appear to be little more that these ACP countries could do to further investor confidence through international agreements.

The Lomé Convention

With regard to the Lomé Convention, Title III, Chapter 3 on Investment provides for investment promotion, investment protection and investment finance, but the resources devoted to these tasks would appear to be quite inadequate, while the usefulness of the European Investment Bank as a vehicle for providing investment finance may be questioned, given its lack of knowledge and local representation (in comparison to other agencies such as the

Commonwealth Development Corporation).

Foreign investors tend to view SSA as a whole and so the problems of some states leads to a general perception that the whole sub-continent is risky and unstable. Much greater effort could be made by the EU to use Ch.3.1 and 3.2 of the Convention (investment promotion and protection) to educate potential investors to the contrary and to back this with investment guarantee schemes for stable countries. Similarly, potentially profitable investment opportunities for involvement by EU multinational companies in the Caribbean and Pacific would also benefit from much greater support from these instruments of the Convention for the dissemination of information and support for SMEs in obtaining equity and loan finance.

Article 271 states that 'in assisting the ACP to invest in PMDT, particular attention shall be paid to supporting optimal use of existing capacity of the ACP states concerned and the need for rehabilitation'. Given the very low levels of processing of natural resources in the ACP countries, and the potential benefits from this, the provisions of this Article are inadequate. PMDT could be targeted as a priority area for action and more resources devoted to identifying the reasons *why* MNEs do not engage in higher levels of processing in the ACP countries, and formulating investment proposals to overcome problems, where such processing could be economically carried out.

Most ACP countries are seriously deficient in a whole range of infrastructures, including not only physical infrastructures, but also financial services, and lack both the capital and personnel to bring these up to a standard essential for the development of an efficient and viable economy. Privatisation programmes in Europe have created large enterprises which are already involved in rehabilitating the

6 Multilateral Investment Guarantee Agency (MIGA); Convention on the Settlement of Investment Disputes between States and Nationals of other States; Convention on Recognition and Enforcement of Foreign Arbitration Awards; Convention for the Protection of Industrial Property.

infrastructure of the Eastern European countries, and a new Convention could include specific mechanisms to encourage similar private sector investments and involvements in the ACP countries and especially those which have already engaged in competitive privatisation programmes.

Measures by ACP countries

Theories of private investment emphasise the important of *country risk and timing* in addition to a high growth in demand for the goods or services in determining investment flows both by local and foreign nationals.

Problems of investment divide into *political risk* (wars, civil disturbance, politically motivated pressure on private and/or foreign property rights) and *transfer risks* arising from restrictions on remitting funds back to the home country of the investor, or losses in doing so due to the devaluation of the host countries' currency. Indicators of transfer risk, such as the Economist Intelligence Unit (EIU) index, emphasise macro-economic policy (debt ratios and debt management, economic growth, strength of the overall balance of payments) and the credibility (basic, lasting reforms) of these policies (often using the degree of openness of the economy as an indicator, on the basis that the international market acts as an automatic 'discipline' on government policies).

Timing of investment is important because investment returns are always uncertain and once made are either difficult or impossible to reverse and therefore carry an opportunity cost (returns which could have been earned from an alternative investment project). The literature sometimes talks of 'first movers' and second movers', with the former being the pioneers who take the highest risk and develop the ground for the latter to move in quickly if the pioneers' experience is favourable (or fail to invest if the former's experience is unfavourable).

With these factors in mind, the ACP countries may wish to review Articles 273 (on currency payments and capital movements) and

274 (treatment of business entities).

Art. 273 states that:

'the Contracting Parties shall refrain from taking action in the field of foreign exchange transactions which would be incompatible with their obligations under this Convention resulting from the provisions relating to trade in goods and services, establishment and industrial competition'.

Does this mean that there is free movement of capital or earnings for foreign investors or not?

Also:

'These obligations shall not, however, prevent the Contracting Parties from adopting the necessary protective measures should they be justified by reasons relating to serious economic difficulties or severe balance of payments problems'.

Since, short of arbitrary restrictions, this is exactly the situation which foreign investors are concerned with, this caveat simply nullifies any guarantee contained in the first statement and, if anything, confirms their worst fears on investing in ACP countries.

A more constructive approach would be for ACP countries, or groups of countries to give clear undertakings covering transfer risk, ideally backed by EU financial guarantees, and these guarantees could perhaps be separately signed as a protocol to a new agreement.

Similarly, Article 274 allows for 'national treatment' of foreign firms, however, 'if for a given activity, an ACP State or a Member State is unable to provide such treatment, the ACP State or the Member State, as the case may be, shall not be bound to accord such treatment for that activity to the nationals and companies or firms of the State concerned'. In plain English, this means that 'you can have national treatment except where we decide you can't have national treatment, with no guarantees of how this might change in the future. The same objection applies to this as to Article 273 – what

'signals' are these provisions of the Convention supposed to be giving to potential foreign investors? It would be far better for the ACP either to be given the financial and technical support of the EU to provide guarantees to EU investors or to omit such clauses altogether. As they stand they are at best useless and at worst, counter-productive.

A recent workshop which examined some of the possible reasons why FDI in Africa has not responded to macroeconomic and legislative changes (MIGA, 1996) highlighted some additional reasons:

- ❖ 'one-stop shops' have often been *additional* shops without the expertise or authority to make decisions on approvals;
- ❖ regulations are still widespread, onerous and haphazard creating uncertainties both for the foreign investor and the civil servants who have to administer the regulations;
- ❖ customs and port operations are singled out as being particularly inefficient, cumbersome and corrupt, causing high transaction costs and long delays in clearing imports and exports; and
- ❖ the legal and judicial system is outdated and ill-suited to the modern world and judges

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lack experience in dealing with corporate law and other economic matters.

6.7 Conclusions

All countries are subject to varying degrees of difficulty in attracting and regulating foreign investment, the problem in Africa, as compared to Asia or Latin America, is that the sum total of these difficulties facing foreign investors is relatively large and both their magnitude and effects are much more unpredictable. All of the ACP countries, including most of the least developed countries, could benefit from a greater focus in a new agreement on financial and institutional measures to encourage a greater volume and diversity of foreign involvement. This cannot be expected to be a major element in strengthening the competitiveness of most of the ACP countries since most FDI will flow to the larger and more industrialised developing countries, but it could provide key inputs which, as discussed at the beginning of this chapter, are not available from other sources. To be effective, such initiatives in a new agreement must be closely co-ordinated with other initiatives within an overall strategy for each ACP country which seeks to develop international competitiveness and not somewhat haphazardly put into a 'national indicative programme'.

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Future Prospects for ACP Exports to the EU for Agricultural and Horticultural Products Covered by the CAP

Summary

The EU's Common Agricultural Policy (CAP) will continue to provide substantial border protection to EU agriculture for some years to come, despite the outcome of the Uruguay Round of GATT negotiations, and the renewed efforts to secure CAP reform. Thus, the Article 168 tariff concessions of the Lomé Convention, and of the commodity protocols, will continue to provide potential benefits for ACP states for some years to come. Even for fruit and vegetables, the preferential margin is of value, although instances occur in which the GSP concessions for the least-developed developing countries are more generous than those available under Lomé. The concessions contained in the commodity protocols cannot readily be improved: indeed, the challenge for the ACP states is to maintain the value of these concessions despite CAP reform. The Protocol 8 arrangements for sugar appear to be consolidated as one of the EU's 'minimum access' tariff quotas in GATT, and thus it should now be independent of Lomé. Reform of the EU's beef regime is more likely than that for sugar; and for sugar – recognising the 'windfall' characteristics of the present arrangements – the beneficiary states should introduce some form of export tax, the proceeds of which could be reinvested in the economy, to wean their sugar industries away from dependence on unsustainable EU prices.

7.1 Introduction

This chapter is concerned with those agricultural products listed in Annex II to the Treaty of Rome and hence covered by mechanisms of the Common Agricultural Policy (CAP), with the

notable exception of bananas. The EU's banana policies, and the ongoing dispute within the WTO, raise such important issues for the ACP states that bananas are considered separately in Chapter 8. Processed food products, not listed in Annex II to the Treaty of Rome, and known as Non-Annex II goods in the EU's jargon, and fish, are discussed in this chapter, as appropriate. However, this chapter does not consider the scheme for the *Stabilization of Export Earnings from Agricultural Commodities* set out in Part Three, Title II, Chapter 1, of the Fourth ACP-EC Convention of Lomé.

This is a long chapter, and some readers may prefer to move directly to Section 7.8 entitled 'Options for Agriculture within a Successor Agreement to Lomé IV'. Sections 7.3 and 7.4 set out background material on the CAP, and speculate on the nature and timing of further CAP reform. Section 7.5 reviews the debate within the EU of the role of the agricultural sector in free trade areas following the conclusion of the Uruguay Round. Section 7.6 examines the existing trade concessions for agricultural products within Lomé IV; whilst Section 7.7 reviews the EU's other concessional trade arrangements involving agriculture, including the EU's Generalised System of Preferences (GSP).

The CAP imposes major distortions on the EU's economy, and throughout the world. The *Agreement on Agriculture* which formed part of the Uruguay Round package will not, fundamentally, change the CAP, but there are some indications that further reform will sooner or later be triggered by budgetary and other pressures (including enlargement to embrace several states from Eastern and Central Europe, and the prospect of a further round of GATT negotiations

beginning in 1999). This poses a major dilemma for the ACP states. It is because the *present* CAP so distorts international trade that agricultural trade concessions – such as those included in the GSP and in Lomé, in particular the sugar protocol – remain of *potential* value to the recipients. We emphasised the word ‘potential’ because we should stress that, whilst such concessions may offer obvious short-term commercial advantages, it does not necessarily follow that this is in accord with the longer-term development interests of the recipient country.

Taking parasitic advantage of the present CAP is one thing. Adopting the CAP would be quite another, and yet the new WTO disciplines on free trade areas seem to imply that a free trade area (or areas) between the EU and the ACP would have to include all sectors of the economy. The inclusion of agriculture in its entirety, given the present unreformed CAP, would – in our view – necessarily involve the adoption of the CAP, or similar trade mechanisms, by the ACP. We cannot believe that this would be in the economic interests of the ACP states concerned.

Accordingly Section 7.8 presupposes that the ACP will be seeking further preferential access arrangements for agricultural products, in: (i) a revised Lomé Convention, (ii) an expanded GSP, or (iii) a free trade area agreement which excludes the bulk of CAP products.

7.2 The ACP's Trade with the EU

The EU is a major player in world agricultural markets. According to the European Commission's calculations, in the early 1990s the EU of twelve member states (prior to the accession of Austria, Finland and Sweden) accounted for about 22% of world agricultural imports, and about 15% of world agricultural exports (excluding intra-Community trade) (calculated from European Commission, 1996, Table 3.6.1). As such a major player in world markets, it is bound to have an impact on both the level of world market prices, and the degree of world market price stability. Its imports, as recorded by

value in Table 7.1, are heavily influenced by tropical products which could not readily be produced in the EU, by products such as timber that are not subject to the CAP, and by concessionary imports under either GATT/WTO tariff quotas, or under other preferential access arrangements. Competitive imports of CAP products under the normal trade regime (the most-favoured-nation [mfn] tariff rate) are rare. Agricultural imports, as defined by the SITC codes listed in Table 7.1, accounted for 11.6% of the EU-12's imports by value in the period 1992-1994.

As Table 7.1 shows, the ACP states (together with the overseas territories of the member states) supplied 3.6% of the EU-12's total imports in the same period, but by contrast some 12.3% of the EU-12's agricultural imports. Thus the agricultural products listed in Table 7.1 accounted for 39.6% of the ACP's exports to the EU-12 in 1992-94. Clearly the agricultural sector represents a major component of the ACP's trade with the EU. As many agricultural products continue to experience excessively high degrees of border protection in the EU, the potential importance of the agricultural trade concessions to the ACP states is clear. It should perhaps also be noted that the rules of origin of the Lomé Convention can more readily be met by agricultural products than might be the case with manufactured goods, thus reinforcing the importance of the agricultural concessions in the Convention. The rules of origin on fish can nonetheless be difficult to meet, and we are advised that there is scope for rationalising the rules of origin for fish caught in ACP waters.

However, the overall aggregates reported in Table 7.1 can be misleading because, as already noted, of its inclusion of timber and of a range of tropical products that could not readily be produced in the European regions of the EU. Fish is also a significant component of the total. Of the range of products covered by the CAP, the most important export revenues earned for the ACP states are generated by fruit and vegetables (influenced strongly by the banana protocol), sugar and honey (influenced strongly by the sugar protocol)

Table 7.1 EU-12's Agricultural Imports from the ACP States (together with the Overseas Territories of the Member States) and the World Market, by Value (Million Ecu), Annual Average 1992-1994

SITC code	Product	World	ACP	ACP as % of World
00	Live animals	608	11	1.8
01	Meat	2,914	144	5.0
02	Milk and Eggs	720	4	0.6
03	Fish	6,941	950	13.7
04	Cereals	1,287	88	6.8
05	Fruit and vegetables	11,033	801	7.3
06	Sugar and honey	1,462	760	52.0
07	Coffee, cocoa, tea, spices	5,103	2,113	41.4
08	Animal feed	4,733	59	1.3
09	Food products	548	2	0.4
11	Beverages	1,007	144	14.3
12	Tobacco	2,406	301	12.5
21	Hides	884	44	5.0
22	Oilseeds	3,792	53	1.4
231	Natural rubber	682	130	19.1
24	Timber and cork	7,339	919	12.5
261 to 265 & 268	Natural textile fibres	2,968	238	8.0
29	Agricultural raw materials	2,108	202	9.6
4	Oils and fats	1,935	219	11.3
592.11	Starches, inuline			
592.12	Gluten	4	0	0.0
	TOTAL	58,472	7,186	12.3
	Imports of all products	504,391	18,157	3.6
	Agriculture as % of all imports	11.6	39.6	

Source: computed from European Commission, 1996, Tables 3.6.2 and 3.6.12.

and tobacco. For sugar and honey, the ACP accounted for 52% by value of the EU-12's imports.

7.3 The 'Old' CAP

The 'old' CAP has been amply documented elsewhere (see for example: Harris, Swinbank & Wilkinson, 1983; Ritson, 1978; BAE, 1985). Although differences existed between products, the CAP was characterised by a managed market system that ensured that EU prices were sustained well above world market levels. Imports were subject to variable import levies (cereals and rice, sugar, olive oil, milk and milk products, eggs and poultry, pigmeat, beef and veal),

minimum import price regimes (some fruit and vegetables, wine) and voluntary export restraint agreements (manioc, sheepmeat). Where imports were relatively free and simply controlled by conventional customs duties (oilseeds, tobacco, some fruit and vegetables) EU production was nonetheless encouraged as a consequence of direct exchequer support to farmers. Export subsidies (known as refunds in the EU's jargon) were used to dump unwanted surpluses on world markets. Furthermore, surpluses could be bought-up (intervention) by the EU's authorities to accumulate in intervention stores, or were destroyed. Fruit and vegetables were often

destroyed and surplus wine distilled into un-saleable ethyl alcohol.

As a result of these policies the cost to the EU's budget was excessive; EU consumers paid unnecessarily high prices for food; environmental degradation was encouraged and world market prices were both much more unstable, and lower, than they would have been in the absence of the policy. Overseas suppliers were squeezed out of the EU market (and in particular suffered from trade diversion following the successive enlargements of the Community), and found that EU traders captured market share elsewhere in the world at their expense, funded by EU subsidies.

Non-Annex II goods

The Treaty of Rome specifies that the CAP shall extend to the products listed in Annex II to the Treaty. In Annex II will be found listed the main agricultural products and their first-stage processing equivalents (butter as well as milk; flour as well as cereals; white sugar as well as sugar beet and sugar cane; wine as well as grapes, for example). However, the list does not extend further down the food chain to embrace the products of the second-stage processing industries. Thus, Annex II to the Treaty of Rome does not list lemonade, pasta, or milk-chocolate bars for example, even though these products contain sugar, durum wheat, and milk, respectively. The CAP significantly increases the raw material costs of these industries, and they could not compete with imports (or sell in world markets) unless the sugar, cereal and milk components of second-stage processed products received a similar degree of protection to that afforded the basic raw materials. Thus, parallel to the CAP was developed a comparable trade regime (involving variable import levies and export refunds) for the Non-Annex II goods that made use of cereals, sugar and milk in their manufacture. These are mainly processed food products, but other industrial sectors are also involved (notably pharmaceuticals based on sugar). Regulation 3448/93 (*Official Journal of the European Communities*, 1993), as amended, sets out the arrangements. Under the

old CAP the import taxes on such Non-Annex II goods were in two parts: a *fixed* component providing a degree of protection to the processing industry (usually in the form of an *ad valorem* customs duty) and a *variable* (or *agricultural*) component reflecting the variable import levies that would have been charged on the CAP raw materials had they been imported into the EU. Further details can be found in Harris & Swinbank (1997), or Noble (1995).

7.4 The 'New' CAP

The 'old' CAP was the subject of much criticism both from within the EU, and from its trading partners. However, apart from some piecemeal reforms induced by budgetary pressures (the introduction in 1984 of physical controls – quotas – on the volume of milk produced, for example) little was done to curb the CAP's excesses, despite the fact that during the 1980s the level of guaranteed prices fell in real terms. In the 1990s, however, significant policy changes were introduced.

In 1986, together with the other GATT signatories, the EU embarked upon the Uruguay Round of GATT negotiations, which was finally concluded in Geneva in December 1993. An important component of those negotiations was the quest to liberalise world trade in agricultural and food products. Elsewhere, Swinbank & Tanner (1996) have argued that this prompted the EU's Mac Sharry reforms of 1992. The *Agreement on Agriculture* which emerged from the Uruguay Round discussions is being progressively applied to the CAP over the period 1995-2000.

These changes amount to a limited, but important, reform of the CAP, and are only the first steps in a long-term, progressive, and radical reform of policy. The European Commission (1995, p. 20) itself has commented: 'Now that the 1992 reforms and the Uruguay Round Agreement are being implemented, the time has come to draw the lessons from the past and to start an in-depth reflection on how the CAP can

be made fit for the first decades of the 21st century’.

Specifically, the concerns driving the current reform debate are:

- ❖ concern that a further expansion of the EU to embrace up to ten states from Central and Eastern Europe (and Cyprus) would be impossible with the present CAP given the GATT constraints already entered into, and the budgetary impact of applying the CAP in these new member states;
- ❖ renewed concern about the budgetary impact of the CAP, which was bound to emerge during the course of the latter 1990s, but which was reinforced in 1996 by the budgetary costs of the BSE crisis, and the concerns of some member states (notably Germany and France) to cut their public sector borrowing requirements in order to meet the convergence criteria, set by the Maastricht Treaty, for Economic and Monetary Union; and
- ❖ the need to begin a new, mini Round of GATT negotiations in 1999, as provided for in the *Agreement on Agriculture*, in the context of a changed world environment, notably the adoption by the USA of its *Federal Agricultural Improvement and Reform (FAIR) Act of 1996* (see MAFF, 1996, for details).

Thus the CAP of the early 21st century may well differ significantly from the CAP of 1996, and this must be borne in mind in preparing for negotiations for a successor agreement to Lomé IV.

The Mac Sharry reforms

In May 1992, following proposals from the then Commissioner for Agriculture, Ray Mac Sharry, the European Council adopted a series of changes to the CAP which have become known as the Mac Sharry reforms (for further details see

Swinbank, 1993). The main change was a switch in support from consumers to taxpayers, which is often seen as a precursor for the further reforms expected in the late 1990s. This view was, for example, largely endorsed by the Commission’s *Agricultural Strategy Paper* of 1995 (Commission, 1995a, p36).

The main change in 1992 concerned cereals. Support prices were reduced by about 30%, and in return farmers became eligible for area compensation payments: that is a payment for each hectare of cereals grown, with the level of payment per hectare varying on a regional basis, reflecting average yields in the region in question in a period prior to the reforms. To qualify for the compensation payments, farmers claiming area payments on more than a small hectareage had to set-aside (i.e. not crop) a specified percentage of their arable land. The set-aside requirement was initially set at 15%.⁷ However, the basic mechanisms of supporting the EU market price for cereals (variable import levies, intervention buying, export refunds) remained in place. With a dual system of support, and the new control mechanisms to ensure that area compensation payments (on land sown to cereals and land set-aside) were not fraudulently claimed, the new policy was more complex than the old.

Nonetheless, support had been switched from consumers to taxpayers, and a precedent set for further CAP reform. Despite this, the new policy contained the seeds of its own destruction. First, the new policy mechanisms were much more transparent than the old, and thus taxpayers could more readily monitor, and criticise, the cost of the policy, and the ‘unfairness’ of large landowners/farmers receiving significant subsidies from the public purse. Second, bowing to political pressure from the powerful farm lobby, Mac Sharry’s initial suggestion that payments should be ‘modulated’ was rejected. Modulation referred to the concept of compensating small farmers in full, but larger farmers in part, for the

⁷ Reduced to a derisory 5% for the 1996/97 crop year, in response to the tight world market conditions.

price cuts. This meant that the cost to the budget of the new policy was intrinsically much greater than that of the policy it displaced. Third, although introduced as compensation for cuts in support prices, the area payments were in fact made a permanent feature of the CAP, payable to any farmer who in the future happened to grow cereals. The predicted cost of extending this scheme to farmers in Central and Eastern Europe is a major factor leading to the unease about these states acceding to an EU with an un-reformed CAP.

Fourth, the EU institutions failed to predict that world market prices would soar. Area compensation payments were fixed in advance in 1992 regardless of future market price developments. Although the EU applied export taxes on cereals in 1996, European farmers nonetheless enjoyed a bonanza on their 1995 and 1996 cereal crops as they benefited from high market prices and area payments which had been premised on significant price falls within the EU. Thus, in July 1996, the European Commission proposed a 7% cut in area payments on cereals, and a 27% cut in area payments on set-aside land, for 1997, ostensibly to meet the budgetary costs of the soaring intervention stocks of beef following the BSE scare (see *Inside Track*, August/September 1996, p.1). The Commission repeated this request in the context of the 1997/98 farm price review, but it was rejected by the Council (*Agra Europe*, 27 June 1997, p. E/1).

For oilseeds, except olives, and protein crops, similar area-based subsidy schemes linked to a set-aside requirement were applied. Changes to the rice regime, modelled on the Mac Sharry reforms of the cereals sector, followed in 1996. Sugar was not the subject of a reform proposal, and indeed in 1995 the existing sugar regime, involving high guaranteed prices and a form of quota mechanism, was – in all its key features – rolled forward for a further six-year term (European Commission, 1996, p.67).

Support prices for beef were cut, and instead, more taxpayer support was focused on a number of annual subsidy payments on eligible animals.

These 'headage payments' on beef animals and suckler cows, and similar headage payments for sheep, were limited by various quota mechanisms. Milk quotas were rolled forward to the year 2000, but with no significant changes to milk policy, even though the Commission had proposed price cuts compensated by headage payments for grass-fed dairy cows, and quota cuts compensated by direct income payments attached to a transferable bond (for further details see Swinbank, 1997). The debate over the future form of EU milk policy, post-2000, has begun; and one idea being canvassed is that the current system of price support and quotas should be replaced by headage payments (for a discussion, see House of Commons, Agriculture Committee, 1996).

Support to tobacco producers was limited by quota, and the provisions for intervention buying and the granting of export subsidies were repealed. Reforms of the fruit and vegetables regime, and the wine policy, were deferred until a later date.

The GATT Uruguay Round and the Agreement on Agriculture

The second set of policy changes prompting the designation 'The New CAP' stem from the implementation of the Uruguay Round *Agreement on Agriculture*. For developed countries, the main elements of the Agreement are as follows:

- ❖ the overall level of support (as measured by an Aggregate Measurement of Support (AMS) is to be reduced by 20% over the six-year implementation period (1995-2000). However, various subsidy schemes deemed to be production neutral, including the EU's area and headage payments introduced by the Mac Sharry reforms, are excluded from the AMS calculations;
- ❖ all non-tariff barriers, including minimum import price regimes and the EU's variable import levy mechanism were to be converted into tariffs (tariffication) and

then, over the six-year implementation period, import tariffs are to be reduced by 36% on average (with a minimum reduction per tariff line of 15%). Where imports represented less than 5% of domestic consumption in the reference period, tariff quotas will apply to enable imports to capture up to 5% of the domestic market; and existing access arrangements under tariff quotas are to be retained (the minimum and current access provisions respectively).⁸ When tariffication has been applied, Special Safeguard Provisions can be invoked if either imports are presented at prices that fall below an historic norm, or if an import surge is experienced;

- ❖ for each major product grouping, the level of expenditure on export subsidies must be reduced by 36%, and the volume of subsidised exports by 21%, over the implementation period; and
- ❖ a new, mini Round of GATT negotiations is due to begin in 1999 to continue the reform process, and in the meantime a Peace Clause (valid until 2004) protects countries from challenge in the WTO, provided they adhere to the terms of the Agreement.

In addition to the *Agreement on Agriculture*, an *Agreement on the Application of Sanitary and Phytosanitary Regulations*, and the strengthened disputes settlements procedures of the new World Trade Organization (WTO), will impact upon the CAP and other agricultural policies around the world.

The detail of the EU's implementation of these constraints is complex and their future

impact on the CAP, and the prospects of third country suppliers in the EU market, uncertain (for discussion see Swinbank, 1996, or Tangermann, 1996). However, most commentators are agreed that the likely impact on the CAP up until the year 2000 will be limited.

The requirement to reduce the EU's AMS by 20% will have no impact upon the CAP, as this reduction has already been secured as a result of the Mac Sharry reforms. However, in the context of an EU Enlargement to embrace states from Central and Eastern Europe, this constraint would have more force, as would a further requirement to cut the AMS, post-2000, as a result of a successor Agreement to the present *Agreement on Agriculture*.

Tariffication was introduced into the CAP in July 1995. Thus the variable import levies so characteristic of the 'old' CAP have disappeared, and in their place *specific* customs duties have appeared.⁹ Thus, for example, the variable import levy on white sugar, which had averaged 542 ecu/tonne in the base period 1986-88, was converted into a tariff equivalent of 524 ecu/tonne; and this in turn is being reduced by 20% in six equal annual steps to a new 'bound' rate of 419 ecu/tonne in the year 2000. For most products, however, there is so much 'water' in the tariff (that is, they have been set at such prohibitively high levels) that, in combination with the Special Safeguard Provisions, commercial imports paying the full mfn tariff rate cannot readily be envisaged. Thus tariff preferences will continue to play an important role.

Despite tariffication, the EU has maintained a minimum import price system for certain fresh fruits and vegetables, and wine, which can still act as a potent trade barrier (see Swinbank &

8 The GATT rules do not allow imports to be physically restricted by quotas; but they do permit tariff quotas. A tariff quota allows a certain volume of imports to be imported at a reduced duty, with quantities in excess of this volume paying the full mfn rate. Of course, the full mfn rate may be prohibitively high, in which case a GATT-legal tariff quota is equivalent to a GATT-illegal quota. Tariff quotas are applied both as part of the GATT Agreement, in which case they must conform with GATT rules, and within preferential trade agreements.

9 The words 'duty' and 'tariff' are used interchangeably, as are the phrases 'import duty/tariff' and 'customs duty/tariff'. Tariffs are acceptable to GATT, and following the Uruguay Round Agreement most GATT signatories have entered into GATT tariff bindings on the full range of agricultural products. A variable import levy is, however, a very different form of border protection, often known as a non-tariff-barrier. As a result of tariffication, variable import levies are now outlawed.

Ritson, 1995, for details). Furthermore, as requested by the USA, the EU applies a maximum tariff rate on cereals and rice which in effect re-invents a variable import levy mechanism (see Swinbank, 1996, p.399; or Yap, 1996, p.385, for further details).

The current access provisions consolidate earlier tariff quota concessions granted in GATT negotiations, and some other access arrangements such as manioc from Thailand and Indonesia, and butter and sheepmeat from New Zealand. Tariff quotas granted the Mediterranean states, and – with one notable exception – the ACP states are not listed. Thus, although the EU's schedule of commitments in GATT does include several tariff quotas for beef and veal, it does not include the ACP quantities listed in Protocol 7 of the Lomé Convention (and discussed below). The EU has, however, declared as part of its GATT commitment a tariff quota covering the quantities of ACP sugar provided for in Protocol 8 of the Lomé Convention. Thus, in our view, this tariff quota for ACP sugar now has a legal existence within GATT/WTO independent of the Lomé Convention (but see the arguments outlined in greater detail below). Quite why ACP sugar is in, and ACP beef is out, is unclear: but one might note that the inclusion of ACP sugar as a GATT tariff quota enabled the EU to avoid the necessity of opening new minimum access tariff quotas for sugar, as it could claim that the minimum 5% market access provision was being met.

It has been suggested that the country-specific tariff quotas, listed by the EU in its schedule of commitments signed in Marrakesh on the conclusion of the GATT Round, could still be challenged in the WTO as being inconsistent with the general mfn rules that form the basis of the GATT Agreement. However, this would open up a can of worms, for the country-specific tariff quotas relate not only to ACP sugar, but to many other products and countries, for example to butter from New Zealand. Furthermore, the *modalities* document which sets out guidelines for implementing the *Agreement on Agriculture* – a document which is not to be used as a basis for

dispute settlement proceedings – whilst specifying that 'Current access opportunities on terms at least equivalent to those existing shall be maintained as part of the tariffication process,' and that any increase in current access opportunities is to 'be provided on an mfn. basis,' does not specifically forbid country-specific current access tariff quotas (GATT, 1993, p.9).

The EU's new minimum access tariff quotas relate mainly to livestock products, and in large part have already been allocated to states of Central and Eastern Europe in the context of the Europe Agreements. There are no obvious opportunities for ACP products.

The main constraints that the *Agreement on Agriculture* imposes on the CAP, at least up until the year 2000 and prior to the next Enlargement, are those relating to subsidised exports. Particular concern has been expressed by EU farm interests over the impact on cereals where – if world market prices subside, and the EU resumes its subsidy programme – further cut-backs in production (i.e. set-aside) are premised. Milk quotas may also have to be cut, and the volume of white sugar benefiting from CAP support may have to be reduced (by reduction of the A and/or B quota). However, these adjustments could be made without lowering support prices in the EU, or opening-up the EU market to competitively priced imports.

Fruit and vegetables

The products subject to the EU's new entry price system, introduced in 1995 as a result of the GATT Agreement, are listed in Table 7.2. In the main, the list, and the periods of applicability, are derived from the earlier minimum import price system applied by the EU (known as reference prices). However, cabbage, lettuce, endives (chicory), and aubergines are no longer protected by a minimum import price system. On the other hand, for tomatoes, cucumbers and courgettes, the earlier reference price system was not operative throughout the year, whereas the new system is, which has considerably increased the protective effect of the new mechanism.

Table 7.2 Products for which Entry Prices are Fixed

Product	Period of Applicability
Apples	All year
Pears	1 July – 30 April
Peaches (including nectarines)	11 June – 30 September
Plums	11 June – 30 September
Cherries	21 May – 10 August
Apricots	1 June – 31 July
Sweet oranges	1 December – 31 May
Mandarins (and other hybrids)	All year
Lemons	All year
Table grapes	21 July – 20 November
Tomatoes	All year
Cucumbers	All year
Courgettes	All year
Artichokes	1 November – 30 June

In the main, the level at which the new entry prices have been set reflects the level of reference prices applicable in the GATT reference period 1986-88. However, for complex reasons explained in Swinbank & Ritson (1995, p.349), the new entry price for sweet oranges was fixed at a level 35% higher than the reference price it replaced. These new minimum import prices for sweet oranges were first applied on 1 December 1995, and caused a storm of protest in the UK because they impacted upon the fresh orange juice market based upon imports of late Valencia oranges sourced in countries such as Cuba, Jamaica and South Africa (*Financial Times*, 12 January 1996). This prompted the EU to reduce the entry price on a 12,000 tonne tariff quota imported between 1 December and 31 March (CIMO, 1995, p.6). Similarly, reductions have since been agreed for cucumbers for processing, and sour cherries (CIMO, 1996, p.10).

When the entry price mechanism is being applied, each consignment of imports has to respect the entry price. Failure to do so triggers the application of an additional import tax,

which rapidly escalates to a prohibitive level. Understandably, when the system was first applied to tomatoes on 1 January 1995 – a period of the year when the old reference price system for tomatoes did not apply – the EU's main supplier at that time of the year (Morocco) protested vigorously. Partly as a result of Moroccan protests, in the new Euro-Mediterranean Agreement between the EU and Morocco, the EU agreed to reduce the entry price on tomatoes originating in Morocco, within tariff quotas and delivery calendars. Morocco also benefits from reduced entry prices on artichokes, cucumbers, clementines and oranges; and Israel from reduced entry prices on oranges (CIMO, 1995, p.6). It seems likely that as the Euro-Mediterranean Agreements (discussed in Section 7.7) are revised, other Mediterranean states will be offered similar concessions on these entry price products. Preferential entry prices have also been determined for some products from Central and Eastern Europe.

To illustrate the complexity of the situation, it might be noted that the full mfn treatment for tomatoes imported into the EU in January 1996 was a minimum entry price of 895 ecu/tonne, and an import tariff of 8.8%. Some countries would have been entitled to supply the EU without paying an import tax, but within tariff quota constraints, provided the entry price had been respected. Morocco, however, had to respect an entry price of 500 ecu/tonne, and had duty-free access, within tariff quotas. Thus the minimum landed price that a non-preferred country could supply the EU with tomatoes in January 1996 was almost twice that of Morocco.

Moreover, from 1 September 1996, the EU has applied the Special Safeguard Clause, provided for in the GATT Agreement, to fruit and vegetables. For 1996-97 eight products are subject to the system. Imports are subject to import licences, and where the volume of imports exceeds the trigger levels indicated below an additional import duty (33% of the mfn rate) is applied.

The products involved are:

tomatoes	565 tonnes 59,923 tonnes	September 1996 1 October to 31 December 1996 – except tomatoes from Morocco
cucumbers	7,808 tonnes	1 September to 31 October 1996
oranges	598,202 tonnes	1 December 1996 to 31 May 1997
clementines	243,851 tonnes	1 Nov 1996 to 28 February 1997
mandarins	90,504 tonnes	1 Nov 1996 to 28 February 1997
lemons	89,313 tonnes 175,189 tonnes	1 September to 31 December 1996 1 January to 31 May 1997
apples	1,254,523 tonnes 1,746,872 tonnes 1,559,722 tonnes	1 September to 31 December 1996 1 January to 31 March 1997 1 April to 30 June 1997
pears	669,866 tonnes 524,006 tonnes	1 September to 31 December 1996 1 January to 30 April 1997

(Regulations 1555/96, 1556/96 and 1557/96, *Official Journal of the European Communities* L193).

Cereals and rice

Figure 7.1 is a schematic representation of the support arrangements for cereals following the Mac Sharry reforms of 1992 and the implementation of the GATT Agreement in 1995. Similar arrangements apply to rice (see also Yap, 1996, p.386).

The intervention price for cereals at the beginning of the marketing year is 119.19 ecu/tonne. Farmers also eligible for an area payment, which is currently determined on the basis of the historic yield (in tonnes per hectare) of the region in which the farm is situated, multiplied by 54.34 ecu/tonne. If, on a particular farm, the area on which area payments is being claimed exceeds a specified maximum, then a specified percentage of that farm's arable land must be set-aside before payments are made (though the set-aside land also qualifies for area payments).

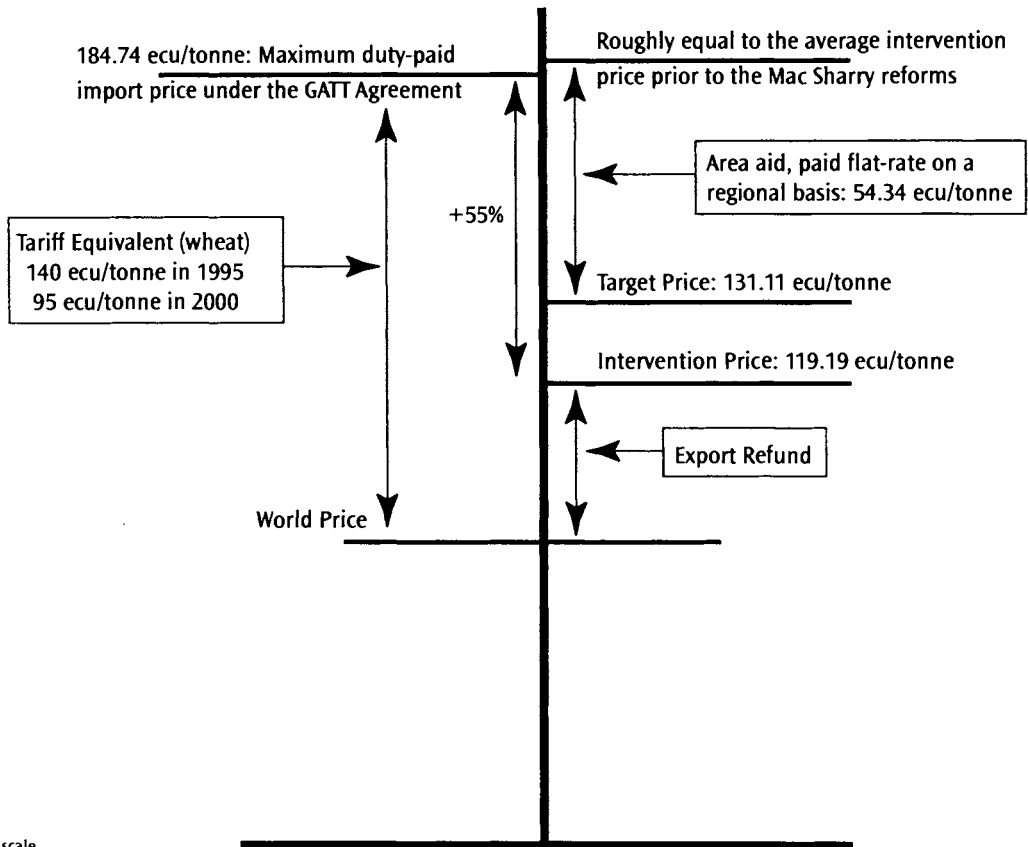
Tariffication has resulted in the variable

import levy on wheat being converted into a tariff equivalent of 149 ecu/tonne. This was reduced to 140 ecu/tonne on 1 July 1995, and – following full implementation of the Agreement – the new tariff will be bound at 95 ecu/tonne on 1 July 2000. However, tariffication was computed on the basis of price gaps (between EU support prices, and world prices) existing in the base period 1986-88, prior to the Mac Sharry reforms. The Mac Sharry reforms considerably reduced the EU's support levels: thus the new tariffs are far too high. One approach to this problem would have been to reduce the new tariffs by the amount that cereal prices were reduced by the Mac Sharry reforms (i.e. by 54 ecu/tonne). Instead, the USA insisted that the EU agree to a formula under which the EU applies an import duty 'at a level and in a manner so that the duty-paid import price for such cereals will not be greater than the effective intervention price...increased by 55%'. The cereals covered by this undertaking are wheat (CCT heading ex 1001), rye (1002), barley (1003), maize excluding hybrid seed (ex 1005), and sorghum except hybrids for sowing (ex 1007). Thus the commitment does not cover oats (1004) or buckwheat, millet, canary seed and other cereals (1008). For millet a base period tariff equivalent of 87 ecu/tonne will be reduced by 36% over the six-year implementation period, to 56 ecu/tonne in 2000. For canary seed the reduction is from 22 to 14 ecu/tonne.

In an attempt to meet the requirement that the import charge on cereals should not result in the duty-paid import price exceeding the effective intervention price plus 55%, the EU determines an import duty on each of six categories of cereals on a fortnightly basis. In effect, and despite tariffication, the variable import levy has been reinvented (for details, see Swinbank, 1997). High world market prices have ensured that the tariffs actually paid on cereal imports into the EU have been significantly reduced (often to zero) in the period since tariffication; and indeed the EU has applied export taxes.

A similar commitment to limit the import

Figure 7.1 Price Support for Cereals from July 1995



Not to scale
Source: Swinbank, 1997

charge actually applied also exists for rice. Here the EU's undertaking with respect to hushed rice falling within subheading 1006 20 55 is 'to apply a duty at a level and in a manner so that the duty-paid import price will not be greater than the effective intervention price...increased by 88% for Japonica rice, and 80% for Indica rice;' with parallel commitments for milled rice (for details see Yap, 1996). For both cereals and rice, the EU's trading partners have claimed that the reference price system used to determine the import charge to be applied is inappropriate. At the meeting of the WTO's Dispute Settlement Body on 25 February 1997, the USA said that 'it remained very concerned with the reference price system in the European Communities for imports of grain, adding that it was at a loss on how this system could be consistent with the

EC's tariff bindings under the WTO;' and requested the establishment of a panel (WTO Focus, No 16, February 1997, p.7).

Sugar

As noted above, in May 1995 the existing sugar regime was rolled forward to the year 2001 with relatively few changes. Quite what will happen to EU sugar policy after that date is an open question on which we will speculate later. For the moment, the policy is characterised by high market prices buttressed by significant taxes on imports and an aggressive export subsidy programme. Furthermore, although the EU produces more than enough sugar to meet its domestic consumption requirements, it has complex preferential import arrangements for raw cane sugar which are particularly important for some ACP countries.

The EU's support for sugar is constrained by

quota. Quota A and B production can be freely sold within the EU, and benefit from the EU's support mechanisms (with the net price for quota B sugar being somewhat lower than that for quota A sugar), whilst C sugar has to be exported from the EU without subsidy. For 1996/97 the EU's A and B quotas total 14,592,000 tonnes of white sugar, whilst domestic consumption amounts to between 12 and 13 million tonnes.¹⁰ EU exports of C sugar were as high as 2.9 million tonnes in 1993/94, but fell to 1.6 million tonnes in 1995/96.

The EU's intervention price for white sugar in 1996/97 is 631.9 ecu per tonne, but taking into account the storage levy that processors are obliged to pay, the effective support price on the EU market is 656.9 ecu per tonne, for bulk white sugar ex-factory. The costs of storing white sugar are reimbursed from funds generated by the storage levy, and hence the EU's massive oversupply of white sugar does not manifest itself in intervention stocks, but in private stores.

Under tariffication, the EU's base duty rate was set at 524 ecu per tonne, and this is being reduced by 20% in six annual steps to reach 419 ecu/tonne in the year 2000. It will be noted that, in the year 2000, the GATT-approved import charge will still amount to 66% of the current support price for sugar. However, even this understates the protection afforded EU sugar producers, for the safeguards clause permits the EU to charge an additional import tax if, on a consignment basis, the import price falls below the EU's average import price for the 1986-88 base period. The EU has, legitimately, declared a trigger price of 531 ecu/tonne,¹¹ reflecting the fact that in the base period the EU's imports were almost exclusively made up of preferential imports from the ACP states under the terms of the Lomé Convention (for further details, see Swinbank, 1996, p.399).

Thus, imports of sugar at the mfn tariff rates

are most unlikely. However, the EU does import raw cane sugar for processing in its sugar refineries. First, there is a GATT tariff quota for 1,304,700 tonnes (white sugar equivalent), of which 10 thousand tonnes is allocated to India and the remainder to the ACP states in accordance with the provisions of Protocol 8 of the Lomé Convention (discussed below). In EU jargon, this sugar is now known as preferential sugar. It enters duty-free, but EU refiners must pay a specified minimum price for these imports, related to the EU support price for white sugar. Historically, these quantities were processed in the UK and France.

Second, the entry of Portugal into the EU in 1986 (and of Finland in 1995) meant that their sugar-cane processing industries would have been disrupted unless arrangements were made for preferential access of raw cane sugars. Accordingly, on an annual basis for the marketing years 1995/96 to 2000/01, tariff quotas are to be opened for additional quantities of unrefined cane sugar, at a reduced import charge of 69 ecu per tonne. Again, EU refiners are obliged to pay a minimum price for this sugar, related to the EU support price; and in 1995/96 this amounted to 511.7 ecu/tonne. The maximum tariff quota that can be determined under these provisions is 474,300 tonnes (white sugar equivalent) per year. These tariff quotas are to reflect supply agreements between the EU on the one hand, and *first*, the ACP states that benefit from the Sugar Protocol attached to the Lomé Convention, and India; and, *second*, other third countries. In EU jargon, this is known as *special preferential sugar*.¹²

To date, separate agreements have been reached with the ACP States party to Protocol 8 of the Lomé Convention, and India. Accordingly, these countries were due to supply 222,000 tonnes in the eight month period 1 July 1996 to 28 February 1997. Of these quantities,

10 Much of the data reported in this section is taken from Noble (1996).

11 See Regulation 1423/95 (*Official Journal of the European Communities*, L141, 1995).

12 See Article 37 of Regulation 1785/81, as amended in particular by Regulation 1101/95 (*Official Journal of the European Communities*, L110, 1995); and Regulation 1915/95 (*Official Journal of the European Communities*, L184, 1995).

Finland was to receive 50,000 tonnes, metropolitan France 10,000 tonnes, mainland Portugal 162,000 tonnes, and the UK 10,000 tonnes. The ACP states have undertaken 'collectively to implement between themselves procedures for the allocation of the quantities under this special ACP quota in order to ensure the appropriate supplying of the refineries.' The two agreements with the ACP states, and with India, state that 'Before 1 January 2001, the two parties to this agreement shall open discussions on its possible continuation.'¹³ The tariff quotas for special preferential sugar are not tariff quotas bound in GATT.¹⁴

Third, in the Uruguay Round, Finland notified GATT of a current access tariff quota of 85,463 tonnes of raw sugar (about 82 thousand white sugar equivalent). On accession to the EU, this current access tariff quota became an EU obligation, over and above the GATT tariff quota for preferential (ACP and Indian) sugar. The tariff quota is allocated to traditional suppliers, with 68% allocated to Cuba, 28% to Brazil, and the remainder to other countries. This allocation was determined – it is understood – following pressure from Cuba in discussions in Geneva. Despite the country-specific allocations, it is referred to as an *mfn tariff quota*. A reduced import duty of 98 ecu per tonne is payable, but otherwise the import price is freely negotiated.

The GATT Agreement also constrains the EU's subsidised exports. However, this does not include C sugar, which is deemed not to be subsidised, or a quantity of white sugar exports equivalent to the volumes of *preferential* and *special preferential* imports of Indian and ACP sugar (which amounted to 1.6 million tonnes in the base period 1986-1990). Thus, it is only a small part of the EU's overall white sugar exports

that are constrained by the GATT Agreement. The maximum annual expenditure, and maximum volume of subsidised exports, together with the implicit average rate of refund if both maxima are reached, are given in Table 7.3. It should be noted that even in the year 2000, an average export subsidy of 391.9 ecu per tonne could still be granted on subsidised exports, amounting to some 60% of the current support price for white sugar in the EU. There are of course also constraints on expenditure on export subsidies on processed products (Non-Annex II goods), which may contain sugar.

If these export constraints become binding over the next few years, the EU might begin to stock-pile sugar within the EU – either in the form of publicly purchased intervention stocks, or as enlarged private stocks funded by the storage levy scheme – or cut-back quotas. The A and B production quotas could be reduced by the European Commission acting alone, as could the non-GATT tariff quotas. However, the GATT tariff quotas which embrace the Lomé Convention commitments, and the mfn tariff quota inherited from Finland, could not be reduced unilaterally by the EU: any reduction would have to be agreed with the beneficiaries in a WTO framework.

Enlargement and economic and monetary union

The pressures which are leading to calls for further reform of the CAP have already been mentioned. First, although the present *Agreement on Agriculture* will do little to prompt further change to the CAP, there are other considerations. The next round of GATT negotiations, due to begin in 1999, will probably result in further reductions in import tariffs, export

13 The Agreements are printed in the *Official Journal of the European Communities* (L181, 1995), and the tariff quotas are specified in Regulation 2308/95 (*Official Journal of the European Communities*, L233, 1995).

14 It is of interest to note, however, that in its draft submission the EU did include both preferential and special preferential sugar in its minimum access tariff quota which was it had intended to set at 1,565,000 tonnes, with 1,555,000 tonnes allocated to the ACP states. This was revised, to the situation outlined in the text, in February 1994 immediately prior to the submission of the final schedules of commitments for the formal signing of the Uruguay Round Agreements in Marrakesh.

Table 7.3 GATT Constraints on EU-15 Sugar Export Subsidies

	Maximum Expenditure (million ecu)	Maximum Subsidised Volume (thousand tonnes)	Implicit Average Refund (ecu/tonne)
Base period			
1986/90	779.90	1,612.0	483.8
1995/96	733.10	1,555.6	471.3
1996/97	686.30	1,499.2	457.8
1997/98	639.50	1,442.7	443.3
1998/99	592.70	1,386.3	427.5
1999/2000	545.90	1,329.9	410.5
2000 and thereafter	499.10	1,273.5	391.9
% change from base	-36%	-21%	-19%

Note: includes adaptations to the constraints following EU Enlargement
 Source: Noble (1996, p. 5), based on information from the European Commission.

subsidies, and the Aggregate Measurement of Support, which will force change to the CAP. In the next round, the EU will probably not have the tacit support of the USA, as it did in the Uruguay Round. In the Uruguay Round, the USA and the EU were able to agree that both the USA's deficiency payments, and the EU's area and headage payments, were 'production neutral' (decoupled), and thus permissible under the rules formulated in the *Agreement on Agriculture*. This decision was then imposed upon the other GATT/WTO signatories – though conceivably it could still be challenged. Following the 1996 Farm Bill, which has considerably liberalised the system of US farm support, the EU will not readily find allies in the next round to sustain the *status quo* on 'production neutral' payments. Furthermore, the AMS and export subsidy constraints declared by the Central and Eastern European states (CEEs) that hope to become members of the EU in the not too distant future will simply not be compatible with the extension of the CAP to these states.

Few people were surprised when the UK Minister of Agriculture's CAP Review Group argued for radical reform of the CAP (MAFF, 1995), because this is what the UK's partners expect of British politicians and agricultural economists. However, press reports indicating that Germany's Ministry of Agriculture had drawn-up

a discussion paper suggesting that 'The EU's agricultural policy will need major changes if it is to survive the huge challenges posed by eastern enlargement and the next round of world trade liberalisation' (*Agra Europe*, 21 June 1996, p. E/6) sent shock-waves through the EU farming circles.

Budgetary pressures are also important. As noted above, the Mac Sharry reforms introduced a system of support which was both more transparent in its delivery mechanisms, and inherently most costly to the EU's budget, than the 'old' CAP which it displaced. Budgetary pressures were bound to emerge, sooner or later, as a potent catalyst for CAP reform. This consideration was reinforced by the prospect of extending not just the CAP, but also the EU's regional and social aids, to the much poorer economies of the CEEs. More recently, the political imperative felt by some member states to achieve economic and monetary union, and thus to meet the convergence criteria – and in particular the condition relating to public sector deficits – has led these member states to reconsider the EU's spending priorities. The *Financial Times* (24 July 1996) began a report: 'France and Germany are leading efforts to hold European Union spending on agriculture in a race to meet the Maastricht targets for economic and monetary union next year'. Despite the escalating cost of supporting the EU's beef market, in the wake of the BSE crisis, EU

Finance Ministers voted to cut the 1997 draft budget for CAP support by 1 billion ecu (*Agra Europe*, 26 July 1996, p.P/5). This may prove more symbolic than real, but the consensus view is that attitudes are changing.

It is impossible to predict with any degree of certainty how policy will evolve. The role of the European Commission, as the *proposer* of policy reform, will be important but not crucial. The response of the Council of Ministers to any reform proposals will be central to the outcome. External pressures, such as GATT/WTO trade negotiations may play a role. The timetable is, however, tight. The EU is committed to begin accession negotiations with Cyprus within six months of the conclusion of the recent Inter-Governmental Conference which was concluded in Amsterdam in June 1997. Negotiations with the selected CEEs will begin at the same time; but for serious enlargement negotiations on the agriculture dossier to proceed it would be preferable that the future form of the CAP be known.

The European Commission, in the *Agricultural Strategy Paper* produced at the request of the European Council meeting in Essen in December 1994, suggested that there were three possible options for 'Future Orientations for the CAP' in view of the possible accession of the CEEs. The first of these, the status quo, would involve further supply control measures (an increase in set-aside, and further quota controls, for example) if the EU were to meet its Uruguay Round obligations. 'In the end, the situation would become increasingly untenable, and a major CAP reform would probably be unavoidable... Thus the status quo option which could appear to be the 'easy way' today would rapidly turn out to be an impasse and an illusion' (Commission, 1995a, p.21).

The European Commission also rejected its second option, that of radical reform, involving the elimination of supply controls, the near removal or elimination of price support, and income compensation payments decoupled from production, but possibly linked to the provision of environmental services. The European

Commission commented that 'Although such a radical reform may be appealing from an economist's point of view, it would imply a number of social and environmental risks...', and 'at least in the first five to ten years, before compensatory payments are phased out to a large extent, it would imply high sums of additional public expenditure' (Commission, 1995a, p.22).

The European Commission's preferred alternative was its third option, 'Developing the 1992 Approach', and although this had three components – a move 'towards higher competitiveness', an integrated rural policy, and 'simplification – the exact details were left (deliberately?) vague (Commission, 1995a, pp.22-24). Readers were, it seems, left to choose which version of the third option they preferred: an option 3 which more closely approached the status quo, or an option 3 that approximated radical reform.

Postscript: Agenda 2000

As the final version of this chapter was being prepared, various newspaper reports commented on the likely content of the Santer Package (or Agenda 2000) which Commission President Jacques Santer was to present to the European Parliament on 16 July 1997. As well as the Commission's 'avis' on the membership applications of the 10 CEE applicants, the Santer package is slated to include proposals for CAP reform, reform of the regional fund, and proposals for financing the EU budget from 1999 to 2006. It is suggested that five CEEs (the Czech Republic, Hungary, Poland, Estonia and Slovenia) together with Cyprus will be invited begin entry negotiations early in 1998, with the applications of the other five CEEs subject to an annual review (*Financial Times*, 11 July 1997, p.2). The proposals for CAP reform will be limited, it is suggested, to cereals, beef and milk. For cereals, the intervention price would be reduced by 24 ecus/tonne, and in *partial* compensation the area aid would be increased by 12 ecus/tonne; beef support prices would be slashed and headage payments increased; and there

would be some reduction in the support price for milk, offset by headage payments, but the quota mechanism would be retained (*Financial Times*, 8 July 1997, p. 29). It appears that the European Commission has toyed with the idea of setting a maximum amount that individual farmers can claim in area and headage payments, but whether this is retained in the actual proposals remains to be seen. These suggestions have already attracted the wrath of the EU farm lobby (*Financial Times*, 10 July 1997) and it will probably be well into 1998 before the Council concludes its deliberations on these proposals and enacts the next instalment of CAP reform.

7.5 GATT, Free Trade Areas and the CAP

The Uruguay Round Agreements have, potentially, changed the way trade in agricultural products will be dealt with in future customs unions and free trade areas. As is well known, Article XXIV of the GATT has always provided for the formation of customs unions, free trade areas, and of interim agreements leading to the formation of customs unions and free trade areas, in which trade barriers are removed on 'substantially all the trade between the constituent territories'. Quite what this phraseology has meant has been unclear, but an informal 80% rule has applied, and potential partners have presumed that a valid customs union or free trade area could be created if 80% of the trade between the partners could be said to be included. Furthermore, and within this 80% framework, the EU has frequently excluded the bulk of the agriculture sector from its customs union and free trade area agreements. Thus, the European Economic Area with the EFTA countries excluded agriculture; and in 1995 the Commission noted that the customs union between the EU and Turkey, due to commence on 1 January, 1996, 'will not include the agricultural sector where only limited adjustments to the current arrangements are foreseen' (Commission, 1995a, p.131).

Furthermore, the frequent use of non-tariff barriers within the CAP, such as variable import

levies and minimum import price mechanisms, allowed a degree of obfuscation to persist. Customs duties might be removed, but the other border mechanisms of the CAP would be retained. Thus, the nature of a customs union or free trade area between the EU and a partner, and incorporating products subject to the CAP, was difficult to specify. Tariffication has eliminated this ambiguity, but has starkly emphasised the difficulty of incorporating a highly protected CAP product into a free trade area or customs union. How, for example, could sugar be included in a free trade area between the EU and a third country if that third country did not adopt the EU's support arrangements for sugar, or something similar? The customs union agreement for Cyprus and the EU envisages the adoption by Cyprus of measures analogous to the CAP if certain agricultural products are to be included in the customs union (see Swinbank & Ritson, 1991, and Tanner & Swinbank, 1997, for further discussion).

As a result of the Uruguay Round there is now an *Understanding on the Interpretation of Article XXIV* annexed to the General Agreement on Tariffs and Trade 1994 (GATT Secretariat, 1994). The intent is that the requirements of Article XXIV must be satisfied, that agreements should be scrutinised and that customs unions and free trade areas should report periodically to the Council for Trade in Goods, and that the dispute settlement procedure can be invoked with respect to any matter relating to the formation of customs unions and free trade areas. The 'reasonable length of time' referred to in Article XXIV:5(c), in which interim agreements should evolve into full customs unions or free-trade areas, 'should exceed 10 years only in exceptional cases'. Quite what impact all this will have is unclear, but many assume that spurious customs unions and free trade areas will be subject to more stringent review, and challenge, in the future; and that agreements which do not include reciprocal trade concessions or which seek to exclude entire sectors of the economy – such as agriculture – will be deemed invalid.

The EU – which in the past has been accused

of spinning an elaborate web of preferential trade agreements dressed-up as legitimate free trade areas and customs unions – may itself take the lead. Press reports indicate that the EU's Commissioner for Trade, Sir Leon Brittan, would like the EU to ask the WTO 'to tighten its rules on regional trade agreements, to ensure that they comply fully with multilateral principles and do not discriminate against non-members', and for the WTO 'to vet a backlog of about 90 outstanding regional free trade agreements, some notified many years ago' (*Financial Times*, 25 July 1996). It is far from clear that the European Commission, let alone the Council of Ministers, would agree to such a plan, because of the potential impact on the EU's own web of agreements. But the EU's Council of Farm Ministers has certainly taken the threat seriously.

In May 1996, the Italian Presidency of the Council of Ministers initiated a discussion at an informal meeting of the Agriculture Council in Otranto. In its discussion paper, the Italian Government remarked that 'Following the integration of agriculture into the general rules governing the trading system, and the reform of the CAP begun in 1992, agriculture in the EU is now at a delicate stage in the transformation process, which is still being completed', and commented on 'the major unknown factors, arising from the throwing into question of the European agricultural system as it has been defined from its inception until the present day' (Italian Government, 1996, p.2).

The discussion document continues: 'It seems clear that, following the Marrakesh declaration, the contracting parties' room for manoeuvre when altering the content of their agreement and establishing the implementing rules has been considerably reduced. In particular, the exclusion of the agricultural sector from the regional free trade agreements under negotiation and from the agreement establishing a customs union with Turkey as from 1 January, 1996, can only be temporary. Under the criterion of 'substantially all the trade', which leaves open the possibility of excluding a few sensitive products from the agreement, it is doubtful whether it will be possible to exclude all

sensitive agricultural products, since it should be remembered that there are also 'sensitive products' in the industrial sector, such as textiles, for example' (Italian Government, 1996, p.8).

If it is true that free trade areas and customs unions will in future be subject to more rigorous review in the WTO, and that agriculture cannot be excluded from such agreements, then three possible scenarios arise:

- ❖ that, as a result of the political necessity to forge such alliances, there will be increased pressure for CAP reform, bringing EU price levels more in line with world market prices;
- ❖ alternatively, as a result of political pressure from the powerful EU farm lobby, the EU may be less willing to enter into such agreements in future, partly because of the erosion of protection to agricultural producers under the CAP; but
- ❖ in those instances in which the EU does participate in customs unions and free trade areas which do include trade in agricultural products, the EU's trading partners in those arrangements will gain a more preferred status for their agricultural products in the EU market vis-à-vis trading partners who are excluded.

7.6 The Agricultural Trade Concessions in Lomé IV

For the purposes of this chapter, the relevant sections of the Fourth ACP-EC Convention of Lomé as Revised by the Agreement signed in Mauritius on 4 November 1995, are:

- ❖ Article 168 dealing with trade preferences for CAP products in general;
- ❖ Articles 182 to 184, and Protocol 6, dealing with rum;
- ❖ Article 213, and Protocol 8, dealing with sugar; and
- ❖ Protocol 7 on beef and veal.

Furthermore, Protocol 5 is concerned with bananas, which will be discussed in the next chapter of this report.

In Council Regulation (EEC) No 715/90 of 5 March 1990 *on the arrangements applicable to agricultural products and certain goods resulting from the processing of agricultural products originating in the ACP States or in the overseas countries and territories (OCT)*, as amended, the EU has specified in greater detail the concessions to be granted under Article 168 and Protocol 7 of Lomé IV.¹⁵

Article 168 and Regulation 715/90

Article 168 is an anachronism in that it still does not recognise the revision of the EU's import arrangements for CAP products introduced in 1995 as a result of tariffication. Instead, annexed to the Lomé Convention, as revised on 4 November, 1995, is a declaration concerning agricultural products referred to in Article 168(2)(a)(ii) – i.e. CAP products which used to be protected by variable import levies and other non-tariff barriers which have now been tariffied – which reads:

'The import treatment applicable to agricultural products and foodstuffs originating in the ACP states agreed between the Community and the ACP states in the context of the mid-term review of the Fourth ACP-EC Convention is in the process of being technically adapted to take account of the new Community Common External Tariff resulting from the Uruguay Round Agreements and other modifications to the Combined Nomenclature. The text of this revised Annex will be published as soon as it is agreed by the Contracting Parties.' [Annex XL]

Neither has Regulation 715/90 been amended to take account of tariffication, although it was amended for other reasons in 1996. However, on 8 January, 1997, the European Commission did submit a proposal to the Council for a Council Decision approving the adoption of the revised Annex XL to the Fourth ACP-EC Convention (Commission, 1997).

Article 168 deals with CAP products listed in Annex II to the Treaty of Rome, and other products 'subject, on import into the Community, to specific rules introduced as a result of the implementation of the common agricultural policy' (that is to say, Non-Annex II goods). Specifically, Article 168 states that such products from the ACP states can be imported free of customs duties provided the only form of border protection for these products is customs duties. Under the 'old' CAP, prior to tariffication in 1995, there were very few such products. Article 168 also states that where other forms of border protection apply (for example, the variable import levies and minimum import price regimes of the 'old' CAP) then 'the Community shall take the necessary measures to ensure more favourable treatment than that granted to third countries benefiting from the most-favoured-nation clause for the same products'. Table 7.4 lists the concessions the ACP states enjoy as a result. It is not a definitive statement. It is based on our reading of Article 168 and Regulation 715/90, supplemented by the proposed changes to Annex XL.

In paragraph 2 of Article 168 of the Lomé Convention there is the provision that: 'If, during the application of this Convention, the ACP states request that new lines of agricultural production or agricultural products which are not the subject of specific arrangements when this Convention enters into force should

¹⁵ *Official Journal of the European Communities* L84, 1990. Amended by Regulations: 297/91 (*Official Journal of the European Communities* L36, 1991), 444/92 (*Official Journal of the European Communities* L52, 1992), 234/94 (*Official Journal of the European Communities* L30, 1994), 235/94 (*Official Journal of the European Communities* L30, 1994), 2484/94 (*Official Journal of the European Communities* L265, 1994), 619/96 (*Official Journal of the European Communities* L89, 1996). As the OCT have enjoyed totally free access to the EU market since 20 September 1991, these provisions no longer apply to the OCT.

benefit from such arrangements, the Community shall examine these requests in consultation with the ACP states.' In line with this provision, in October 1994 seedless table grapes (in the period 1 December to 31 March) were added to the list of fresh fruit and vegetable products that could obtain duty-free access to the EU market within:

- (i) a tariff quota of 400 tonnes between 1 December and 31 January; and
- (ii) a reference quantity of 100 tonnes in the period 1 February to 31 March.

Subsequently, Namibia requested a further tariff quota of 600 tonnes for the period 1 to 31 January. The EU agreed to a further 400 tonnes, 'on account of the economic importance of seedless table grapes for the ACP states', so that a tariff quota of 400 tonnes now applies for December and a further tariff quota of 400 tonnes for January, as well as the reference quantity of 100 tonnes to cover the months of February and March (Regulation 619/96, *Official Journal of the European Communities* L89).

A reference quantity is almost a tariff quota. Regulation 715/90 specifies that, 'if imports of the productexceed the reference quantity' the EU has the right to make such imports subject to 'a ceiling equal to the reference quantity, having regard to the annual balance of trade in the product.' (Article 16(2)).

The mid-term review undertaken in 1994/95 extended some of the Article 168 concessions. These additional concessions included some increase in tariff quotas and increased margins of preference. These additional concessions have not as yet been incorporated into Regulation 715/90; but they are included in the proposed revision to Annex XL and are thus reflected in Table 7.4.

Protocol 6 on rum

Protocol 6 on rum is concerned with rum, taffia and arrack, and provides for the duty-free importation of these products within tariff quotas. The EU has not as yet adopted 'a common organization of the market in spirits' and, in order to preserve flexibility should such a development seem desirable in the future, the life of Protocol 6 is limited to the date of the entry into force of such arrangements.

The tariff quota is expressed in hectolitres of pure alcohol, and in 1995 stood at 244,000 hectolitres for all ACP rum. As of 1996, new arrangements have come into play, and duty-free access for 'light' rum is no longer controlled by tariff quota. Until the year 2000, however, duty-free access for 'traditional' (dark) ACP rum¹⁶ is to be controlled by tariff quota:

- ❖ in 1996, 58,000 hectolitres (expressed as pure alcohol);
- ❖ in 1997, 61,000 hectolitres;
- ❖ in 1998, 64,000 hectolitres; and
- ❖ in 1999, 67,000 hectolitres (Regulation 2599/95, *Official Journal of the European Communities* L267). The Commission administers the tariff quota.

Although rum is not a product of interest to European farmers (except as a competitive product to other spirits such as brandy and whisky), it is of course of interest to EU producers in the French Overseas Departments (the DOMs, or *Départements d'Outre-Mer*), and hence it remains a sensitive product for the CAP. As a result of the Uruguay Round Agreement, the import tariff on rum shipped in bulk is being reduced by 40% from 1.0 to 0.6 ecu per degree alcohol per hectolitre. Thus, the preference inherent in the Protocol will be seriously eroded by the year 2000.

¹⁶ 'Rum with a content of volatile substances other than ethyl and methyl alcohol equal to or exceeding 225 grams per hectolitre of pure alcohol with a 10% tolerance.'

Table 7.4 Article 168 Concessions on the Import of Various CAP Products from the ACP States as Listed in the Proposed Revisions to Annex XL

Beef and veal	Free of ad valorem customs duties, provided import growth does not exceed 7% per annum. 92% abatement of the specific customs duty, within tariff quotas, as detailed in Protocol 7
Sheep and goatmeat	Free of customs duties
Poultrymeat	Live poultry: 16% reduction in customs duty Fresh meat: 65% abatement of customs duty, 400 tonnes per year Prepared products: 65% abatement of customs duty, 500 tonnes per year
Pigmeat	Fresh meat: 50% abatement of customs duty, 500 tonnes per year Sausages: 65% abatement of customs duty, 500 tonnes per year
Milk products	16% reduction in customs duty for some products Concentrated milk: 65% abatement of customs duty, 1,000 tonnes per year Cheese and curd: 65% abatement of customs duty, 1,000 tonnes per year
Fish	Free of customs duties
Oils and fats	Free of customs duties
Cereals	Sweetcorn: customs duty reduced by 1.81 ecu/tonne Grain sorghum: 60% abatement of customs duty on 100,000 tonnes per year; 50% abatement thereafter. Millet: full abatement of customs duty on 60,000 tonnes per year; 50% abatement thereafter
Rice	Complex array of abatements of the customs duty on the equivalent of 125,000 tonnes per year of husked rice and 20,000 of broken rice. Entry into the EU is conditional upon an export charge of an amount equivalent to the reduction being charged by the exporting country
Sugar	16% reduction in customs duties on some products, but not white sugar Molasses: exemption from customs duties on 600,000 tonnes per year
Fruit and vegetables	Four possibilities: i) free of customs duties; ii) free of customs duties but constrained by tariff quotas or reference quantities; iii) tariff reductions; or iv) no concessions
Processed fruits and vegetables	Selected products: free of customs duties.
Grape must	Free of customs duties
Tobacco	Free of customs duties
Cut flowers, etc	Free of customs duties

Warning: this is not a complete or definitive list!

Trinidad and Tobago is the main beneficiary of this concession, accounting in 1992 for 41% of the EU's total rum imports by value (61% of its rum imports from the ACP states) (Davenport *et al*, 1995, p. 15). Davenport *et al* report that it is a light rum, rather than a dark rum producer.

Beef and veal¹⁷

In the first Lomé Convention, the ACP concession on beef and veal was limited to an elimination of conventional customs duties, on 'a quantity equivalent to imports into the Community during whichever year between 1969 and 1974 Community imports of products

¹⁷ We are very grateful to Mr Ove K Neilson, Chief Executive of the Botswana Meat Commission (UK) Holdings Ltd, for his help in researching this topic.

of that origin were highest, plus an annual growth rate of 7%' (Article 2 of Regulation 715/90), but it was intended that the full variable import levy remained payable. These original quantities were determined at:

Botswana	18,916 tonnes (1973)
Kenya	142 tonnes (1971)
Madagascar	7,579 tonnes (1972)
Swaziland	3,363 tonnes (1973)
total	27,531 tonnes

Under the 'old' CAP a distinctive feature of the mfn import regime for beef and veal was that customs duties (at 20% *ad valorem* on boneless beef) and variable import levies were applied. For Botswana and Swaziland, which had traditionally enjoyed free access to the British market, the prospect of paying the full variable import levy was problematic, and indeed a sharp rise in the variable import levy in March 1975 quickly rendered the trade commercially unviable. There followed a flurry of diplomatic activity, which resulted in the EU offering a 90% abatement of the variable import levy, on the quantities listed above, provided the exporting state levied an export tax of an equivalent amount, the proceeds of which could be used at the discretion of the exporting state. In the case of Botswana, the government levied the tax under the Export Tax (Chilled or Frozen Boneless Meat) Regulations 1975, and then paid the proceeds back to the Botswana Meat Commission under the Meat Industries Beef Equalization Special Order, 1975 (Botswana Meat Commission, 1989, p.6). The requirement upon the exporting state to charge an export tax equivalent to the levy abatement no longer applies.

Under Lomé IV, in addition to the Article 168 concession abating to zero the convention-

al customs duties applicable on the signing of Lomé (for traditional quantities augmented by a 7% annual growth factor as detailed above) Protocol 7 provides for an abatement of the variable import levy on annual tariff quotas of 52,100 tonnes of boneless beef and veal from six ACP states, allocated as follows:

Botswana	18,916 tonnes
Kenya	142 tonnes
Madagascar	7,579 tonnes
Swaziland	3,363 tonnes
Zimbabwe	9,100 tonnes
Namibia	13,000 tonnes

Namibia was included in the scheme in 1991, with an annual tariff quota of 10,500 tonnes, which was increased to 13,000 tonnes in 1993.

The concession, as specified in Article 1 of the Protocol, amounts to a 92% abatement of any import charge *other than* customs duties.¹⁸ Tariffication, on 1 July 1995, resulted in the replacement of the variable import levy by a specific customs duty. Thus, the mfn import charge on boneless beef in the period 1 July 1996 to 30 June 1997 amounts to an *ad valorem* customs duty of 17.6% and a *specific* customs duty of 417.1 ecu/100 kg (Regulation 1035/96, *Official Journal of the European Communities* L152). In implementing Protocol 7, the EU now applies the 92% abatement to the specific component of the customs duty, in addition to the total elimination of the *ad valorem* component. This remains a significant tariff concession, and will remain so until the EU's mfn tariff rate on beef and veal is substantially reduced in a future GATT/WTO negotiation. Nonetheless, given the problems of oversupply in the EU beef market – in part triggered by fall in EU consumption the wake of the BSE crisis – the EU may rapidly move to a radical reform of the beef regime

18 See also Articles 3 and 4 of Regulation 715/90 (*Official Journal of the European Communities* L84), as amended. The abatement was increased from 90 to 92% in the 1994/95 mid-term review (Vernier, 1996, p. 10). The ACP states and the EU are in dispute as to whether the switch from 90 to 92% should have occurred on 1 July 1995, with tariffication (the ACP view), or on 1 January, 1996, with the coming into force of the other components of the mid-term review (the EU's view).

involving very much lower market prices (to stimulate consumption), and direct support to producers, possibly in the form of enhanced headage payments.

Despite the potential benefit of these concessions, the ACP states have had difficulty filling the tariff quotas, and some commentators have criticised the unsuitability of the concession. The ACP states are not relieved of the need to meet stringent veterinary and public health checks imposed by the EU, involving controls against foot and mouth disease for example, and their products must meet customer requirements in the EU. Because of drought and foot and mouth disease, there has been a history of the ACP failing to fill the tariff quotas allocated;¹⁹ and more recently the BSE crisis has adversely affected all beef consumption in Europe, whatever its origin. Table 7.5 records the quantities shipped in the period 1992 to 1995. Zimbabwe has in the main filled its tariff quota, whereas Kenya and Swaziland have been much less successful.

Article 3 of Protocol 7 does say that the Community 'is willing to consider' postponement of deliveries to the following year, 'In the event of an actual or foreseeable recession in these exports due to disasters such as drought, cyclones or animal disease'. Furthermore, if in any year one of the beneficiaries is unable to supply the tariff quota quantities, and does not wish to benefit from the provisions of Article 3, then – on a request from the ACP states – the Commission is authorised to share out this quantity among those ACP states able to supply. We understand from the Commission Services that such a request would normally be accepted, and this is consistent with the data recorded in Table 7.5. Thus in 1993 some of the unused quantities were carried forward to 1994, for the benefit of Zimbabwe; and further

transfers to Zimbabwe were effected in 1994 and 1995. In the period recorded in Table 7.5, only 72% of the total tariff quota offered ACP states was taken up. Thus, the impression gained is that exports to the EU are not constrained by the global 52,100 tonne tariff quota.

Namibia was added to the list of beneficiaries with effect from 1991 on becoming an ACP state. Given the chronic problems of over-supply in the EU's beef market, it seems unlikely that the EU would willingly countenance an extension of the global quantity of 52,100 tonnes, even though other ACP states might wish to become beneficiaries. Davenport *et al* (1995, p.17), for example, have suggested that Ethiopia could benefit from being listed among the beneficiaries, but this would undoubtedly involve a reduction in the tariff quota currently extended to one or more of the existing beneficiaries.

In practice the Botswana Meat Commission plays a dominant role in the trade. Its European subsidiaries, operating from London, manage the EU's imports under the Lomé Protocol from Namibia and Swaziland as well as Botswana, and for many years they did so for Zimbabwe, selling into the UK, Germany, The Netherlands and Greece. The European subsidiaries handle applications for import licences under the tariff quotas, and by virtue of their ownership of a bonded warehouse they can control release from customs control and thus the date of the official 'import' into the EU.²⁰ Meat is shipped as chilled vacuum-packed hindquarter cuts, mainly for the catering trade, and frozen forequarter cuts for manufacture (mainly burgers).

Beef consumption in the wake of BSE, the future of the EU's beef regime, and the continuation of the Lomé concessions, are all vital issues relating to this trade, but the Botswana Meat

19 Drought first accelerates slaughtering and shipments, and then has a depressing effect. A severe drought afflicted the whole of Southern Africa in 1991/92 (Botswana Meat Commission, 1993, p.24).

20 We understand that Zimbabwe, whose product is no longer handled by subsidiaries of the Botswana Meat Commission, has requested a change in the regulations to allow Zimbabwe to issue the licences for the tariff quota, rather than authorities in the EU. Elsewhere in this chapter we refer to the difficulties a beneficiary country can face in 'capturing' any rents that may be implicit in a tariff quota. In the case of Protocol 7 beef however, where a wholly-owned subsidiary has controlled the supply chain, including importation and the bonded warehouse from which the product clears customs, the probability is that the bulk of the rent is captured by the importer.

Table 7.5 ACP Utilisation of Beef Quotas, 1992-1996

1992	Quota	Utilised	Unused
Botswana	18,916	15,914.90	3,001.10
Kenya	142	15.00	127.00
Madagascar	7,579	1,275.62	6,303.38
Namibia	10,500	9,200.80	1,299.20
Swaziland	3,363	128.31	3,234.69
Zimbabwe	9,100	8,326.87	773.13
Total	49,600	34,861.50	14,738.50

1993	Quota	Transfer, March '94	Utilised	Unused
Botswana	18,916	-1,000	14,650.00	3,266.00
Kenya	142	-142	—	—
Madagascar	7,579	-2,500	1,784.30	3,294.70
Namibia	13,000	-1,000	10,350.50	1,649.50
Swaziland	3,363	-500	703.00	2,160.00
Zimbabwe	9,100		9,100.00	0.00
Total	52,100	-5,142	36,587.80	10,370.20

1994	Quota	Transfer 1993	Transfer 1994	Utilised	Unused
Botswana	18,916		-1,000	12,425.00	5,491.00
Kenya	142			0.00	142.00
Madagascar	7,579		-2,500	2,159.14	2,919.86
Namibia	13,000		-1,000	11,087.00	913.00
Swaziland	3,363		-1,000	642.00	1,721.00
Zimbabwe	9,100	5,142	5,500	16,242.50	3,499.50
Total	52,100	5,142	0	42,555.64	14,686.36

1995	Quota	Transfer Oct '95	Utilised	Unused
Botswana	18,916		13,770.77	5,145.23
Kenya	142	-142	—	—
Madagascar	7,579		4,040.62	3,538.38
Namibia	13,000	-500	11,778.20	721.80
Swaziland	3,363	-1,000	719.50	1,643.50
Zimbabwe	9,100	1,642	10,742.00	0.00
Total	52,100	0	41,051.09	11,048.91

Table 7.5 ACP Utilisation of Beef Quotas, 1992-1996 (continued)

1996	Quota	Utilised	Unused
Botswana	18,916	11,511.00	7,405.00
Kenya	142	0.00	142.00
Madagascar	7,579	1,730.69	5,848.31
Namibia	13,000	10,256.99	2,743.01
Swaziland	3,363	533.20	2,829.80
Zimbabwe	9,100	7,752.82	1,347.18
Total	52,100	31,784.71	20,315.29

Source: European Commission.

Commission (UK) Holdings Ltd also raise a number of specific issues relating to the implementation of Protocol 7:

- ❖ footnote 12 has already alluded to the dispute between the EU authorities and the importers as to the date on which the levy abatement should have been increased from 90 to 92%;
- ❖ although the concession relates to boneless beef, making no reference either to chilled or frozen products, import licences do specify chilled or frozen, thus adding to the complexity of managing imports. Furthermore, if an import licence is taken-out, but not used, the quantities will be lost because the tariff quota is operated with regard to licenses issued rather than quantities imported;
- ❖ requests for import licences have to be lodged by noon on the 10th day of the month, and – after examination by the European Commission in Brussels to ensure sufficient volumes of the tariff quota remain used – they are then issued on the 21st of the month. This means that in managing an *annual* tariff quota, imports cannot be effected in the first three weeks of January, compounding the problems of managing the business. Other preferential import arrangements for beef do, apparently, overcome this difficulty by allowing traders to lodge securities which would be forfeited if a tariff quota licence was not subsequently obtained;
- ❖ difficulties have arisen over the definition of a forequarter. For marketing purposes, forequarter meat-cuts are packed in standard-weight cartons of 28 kg, based predominately on the forequarter of a particular carcass, but perhaps with meat added or removed to make up a standard weight. This means the product is then classified as ‘other meat cuts’, paying a higher duty than would be the case if it were classified as a forequarter; and
- ❖ finally, an issue not specific to Protocol 7, is the complaint that with tariffication on 1 July 1995 an anomaly crept into the new duties fixed for frozen forequarters and cuts, and frozen ‘other’, so that these products now face an import tax disproportionately high in relation to chilled boneless meat.

Sugar

The Sugar Protocol (Protocol 8) is potentially one of the most vexatious in the Convention. It reproduces the text of Protocol 3 of the original Lomé Convention of 1975. Article 1 states that ‘The Community undertakes for an indefinite period to purchase and import, at guaranteed prices, specific quantities of cane sugar, raw or white, which originate in the ACP states and which these States undertake to deliver to it’. Key phrases are: ‘indefinite period’, ‘purchase and import’, and ‘guaranteed prices’.

Article 10, however, does limit the concept of an indefinite duration. Basically it specifies that although the Sugar Protocol will remain in force even after the Lomé Convention lapses, the Sugar Protocol may nevertheless 'be denounced by the Community with respect to each ACP State, and by each ACP State with respect to the Community, subject to two years' notice'. The EU did add a declaration that 'The Community declares that Article 10 providing for the possibility of denunciation in that Protocol, under the conditions set out in that Article, is for the purposes of juridical security and does not represent for the Community any qualification or limitation of the principles enunciated in Article 1 of that Protocol'.

Whilst the Protocol is in force, it commits the EU 'to purchase and import, at guaranteed prices, specific quantities of cane sugar.' This is reflected in part in the tariff quota the EU has entered into in the WTO. The 'current access quota' commitments in the EU documentation submitted at Marrakesh specify a conventional 1,304,700 tonne tariff quota for cane or beet sugar under tariff heading 1701. Under column 7, 'Other terms and conditions', the following wording appears:

*'Allocated to supplying countries as follows:
India 10,000 tonnes
ACP 1,294,700 tonnes in accordance with
the provisions of the Lomé Convention.'*

Two questions are raised by this. First, is this provision in any way linked to the waiver arranged for Lomé IV? (i.e. would it lapse if a successor agreement and waiver were not agreed?); and second, are country-specific tariff quotas acceptable in GATT? (i.e. are they compatible with Article XIII of GATT?).

It is our current interpretation, supported by discussions with some, but not all, the Commission officials we met in Brussels, and in the WTO Secretariat, that the tariff quota is not linked to Lomé IV and its waiver: that the phrase 'in accordance with the provisions of the Lomé Convention' simply refers to the distribution of

the 1,294,700 tonnes allocated to the ACP states, and does not refer to the tariff quota in its entirety. But it would appear that there are two views on this. A corollary attached to our interpretation is that the EU cannot unilaterally withdraw the tariff quota: instead it would have to seek the acceptance of India and the ACP states.

We understand that any *country-specific* tariff quota notified by the EU is potentially subject to challenge because of its violation of the GATT's most-favoured-nation rules and in particular Article XIII of GATT on the 'Non-discriminatory Administration of Quantitative Restrictions', but we think this unlikely as such a precedent would open up a whole series of challenges (for example the tariff quota extended by the EU to New Zealand for butter). We do not believe this conclusion is inconsistent with the reports we have seen of the banana panel's recent ruling on the application of Article XIII, but the full panel report requires further examination.

The GATT binding does not commit the EU to 'purchase and import', and nor does it specify prices, but in our view *it is a commitment of indefinite duration* (or until the ACP states concerned voluntarily agree to release the EU from this commitment).

The words 'to purchase and import' are fairly unambiguous. It would appear that the EU is bound to purchase and import the quantities specified. In practice of course, it is not the EU authorities which 'purchase and import', but instead private traders, but the EU is required to purchase any quantities that private traders do not take up. Furthermore, although the EU does import this sugar, an equivalent quantity of EU sugar is in fact exported to the world market. Some CAP apologists have in the past suggested that it would be more rational to do away with the requirement to import ACP sugar given that the EU then exports an equivalent amount of EU sugar.

The phrase which is most problematic is the reference to 'guaranteed prices'. Article 5(4) of the Protocol specifies: 'The guaranteed price, expressed in units of account, shall refer to unpacked sugar, c.i.f. European ports of the Community, and shall

be fixed in respect of standard quality sugar. It shall be negotiated annually, *within the price range obtaining within the Community*, taking into account all relevant economic factors, and shall be decided at the latest by 1 May immediately preceding the delivery period to which it will apply' (italics added). The critical issue for the ACP states is the level of sugar prices that might apply in the EU in the future, following any reform of the sugar regime. If, for example, the support price for sugar were to be slashed, and EU producers 'compensated' by some type of direct payment, in the form say of area payments, then it seems clear that the price guarantee to the ACP states would be unilaterally reduced. The Protocol would provide no protection for the ACP states, and only moral and diplomatic pressure on the EU could secure 'compensation' for ACP suppliers who faced a sudden, and dramatic, price cut.

Article 3 of the Lomé Convention (and Annex) sets out the quantities, expressed in tonnes of white sugar, as follows:

Barbados	49,300
Belize	39,400
Fiji	163,600
Guyana	157,700
Jamaica	118,300
Kenya	5,000
Madagascar	10,000
Malawi	20,000
Mauritius	487,200
Republic of Congo	10,000
St Kitts-Nevis-Anguilla	14,800
Surinam	4,000
Swaziland	116,400
Tanzania	10,000
Trinidad and Tobago	69,000
Uganda	5,000

The provisions relating to rules of origin are lax, or non-existent, except for a requirement that the sugar originates within the ACP states; but in

practice the sugar has to be *shipped* from the relevant ACP state listed above. Shortfalls, as a result of *force majeure*, can at the discretion of the Commission be shipped in later periods or – with the consent of the ACP state concerned – be reallocated to other beneficiaries. Shortfalls which are not the result of *force majeure* result in a permanent reduction in the allocated tariff quota, and may at the discretion of the Commission be permanently reallocated to other beneficiaries.

As noted in Section 7.4, these same ACP states, and India, are also beneficiaries of annual tariff quotas that could amount to 474,300 tonnes per annum, at a special import tax of 69 ecu per tonne, with the EU refiners obliged to pay a minimum price related to the EU support price. The justification of this programme is the support of the 'port-related refining industry ... in Finland, mainland Portugal, the United Kingdom and southern and western France.'²¹ These are clearly not traditional CAP constituencies, and the programme may seem illogical in the face of the massive over-supply of white sugar and other sweeteners in the EU. Nonetheless, the potential benefit to the ACP states is clear. Retaining this concession, post-2000, will require considerable diplomatic effort on the part of the ACP. Allocating the tariff quota among the potential ACP beneficiaries – given the financial benefits attached – may strain the ACPs' institutional arrangements to their limits.

7.7 The EU's Other Preferential Trading Arrangements

The Generalised System of Preferences [GSP]

The EU's GSP dates back to 1971, and the EU's offer on trade preferences in the context of the United Nations Conference on Trade and Development (UNCTAD). The EU's present scheme for agricultural products,²² valid from 1 January, 1997, to 30 June, 1999, is set out in

21 Regulation 1101/95 (*Official Journal of the European Communities*, L110, 1995), p.2.

22 The EU's GSP for agricultural goods is a separate, but similar, scheme to that applied for industrial products (Driessen, 1996).

Council Regulation (EC) No 1256/96 (*Official Journal of the European Communities* L160). The beneficiary states include Albania and the non-Baltic states of the former USSR (including Russia), following the break-up of the Soviet empire. A number of beneficiaries have high per capita incomes, such as Cyprus, Saudi Arabia and the United Arab Emirates.

All of the ACP states are included as GSP beneficiaries, as are the Mediterranean countries (except Malta and Turkey) referred to in the next section. The Central and Eastern European states with which the EU has signed Europe Agreements (discussed below) are no longer GSP beneficiaries.

A distinction is drawn between the 'least-developed developing countries', which includes some, but not all, of the ACP states, and the rest, and some further distinctions are drawn in the granting of preferences. Table 7.6 lists the ACP states, with those that are deemed to be the 'least-developed developing countries' identified. This distinction is potentially divisive among the ACP ranks.

The Regulation contains five lists of agricultural products. It should be noted that in practice there is a sixth, unpublished, list detailing the agricultural products on which preferences are not granted.

The 'least-developed developing countries' have duty-free access for all the agricultural products listed in the five published lists. Latin American countries, in the Andean Group and in the Central American Common Market, have duty-free access for products listed in the fifth of those published lists (Annex VI to the Regulation).

The first four lists (Sections 1, 2, 3 and 4 of Annex I of the Regulation) list 'very sensitive', 'sensitive', 'semi-sensitive', and 'non-sensitive' products respectively. As noted above, the 'least-developed developing countries' have duty-free access for all of the products on these four lists.

For the remaining countries however, the tariff concessions are limited. For 'very sensitive' products, the concession is a 15% abatement of the tariff. Thus, beneficiaries pay 85% of the mfn rate.²³ For 'sensitive' products, the abatement is 30%, and for 'semi-sensitive' products a 65% reduction applies. Duty-free access is available for all the GSP countries for 'non-sensitive' products.

Given that the products listed in Section 1 of Annex I are known as 'very sensitive' products, it is difficult to find the correct vocabulary to describe those that are not listed at all. However, examples of products which are not listed – and consequently on which no GSP tariff concessions apply – can readily be found. Thus, for example, tomatoes (CN code 0702) are not to be found on any of the lists. There are, however, limited concessions on tomatoes under the Lomé Convention.

Nonetheless, the GSP concessions are potentially valuable, particularly for the 'least-developed developing countries'. Thus, for example, new potatoes (from 1 January to 15 May) appear on the 'very sensitive list', as does asparagus throughout the year. All 'least-developed developing countries' can gain duty-free access, with a 15% tariff reduction for the remaining GSP beneficiaries. The Lomé Convention offers no further concessions on new potatoes, and on asparagus an elimination of tariffs between 15 August and 15 January, a 40% tariff reduction from 16 January to 31 January, and a 15% reduction for the remainder of the year. Thus, for the 'least-developed' Lomé countries in particular, the GSP concessions on these products are superior to those contained in the Lomé Convention.

Two further features of the GSP should be noted: first, the 'graduation' mechanism which is to 'be used to transfer preferential margins from advanced to less-developed countries'. None of the countries concerned are in the

²³ For Greenland and a number of states of the former USSR, a shortened list applies.

Table 7.6 List of ACP States with the ‘Least-Developed developing Countries’ Identified

- | | |
|----------------------------|--|
| • Angola | • Madagascar |
| Antigua and Barbuda | • Malawi |
| The Bahamas | • Mali |
| Barbados | • Mauritania |
| Belize | Mauritius |
| • Benin | • Mozambique |
| Botswana | Namibia |
| • Burkina Faso | • Niger |
| • Burundi | Nigeria |
| Cameroon | Papua New Guinea |
| • Cape Verde | • Rwanda |
| • Central African Republic | • São Tomé and Príncipe |
| • Comoros | Senegal |
| Congo | Seychelles |
| • Chad | • Sierra Leone |
| Côte d’Ivoire | • Solomon Islands |
| • Djibouti | • Somalia |
| Dominica | South Africa |
| Dominican Republic | St Kitts and Nevis |
| • Equatorial Guinea | St Lucia |
| • Eritrea | St Vincent and the Grenadines |
| • Ethiopia | • Sudan |
| Fiji | Surinam |
| Gabon | Swaziland |
| • The Gambia | • Tanzania |
| Ghana | • Togo |
| Grenada | Tonga |
| • Guinea | Trinidad and Tobago |
| • Guinea-Bissau | • Tuvalu |
| Guyana | • Uganda |
| • Haiti | • Vanuatu |
| Jamaica | • Western Samoa |
| Kenya | • Zaire (Democratic Republic of Congo) |
| • Kiribati | • Zambia |
| • Lesotho | Zimbabwe |
| • Liberia | |

• *‘least-developed developing countries’ under the EU’s GSP for agricultural products*

Source: Annex I of Regulation 715/90, as amended; and Annex IV of Regulation 1256/96.

South Africa’s membership of the Lomé Convention was agreed in April 1997, but for the duration of Lomé IV the articles concerning trade and development are not applicable to it.

Angola is not listed as a least-developed country under the EU’s GSP for industrial products (Driessen, 1997, p176).

Lomé group. Second, provisions ‘to withdraw temporarily some, or all of a country’s preferential entitlement’ if certain labour standards are not met, or if the country fails to apply adequate controls with respect to drugs

trafficking or money laundering, and plans for a system of ‘additional preferential margins’ for countries that meet certain environmental and International Labour Organization (ILO) standards.

The Euro-Mediterranean Agreements

The EU's trade arrangements with its Mediterranean partners date back to the 1960s and 1970s. The EU had entered into preferential trade agreements with Cyprus, Malta and Turkey which envisaged the eventual formation of customs unions; interim free trade area agreements with Israel and the former Republic of Yugoslavia; and a series of agreements with Jordan, Lebanon, Syria and most of the North African states which the EU claimed involved a free trade area obligation on the part of the EU under Article XXIV of GATT, but which did not involve reciprocal trade barrier reductions on the part of the EU's trading partners, as – claimed the EU – was sanctioned by the *Trade and Development* provisions in Part IV of the GATT (Swinbank and Ritson, 1991, p.279). This web of preferential trade agreements covered all the Mediterranean states except Albania and Libya.

The agricultural trade concessions in these agreements were limited, reflecting the fact that many of the products considered to be of export interest by the Mediterranean states were considered by farming interests in the southern member states to threaten their legitimate expectations established under the CAP. The preferences, though limited, were sophisticated. On fruit and vegetables and wine there would generally be a tariff reduction, but usually within a tariff quota and calendar. Thus, a country might have benefited from, say, a 50% reduction in the mfn tariff rate on 10,000 tonnes of product landed in the EU in the months of May and June, for example. Reference (minimum import) prices had still to be respected. For olive oil the general arrangement was to allow a small reduction in the variable import levy (of 0.5 ecu/100 kg) to allow the Mediterranean States a 'commercial' advantage on EU markets; and a second, but more substantial, levy reduction of 20 ecu/100 kg provided the Mediterranean State levied an equivalent export tax. The EU called this

second levy reduction an 'economic' advantage even though it did not allow EU market prices to be undercut (see Swinbank and Ritson, 1991; and Swinbank and Ritson, 1995).

In 1991 the EU embarked upon a 'New Mediterranean Policy' with Algeria, Egypt, Israel, Jordan, Cyprus, Lebanon, Malta, Morocco, Tunisia, Syria and Turkey. Responding to the reduced value in preferences enjoyed by the other Mediterranean states, following the accession of Portugal and Spain to the EU, the EU enhanced the agricultural preferences enjoyed by its Mediterranean associates (including the Palestinian autonomous territories) in three ways. First, tariff quotas were increased by 5% (3% for sensitive products) per year, for five years; second the within-tariff quota tariff rates were reduced to zero; and third, for some countries, on certain products (citrus, table grapes and tomatoes), and for specified quantities, an abatement of the reference price system was introduced.

Cyprus is now of course an applicant for EU membership, as was Malta until the recent election, and as noted above a customs union with Turkey came into being on 1 January, 1996, which, however, largely excludes the agricultural sector. Following the conclusion of the Uruguay Round, and the enlargement of the EU to embrace Austria, Finland and Sweden, the EU embarked on a new Euro-Mediterranean partnership, and new agreements with Morocco, Tunisia and Israel have already been concluded (European Commission, 1996, p.156). Reflecting, perhaps, the more stringent interpretation of Article XXIV of GATT, following the Uruguay Round, the new agreements with Morocco and Tunisia envisage the establishment of free trade areas within twelve years (Italian Government, 1996, p.12). However, the concessions on agricultural products retain the characteristics of the old agreements (elimination of tariffs within tariff quotas, concessions on the new entry (minimum import) price system for fruit

and vegetables, discussed in Section 7.4) and certainly do not extend to free trade in agricultural products.

On the initiative of the Spanish Presidency, a Euro-Mediterranean Conference was held in Barcelona in November 1995. One outcome of this conference was a declaration of the participants' intention to establish a Euro-Mediterranean free trade area by the year 2010 (Italian Government, 1996, p.12).

The Europe Agreements

Ten Central and Eastern European states (CEEs) have Europe Agreements with the EU. They are:

Bulgaria
Estonia
The Czech Republic
Hungary
Latvia
Lithuania
Poland
Romania
Slovakia
Slovenia

At the meeting of the European Council in Copenhagen in June 1993, the EU decided that all of these associated countries 'that so desire shall become members of the European Union. Accession will take place as soon as an associated country is able to assume the obligations of membership by satisfying the economic and political conditions required' (Commission, 1995a, p.4), and although the formal negotiations will not begin until 1998, preparatory work is underway.

The trade component of the present agreements is a series of interim free trade area agreements between the EU and each of the ten CEEs, although the Visegrad four (the Czech Republic, Hungary, Poland and Slovakia) have their own free trade area agreement.²⁴ For the moment, the trade concessions granted by the

EU in the context of these agreements are limited, and the CEEs have had difficulty in making full use of the tariff quotas made available to them (for an overview, see Tracy, 1994). However, as and when these economies develop, it must be expected that they will be better able to take advantage of the trade concessions offered by the EU.

Furthermore, the geo-political imperatives that lie behind the quest for enlargement will almost certainly mean:

- ❖ that the more economically (and politically) advanced of these economies will join the EU within the next decade;
- ❖ that as a precursor to membership, not only will the EU embark upon CAP reform but it will also extend more generous trade concessions on agricultural products to the member states-designate; and
- ❖ that, by way of compensation, the other CEEs will be offered more meaningful trade concessions on agricultural products.

Indeed, it might not be too far fetched to imagine the eventual formation of a Europe-wide free-trade area, involving not only the existing EU (and EEA) and CEEs, but the other European states left out of the present arrangements (Switzerland, Albania, and the other states of the former Yugoslavia and the former USSR). One scenario for the year 2010 then is for the EU to form the hub of a number of free trade areas embracing:

- ❖ a European free trade area;
- ❖ a Mediterranean free trade area;
- ❖ a North-Atlantic free trade area (embracing say the EU, the USA, and Canada); and
- ❖ a free trade area successor agreement to Lomé IV.

²⁴ Enders and Wonnacott (1996) discuss some of the complications that arise in these overlapping free trade area agreements.

South Africa

The EU has explored a number of other possibilities. Its flirtations with the USA, and with Russia and the Ukraine, are subsumed within the speculations of the preceding paragraph. In addition, it has an economic co-operation agreement with the MERCOSUR countries (Argentina, Uruguay, Paraguay and Brazil) which could eventually lead to the establishment of a free trade area; and it has entered into negotiations with the Republic of South Africa.

In 1995 the EU extended to the Republic of South Africa the GSP, excluding the GSP concessions on 'very sensitive' agricultural products. In June 1995 the EU institutions agreed to open negotiations with South Africa with a view to establishing a trade and co-operation agreement, and accession to the Lomé Convention. However, South Africa was to be excluded from the Lomé Protocols on bananas, rum, beef and veal and sugar 'because of the good level of development in these sectors' (European Commission, 1996, p.158).

By February 1996 press reports indicated that the EU's Foreign Ministers were having second thoughts about the ongoing negotiations to establish a free-trade area with South Africa, and that in particular they were worried about any precedent which might be established. Particular concern focused on the agriculture sector where several states wanted to exclude from the free trade area a number of 'sensitive' products – including maize, beef and sugar not exported by South Africa to the EU – whilst recognising that a long negative list could breach WTO rules (*Financial Times*, 27 February, 1996). Later South Africa rejected the proposed free trade area agreement; and in February 1997 Spain blocked South Africa's partial membership of the Lomé Convention because of an unresolved dispute over access to fishing grounds (*Financial Times*, 25 February, 1997).

7.8 Options for Agriculture within a Successor Agreement to Lomé IV

We are of the view that the global interests of the EU, and of its trading partners, would be best

served by radical reform of the CAP. This, it is believed, would also be in the long term interest of the ACP states. Radical reform of the CAP would involve the substantial reduction, indeed possibly the elimination, of border protection; the elimination of export subsidies and of internal mechanisms of domestic price support; and possibly the introduction of decoupled compensation payments. However, adopting a more pragmatic stance, it is recognised that such an outcome is unlikely in the near future, and that the CAP will continue to provide significant protection to EU farmers. Under these circumstances, preferential trade agreements, such as the Lomé Convention, will continue to offer significant potential benefits to the EU's favoured trading partners. These benefits will, however, be eroded as levels of EU farm price support are reduced, as GATT/WTO negotiations reduce mfn tariff rates, and as the web of preferential trading arrangements grows.

Set against this background, the following comments attempt to explore how the ACP states might make better use of the preferential arrangements for agricultural products embodied in the Lomé Convention, and what further concessions they might legitimately hope to negotiate in any successor agreement. It avoids 'knocking-copy': hence it does not suggest that the ACP states should seek a reduction of the preferential arrangements enjoyed by non-ACP states. Even though it might seem intuitively obvious that such a move would increase the ACP's preferential margin, diplomatically this would be a suicidal approach. Instead, the ACP states should be seeking preferential terms which match those currently on offer to the EU's other preferred suppliers.

A particular issue that has not been addressed in this chapter is the resolution within the ACP camp of the conflicting interests of the 'least-developed developing countries' and the other ACP states, in that the former can obtain better preferences under the agriculture GSP than they do under the Lomé Convention. Elsewhere in this report, the alternative possibilities of a range of successor agreements to both the Lomé

Convention and the GSP are explored, with the possibility of either geographical or economic indicators resulting in different levels of preference.

Tariff quotas

One general issue of direct relevance to this chapter, however, is the role of tariff quotas. On preceding pages, tariff quotas have frequently been identified, either (i) bound in GATT, either on an mfn basis or reserved for specified countries, (ii) extended unilaterally by the EU to specified countries, but not bound in GATT (as with the arrangements for sugar imports over and above the Sugar Protocol quantities), or (iii) extended to particular supplying countries in the context of their free trade or other preferential agreement with the EU. Superficially, tariff quotas can appear attractive, but appearances can be deceptive. They lack transparency, they can encourage fraud and corruption, and they may not confer their significant potential financial benefits on the exporting country.

The problem lies in the quota rents that can be earned by those who control the allocation or use of licences. When a tariff quota is opened on an mfn basis, or for a group of countries without specifying the allocation between the countries, it will have to be administered by the importing country. Import licenses are valuable: they allow traders to import goods at a reduced tariff rate. If these licences are issued to the EU's traders – which is the EU's intent – then the bulk of the financial benefit implicit in the reduced tariff will be captured by the EU-based trader rather than by the supplying country. This is not to say that the supplying country will gain no benefit, for trade has to take place for the quota rent to be captured, but it is almost axiomatic that the bulk of the quota rent will be retained by the importer, and not transferred to the exporter. The ACPs' interest in such instances is to press for annual increases in the tariff quota, until such

time as the tariff quota is no longer fully utilised and all the EU's imports are effected at the reduced tariff-quota rate. At this stage the EU can safely abolish the tariff quota, and apply the lower tariff quota rate to all its imports from that group of countries (e.g. the ACP), or on a mfn basis, as appropriate.

Where the tariff quota is country specific, the country concerned should insist that it issues the licenses.²⁵ Again it should be noted that as they are in limited supply they have a financial value. Corrupt civil servants should not be allowed to expropriate this value, and nor should traders (whether multinational or located in the exporting country). Instead, the government concerned should capture the benefit for the country as a whole by allocating the licences to traders by open tender. Again, it *may* be in the interest of the recipient to seek an increase in the tariff quota until it is no longer a binding constraint, but this requires some careful thought as an increased volume of exports may drive down the price in the EU market and could conceivably lower overall export revenues.

Where tariff quotas are allocated to the ACP as a group, a dilemma arises. Only one authority can legitimately issue licences, and until now it has been the European Commission on a first-come, first-served basis, or by scaling back any application received. However, in the case of *special preferential sugar* a precedent has been set, in that the ACP states involved have collectively been charged with allocation of the overall tariff quota. Admittedly, the case is rather different in that the EU refiners are obliged to pay a specified minimum price if the sugar is to be legally traded. Nonetheless, on the basis of this precedent, the ACP states should investigate the possibility of establishing an ACP international authority which the EU would recognise as the legitimate authority for issuing export licences within the constraints of EU tariff quotas

25 In the case of Protocol 7 beef, although licences have been issued in the EU, the Botswana Meat Commission's European subsidiaries, by controlling the marketing chain and customs clearance, have in effect controlled the licences.

extended to the ACP states. This ACP international authority would be empowered to allocate by competitive tender the licences to ship ACP produce. The quota rents implicit in the tariff quotas would then accrue to the ACP states collectively, rather than to EU-based traders.

Sugar

The Sugar Protocol cannot readily be improved: instead, the challenge for the ACP states is to retain the benefits it contains. Similarly, it is difficult to imagine that the arrangements for *special preferential sugar* could be improved: here the prospect of a diminution of the benefits post-2000 is real.

The Sugar Protocol already provides for duty-free access. It sets out tariff quotas, repeated in GATT bindings, that cannot readily be reduced by the EU. Two conditions would have to be met for the quantities to be reduced: first, an ACP beneficiary would have to fall short of its allocated tariff quota because of circumstances other than *force majeure*, to trigger the provisions of the Protocol; and within the WTO all the ACP beneficiaries would have to agree to a reduction in the overall tariff quota.

Equally, there is little likelihood that the EU will be willing to increase these tariff quotas, or consolidate within the Lomé Protocol the preferential arrangements it currently has in place to import up to 475 thousand tonnes (white sugar equivalent) at a reduced import tax of 69 ecu/tonne to supply the cane refineries of Portugal and Finland. Indeed, as the EU tries to grapple with the constraints on its subsidised exports of sugar, imposed by the GATT Agreement, these additional concessionary imports are likely to be phased down, if not eliminated entirely.

Under the present sugar regime, the Sugar Protocol allows the recipient ACP states to obtain high prices from the EU market. The downside, of course, is that the EU's subsidised exports depress and destabilise world market prices. If the EU were to substantially reduce its internal support prices for sugar, which is a distinct possibility at the end of the present quota

regime in 2001, then the price benefits of the Sugar Protocol would be eroded (and would disappear if EU price support were to be abolished). With EU price cuts of sufficient magnitude to stimulate EU consumption and cut back on production, there would be some offsetting gain as world market prices increased.

The diplomatic challenge facing the ACP states, in such a scenario, is that of convincing the EU that in addition to providing compensation payments to EU producers consequent upon cuts in EU support prices, corresponding compensation payments should also be made to ACP states who also lose out as a consequence of the price cuts.

In the meantime, the individual ACP states that benefit from the Sugar Protocol should treat the price advantage of protected sugar sales into the EU market as a windfall gain. Local producers should not be encouraged to believe that existing EU prices can be paid indefinitely on their sales to the EU. Instead, they should be encouraged to produce (to fill the tariff quotas) at costs approximating those of efficient producers elsewhere in the world, and the governments concerned should impose an export tax to ensure that this is the case. The proceeds from such export taxes should be used to provide a sustainable future income source for the country, preferably by productive investment in the economy. Each government will need to take specific advice relating to its circumstances, and in particular the costs of sugar production, before deciding on the appropriate level of export tax.

With respect to *special preferential sugar*, effective collaboration between the ACP states is vital to ensure that the ACP states do fulfil the tariff quota, and that import opportunities are not left unfilled, giving the EU cause to turn to other third countries for supplies. Equally, a continuation of the effective collaboration with the cane refiners in the EU is important, to ensure that post-2000 an influential EU lobby continues to press for preferential access of raw cane sugar.

Beef

There seems to be little prospect that the EU will be willing to expand the ACP tariff quota beyond the existing volume of 52,100 tonnes per year; in part because of the severe problems of over-supply on the EU's market, and in part because of the past failures of the ACP to fill the tariff quota. It might be argued that, as a negotiating strategy, such a request should be tabled in the hope that this might trigger a counter-offer by the EU for a more useful concession on another product; but in our view this would be an unproductive – even a counter-productive – strategy.

Nonetheless, while the EU maintains market prices for beef well in excess of those prevailing on world markets, protected by the existing customs duties bound in GATT, and provided European beef consumption recovers from the BSE scare, the existing tariff quota is *potentially* of significant benefit to the ACP states, and negotiating effort might best be directed to ensuring greater flexibility in the reallocation of tariff quota in the event of supply shortfalls, to ensure that the tariff quota is fully utilised every year. We listed various ways in which the existing regulations could be ameliorated to facilitate the trade.

We are conscious of the fact that the tariff quota provides only potential benefits, and that considerable costs must be incurred by the ACP states in meeting the stringent health and veterinary requirements laid down by the EU. It was not in our brief, and we have not attempted, to undertake a benefit-cost analysis of the net costs or benefits of the scheme, either for the group of ACP states as a whole, or for individual countries; but we would emphasise that ACP countries should be clear that they can gain advantages from Protocol 7 before embarking on extensive negotiations to seek its revision.

Greater flexibility in the utilisation of the tariff quota involves two components. First, reallocation of quantities within the existing group of beneficiaries in the event of one or more of the countries being unable to fill their allocation in any particular year; and second the reallocation

of quantities from existing beneficiaries to other ACP states not currently benefiting from Protocol 7.

The traditional route for providing relief on the first issue would be to seek improved administrative procedures in Brussels, and in particular more speedy decisions from the Commission. However, this leaves the allocation of potential benefits in the hands of the Commission; and existing beneficiaries may well be unwilling to give up their allocated quantities until the year is so far advanced that a reallocation becomes impractical. An alternative solution, which would better ensure reallocation and fulfilment of the overall tariff quota, and maintain the financial benefit to recipient states, would involve the free transferability of export licences between ACP states. So, for example, the authorities in Kenya (or their agents) would be entitled to request import licences for 142 tonnes of boneless beef per annum, but these licences would be valid for products originating in *any* of the six beneficiary states (or indeed in any ACP state). The relevant ACP authorities in receipt of licences would be entitled to sell them to the highest bidders in another (Protocol 7) ACP state.

The second issue, a permanent reallocation of the right to issue licenses within the overall tariff quota framework of 52,100 tonnes per annum is essentially a political issue for the ACP states to resolve among themselves, and lies beyond the scope of this report. Nonetheless, it might be noted that a market-based solution could entail the sale and purchase of the right to issue export licenses.

In the foregoing discussion, it has been assumed that the Protocol 7 concessions will remain valuable for the foreseeable future. The present support arrangements for beef in the EU retain the concept of high market prices, and the tariff bound in GATT remains high. However, as a result of the BSE scare, market prices in the EU have slumped, and thus the value of the Protocol 7 concessions has been seriously eroded. As a result of the beef 'crisis' currently underway in the EU, radical reforms to

the regime in the near future cannot be ruled out. Any move to further weaken market prices within the EU, perhaps to a level approaching the world market price, would ultimately render the Protocol 7 concessions virtually valueless. If imports from around the world were to be allowed free access to the EU market, it is far from clear that ACP products could retain market share. In the direct consumption market, high quality ('Hilton') beef imports would dominate; and in the market for manufacturing beef (for meat products), the price advantage of the lean carcasses reared on the extensive grasslands of South America could be significant.

Rum

The ACP states now enjoy duty-free access for light rum, unconstrained by tariff quotas, and the tariff quota constraints on the duty-free access for dark rum are due to be abolished in 2000. Consequently there is no further concession that can be negotiated.

Fruit and vegetables

As was noted earlier in this chapter, the EU's protective regime involves minimum import prices (known as entry prices) as well as customs duties. Both customs duties and entry prices vary through the year, and there is a bewildering array of preferential access arrangements: GSP, Lomé, Euro-Mediterranean and for the CEEs. These preferential arrangements include abatement of customs duties (frequently by 100%), and concessions on entry prices, but often limited by tariff quotas or reference quantities. A further complication arises in that, potentially, some Lomé countries (the 'least-developed developing countries') can gain better access under the GSP than they do under the Lomé Convention. It is beyond the remit of this report to identify the products, the periods of the year, and the ACP states, that could benefit from further concessions under the Lomé Convention. A detailed study of the ACP's export potential in these products is required, because much time and effort could be expended on trying to achieve

concessions for the ACP states which might have no practical relevance.

However, some general principles can be enunciated. First, on items where *limited* concessions are already offered to the ACP, and these are utilised, then the ACP should press to remove or relax the limitations. Thus if the concession is less than a full abatement of the customs duty, full abatement should be the objective. If the concession is limited in time to only particular weeks or months in the year, then the ACP should press to see these time constraints relaxed, provided at least one ACP state indicates that it could take advantage of such a concession. Where the concession is limited by tariff quotas (or reference quantities), and these tariff quotas are already filled or in danger of being filled, then the ACP should press for the tariff quota to be expanded, or better still removed.

Second, the ACP states should undertake an investigation to determine whether or not the entry price system is having a harmful effect on their exports to the EU. If it is, then on those products the ACP should seek to have special, lower entry prices determined for ACP produce. The precedent has already been set, in the Euro-Mediterranean Agreements with Morocco and Israel.

Third, if ACP states already export fresh fruit and vegetables to the EU without benefit of tariff concessions, the ACP should ask for tariff concessions on these products.

Finally, if ACP states can identify products that they could export to the EU if tariff concessions were conceded, then tariff concessions on these products should also be sought.

It is doubtful that the EU would be willing to extend significant further concessions on fresh fruit and vegetables. One over-riding consideration is the complementarity of EU and ACP production seasons. If ACP suppliers are competing with EU production, particularly with expensive 'out-of-season' EU produce, then Europe's farm lobby will be opposed to further concessions. However, if product and calendar niches can be identified that involve ACP sup-

plies that do not compete directly with EU farm production, opposition is much less likely. Indeed Europe's retailers wish to obtain good quality, competitively priced, supplies throughout the year to ensure continuity of supply on their super-market shelves.

Cereals and rice

In Table 7.4 we reported on the limited concessions on cereals and rice: a small tariff reduction on sweet corn; a 100% abatement of the tariff on a tariff quota of 60,000 tonnes of millet, and a 60% abatement on 100,000 tonnes of sorghum, and a 50% abatement on both thereafter; and a 15% abatement of the tariff on 125,000 tonnes of rice.

ACP rice imports into the EU have had difficulty filling the tariff quota. In recent years imports have been:

42,382 tonnes in 1992/93;

87,267 tonnes in 1993/94; and

20,683 tonnes in 1994/95 (European Commission, 1995 p.51; 1996, p.63).

By contrast, the duty-free imports of rice from the Dutch Antilles (an OCT) have been much more buoyant, at about 140 thousand tonnes per year. Under present conditions there is little to be gained by an increase in the tariff quota: instead the ACP should seek an increase in the abatement of the tariff, ideally to 100%, to match the tariff concession available to the OCT.

However, there is a further complication in the case of rice. The tariff abatement is conditional upon the exporting country collecting 'an export charge of an amount equivalent' to the tariff reduction. Thus, from the perspective of the trader, there is no commercial advantage to be gained from the concession: in effect the trader faces the EU's full mfn rate, of which part is collected on export, and part on import into the EU. Set against these circumstances, the ACP export volumes are creditable. If the intent really is to increase exports, rather than simply to transfer tax revenue to the ACP, then some part of the tariff concession should be reflected in

lower overall charges faced by the trader, thus encouraging exports.

Wine and grape must

The ACP enjoy no tariff preferences on wine, although they do on grape must. Although climatic factors rule out most ACP states as potential wine producers, the accession of South Africa, a major wine producer, to the Convention would provide an excuse for the addition of wine to the list of preferences, to the benefit of other ACP states.

Grape must is subject to the entry price regime, as with some fresh fruit and vegetables. If this is proving an obstacle to ACP suppliers, then a request for a special, lower entry price for ACP products should be lodged.

Processed Products and Non-Annex II Goods

Whilst an increase in agricultural exports, and higher export prices on sales to the EU, is of direct benefit to the ACP states, the benefits could be enhanced if those same agricultural exports were to be exported not in unprocessed or semi-processed form, but in processed foods and other products. Mostly these will be treated as Non-Annex II goods, rather than CAP products, on import into the EU.

The Article 168 concession has been a full abatement of what used to be known as the fixed component, which provided protection to the processing activity, but only limited concessions on the agricultural component reflecting the protection on the agricultural raw materials included in the product. Thus, under Tariff heading 1704 (Sugar confectionery including white chocolate, not containing cocoa) there is only a partial abatement on chewing gum, but a full abatement on white chocolate. This means that on ACP imports into the EU, the sugar component of chewing gum would be taxed, whilst the sugar contained in white chocolate enters duty free.

Where the ACP enjoy a tariff preference on an agricultural product, but not on that product when incorporated into a processed product, the

ACP states suffer from a high degree of *effective* protection on the processed product because of this tariff escalation. The tariff structure means that there is a commercial incentive to locate the processing industry within the EU, to process the imported ACP raw material, rather than to locate that industry within the ACP.

An important principle to establish with the EU in any successor agreement should be that where tariff concessions have been extended to the ACP states on agricultural goods, these same concessions should be carried through to processed products. This would eliminate tariff escalation, and encourage the location of processing industries in the ACP. Although this may have little practical effect at the outset, the long term development prospects of a number of countries could be enhanced.

Where the agricultural concession is limited by tariff quota, and the EU is unwilling to extend the preference to processed products, it could conceivably be in the interest of the ACP states to count the processed product against the tariff quota. Further study of the potential of individual processing sectors would be required, but if, for example, it could be shown that there was the potential to produce (to EU customer requirements) chewing gum and boiled sweets in ACP states, then it might be more profitable to ship Protocol 8 sugar in the form of chewing gum and boiled sweets than in the form of unrefined cane sugar.

This last example was left deliberately vague, to illustrate the complexities that can arise with respect to rules of origin on processed products. The Protocol 8 concessions are of course country specific. More generally, agricultural raw materials originating in one ACP state might be processed in another. Thus, for a scheme along the lines outlined in the previous paragraph to be fully effective, the rules of origin would have to permit production in one ACP state, and processing in a second, to be counted against either the ACP tariff quota, or the country specific tariff quota, on the raw material as the case may be.

Moreover, sugar was a bad example to use in that the political support within the EU for Protocol 8 sugar comes from the refining industry which wishes to maintain its access to unrefined sugars and would not welcome the prospect of Protocol 8 sugar being shipped in processed form.

Fish

The ACP states enjoy duty-free access to fish, and so no further concession need be sought here. However, the fishing industry does give rise to problems relating to rules of origin. Country of registration – and country of ownership – of fishing boat, port of landing, and country of processing, are all relevant considerations as well as the territorial waters in which the fish were caught. Further relaxation of the complex rules of origin would be beneficial to the ACP states.

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The Lomé Banana Protocol

Summary

A special protocol of the Lomé Convention assures preferential treatment of banana exports to the European Union from 'traditional' ACP exporters. The Lomé protocol has until recently been successful in maintaining ACP exports but less successful in raising the competitiveness of ACP exporters. The Lomé preferences have been delivered by the EU's banana trade regime. Without the preferential treatment accorded by the EU regime, ACP exports could not compete on EU markets because of high costs and variable quality compared to Latin American supplies. The EU's banana policy has been challenged in the WTO. The WTO Panel found against aspects of the regime and the EU has lodged an appeal. Some ACP exporters, notably the Windward Islands, are highly dependent on banana exports in terms of contribution to GDP and employment. The loss of banana trade preferences could lead to the loss of the banana industry in certain ACP states, with far-reaching economic and political effects. Whatever the outcome of the WTO case, it is essential to raise the competitiveness of ACP banana exports, and the trade development provisions of the Lomé protocol need to be emphasised. A smaller industry producing higher quality bananas is the likely result. Diversification opportunities in the Windward Islands are limited. Competition on world markets for alternative horticultural crops is severe. Tourism development thus far has arguably contributed little to the local demand for agricultural products.

8.1 Introduction

A special protocol of the Lomé Convention has assured preferential treatment of banana exports

to the European Union from 'traditional' ACP banana exporters. The mechanisms by which these preferences are delivered are those of the EU's banana trade regime. Indeed, the need to satisfy the Lomé commitment was perhaps the major motivating factor in the development of the EU's common banana trade policy. The Lomé Protocol and the EU banana policy are therefore inextricably linked, and consideration of the future of the Lomé commitment cannot be divorced from consideration of the future of the EU regime. Since its introduction in 1993, the regime has been under attack not only from those Latin American banana exporters who regard it as discriminatory, but also from the US for the same reason, and from certain EU members, notably Germany, who regard it as costly and inefficient. The regime has recently faced a challenge in the WTO, and the Interim Report of the WTO Panel has found against certain aspects. An appeal is currently being prepared by the EU. The outcome of the WTO case will be a major influence on the future of the Lomé Protocol. The stakes are high for all the banana exporting countries, but for some highly dependent ACP exporters in the Caribbean the Lomé Protocol is vital not only to their banana trade, but to their very economic survival. The weak competitive position of ACP banana exports vis-à-vis Latin American exports (so-called 'dollar bananas') means that preferential trade arrangements with the EU are essential if ACP production is to be maintained. Relatively few ACP countries are directly affected by the WTO judgement. However, the outcome of the WTO's deliberations has a wider significance beyond banana trade, since it provides a test case of the sustainability of Lomé preferential trading arrangements after the Uruguay Round.

8.2 The Lomé Banana Protocol

Article I of Protocol 5 to the Fourth Lomé Convention states that:

'In respect of its banana exports to the Community markets, no ACP State shall be placed, as regards access to its traditional markets and its advantages on those markets, in a less favourable situation than in the past or at present.'

This implies a legal obligation on the part of the EU to maintain access to EU markets for bananas from traditional ACP exporters on at least as favourable a basis as had been enjoyed by those exporters up to the signing of the Convention in 1990. This is a highly specific commitment, and one which would be difficult to meet by means other than those of the current EU banana regime. Article 1 has not surprisingly attracted most attention in discussions of banana trade policy, but the Lomé commitment has a broader content which should not be overlooked. This involves trade development aimed at the expansion of ACP-EU trade through improving ACP access to EU markets and enhancing ACP competitiveness in those markets. Thus, the banana protocol envisages EU assistance to improve competitiveness at all stages of production and marketing by ACP exporters, and financial assistance mainly through the STABEX scheme. Article 2 of the banana protocol provides for activities to 'improve the conditions for the production and marketing of bananas', and mentions research, harvesting, packaging and handling, internal transport and storage, marketing and trade promotion. As the future of the preferential trade arrangements has become less certain, so these trade development measures become increasingly important. The ACP banana exporters need to consider what is the most appropriate form for these provisions.

8.3 The EU Banana Regime

Under Article 115 of the Treaty of Rome, individual EU member states were allowed to

determine their own banana trade policy prior to 1993. However, this was subject to the general requirement that imports from ACP countries should enter duty free, while imports from non-Community or non-ACP countries should be subject to the 20% Common External Tariff (CET). Thus, at the time of the signing of Lomé IV, each member state of the European Community pursued its own banana trade policy. Delivery of the Lomé commitment rested on a limited number of member states – UK, France and Italy – and mainly reflected past colonial ties with certain ACP banana exporters. In general, this commitment was taken on willingly by the importing countries concerned.

In practice, more than half of the Community's imports of ACP bananas were into the UK. The UK guaranteed a market for exports from the Windward Islands, Jamaica, Belize and Surinam. These countries exported almost exclusively to the United Kingdom. The Windward Islands were the major supplier with about half of the market and rapidly increasing export volumes. Licences were issued to import dollar bananas to meet any estimated shortfall between demand and imports from the preferred exporters. France guaranteed two thirds of its market for production from its overseas departments, Guadeloupe and Martinique. The remaining third was allocated to supplies from Francophone Africa, especially Cameroon and Côte d'Ivoire. Imports from other sources were permitted under licence only when there was a supply shortfall from the preferred sources. Italy guaranteed a market for imports from Somalia, although the bulk of Italy's imports were from Latin America under quota and subject to the 20% common external tariff (CET). Outside these preferential arrangements, the largest Community market, Germany, obtained all its supplies from Latin America. These entered duty free under a special dispensation under the Treaty of Rome. Belgium, Denmark, Ireland, Luxembourg, and the Netherlands also obtained all their imports from Latin America, but subjected them to the CET. Greece, Portugal and Spain are self-sufficient to varying degrees.

With the creation of the so-called 'Single Market' all barriers to trade within the EC were to be removed by 31st December 1992. The removal of obstacles to trade in bananas from one European Community state to another opened previously protected markets to imports of low-cost dollar bananas, and meant that the protective and preferential trading arrangements operated by certain member states could no longer be sustained. Supplies from ACP exporters and European Community producers could not compete on a free market, not even with the protection of the 20% tariff on dollar imports. This called for the harmonisation of member states' arrangements, in a common banana trade policy presumably by somehow extending the preferential trade arrangements of UK, France and Italy to all EC states so that honouring the Lomé commitment became a Community concern. Unlike the previous arrangements, this commitment has not been taken on willingly by all member states.

However, a banana trade policy for the European Union as a whole needed to satisfy more than just the Lomé commitment: the single market requires unobstructed trade between member states; there is an obligation to maintain Community production in the Canary Islands, Crete, Madeira and French overseas departments of Guadeloupe and Martinique; any protection against lower cost dollar supplies must be compatible with obligations not to raise tariffs or introduce new restrictive trade measures under the GATT; since ACP and domestic supplies are inadequate to meet demand, dollar supplies must continue to provide a significant proportion of requirements; finally, the impact of any trade policy on the interests of consumers must be considered. Not surprisingly, given these sometimes conflicting objectives, discussion of the shape of the common banana policy was heated.

Needless to say, those member states with free or relatively free markets – Germany and the Benelux countries – favoured the most liberal options of either a free market or a tariff regime, since anything else would lead to higher prices.

On the other hand, France, Greece, Portugal, Spain and the United Kingdom with domestic production or preferential suppliers to protect, favoured the more protectionist regimes. Given such strong differences of opinion within the European Community, and the intense lobbying by exporting countries and banana companies, it is not surprising that the European Commission's proposed regulations were not presented until August 1992, leaving little time for discussion and agreement if they were to be adopted by the end of December. However, the likely basic features of the regime – quotas on dollar banana imports and the controversial mechanisms for allocating import licences – were becoming clear following the DGVI Background Note on a proposal for the regime released in February 1992.

A compromise agreement was not reached until December 1992. This was formally approved in March 1993, and the system introduced from 1st July, making bananas the only exception to the single market.

The elements of the regime were set out in Regulation 404/93. The new regime allowed tariff-free imports from each traditional ACP country up to the maximum quantity they exported to the Community in any year up to and including 1990. This provided for a quota of 857,700 tonnes distributed between the traditional ACP exporters as follows: Côte d'Ivoire 155,000 tonnes; Cameroon 155,000 tonnes; Somalia 60,000 tonnes; Madagascar 5,900 tonnes; Cape Verde 4,800 tonnes; St Lucia 127,000 tonnes; Dominica 71,000 tonnes; St Vincent 82,000 tonnes; Grenada 14,000 tonnes; Jamaica 105,000 tonnes; Belize 40,000 tonnes; and Surinam 38,000 tonnes. Under the 1994 'Framework Agreement', ACP exports above this level – non-traditional ACP trade – may also enter tariff free up to 90,000 tonnes within the overall quota for imports from non-traditional ACP suppliers. Cameroon, Côte d'Ivoire and Belize have been allocated about one third of these 90,000 tonnes. Non-traditional ACP imports over the quota were subject to a tariff of 750 ecu per tonne – a lower rate than for over-

quota dollar supplies. A tariff of 100 ecu per tonne was to be charged on imports of dollar bananas initially up to two million tonnes (approximately the quantity imported in 1990). Subsequent adjustments to the dollar quota under the so-called 'Framework Agreement' raised this to 2.2 million tonnes in 1995, or 2.11 million tonnes after allowing for non-traditional imports from ACP countries of 90,000 tonnes, and reduced the in-quota tariff to 75 ecu per tonne. The Framework Agreement, signed by Colombia, Costa Rica, Nicaragua and Venezuela, gave country-specific quotas to the four signatories (of 21%, 23.4%, 3% and 2% respectively) who undertook not to complain to the WTO about the EU regime until 2003. The quota was raised again in 1996 by 353,000 tonnes to 2.533 million tonnes to cover the additional requirements following the accession of Austria, Finland and Sweden in 1995 (353,000 tonnes being the annual average consumption in these countries between 1991 and 1993). Dollar imports in excess of the quota faced a prohibitive tariff of 850 ecu per tonne, around 170% at current prices, in the regime as introduced. Provision was made through the licence allocation procedures for traders who marketed Community and traditional supplier ACP bananas between 1989 and 1991 ('category b' traders) to cross-subsidise this activity: they are allocated import certificates to sell 30% of the dollar supplies. Operators who marketed dollar or non-traditional ACP supplies ('category a' traders) are awarded 66.5% of the certificates, and the remaining 3.5% of certificates go to operators who started marketing dollar or non-traditional ACP supplies in 1992 ('category c' traders). Following the raising of the quota to 2.553 million tonnes in 1996, the allocation to 'category a' importers was increased to 70% and the allocation to 'category b' importers reduced to 26% to reflect the fact that the new member states had relied on dollar imports prior to accession. Although the 'category b' allocation was reduced in percentage terms, in volume terms it remained unchanged. A further amendment made at this time was to

introduce provision for 'category c' traders to earn 'category a' status after three years. The distribution of certificates to individual traders is based on their average volumes traded in the previous three years multiplied by a coefficient relating to the extent of their involvement in the import and distribution chain. The chain is divided into three: purchase and transport of bananas to the EC (coefficient=0.57); customs processing on arrival (coefficient=0.15); and ripening and selling to wholesale (coefficient=0.28). In practice most operators would undertake all these activities. The regime provided for deficiency payments to EU suppliers, including overseas territories, on production up to 854,000 tonnes. This quantity is distributed between the various suppliers: Canary Islands 420,000 tonnes; Madeira 50,000 tonnes; Crete 15,000 tonnes; Guadeloupe 150,000 tonnes; and Martinique 219,000 tonnes. A direct payment of 1000 ECU per hectare is also available to those producers ceasing production. At the conclusion of the Uruguay Round, the banana regime, including the Framework Agreement, was explicitly accepted as part of the package.

The significance of the 'Banana Protocol' to the discussions of the creation of an EU banana regime must be stressed. Any proposal for a regime had to pass the test of not placing the ACP traditional exporters in 'a less favourable situation than in the past or at present'. The UK, France and Italy were relatively high-price markets and, as such, were attractive targets for the multinational banana companies – Chiquita, Dole and Del Monte. If dollar bananas had been allowed free access on to these markets, or access subject only to a 'reasonable' tariff there is no doubt that they would have been able to force the ACP fruit out by an aggressive price and marketing policy. This would have contravened the requirement set out in the banana protocol of the Lomé Convention. If ACP bananas were forced out of these markets, there would have been nowhere else for them to go. The price would be unattractive for other European consumers who would still have full access to dollar

bananas if duty-free dollar bananas from Germany, for example, were allowed to circulate freely in the Community. The banana multinationals would have been given a free hand in the EC, at the expense of the Community's traditional partners. Therefore, the ACP exporters would have been left in a worse position on their traditional markets and it would have been impossible to fulfil the Lomé IV commitments. Apparently, this view of how the banana market would operate after the European Single Market came into force strongly influenced the European Commission's view of what Europe's banana trade policies should be.

8.4 The Lomé Protocol and ACP Banana Trade

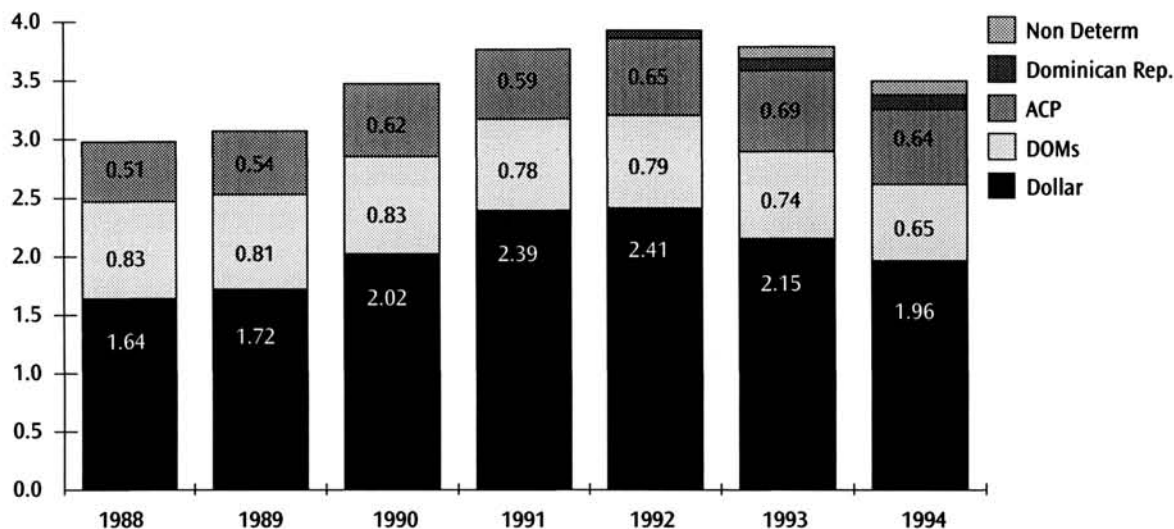
The *Lomé Protocol* might be regarded as successful in the sense that it has allowed access to the EU market and ACP banana exports to the EU broadly to be sustained. ACP exporters have fared less well since the replacement of the various national arrangements with the common regime which has exposed ACP fruit to competition from dollar fruit and to lower prices on previously protected markets. Without preferential trading arrangements, and arguably preferential trading arrangements of the specific kind provided by the EU banana regime, the ACP exporters would have no chance of competing on the EU market, or perhaps any other market, with dollar imports from Latin America. The loss of such preferential arrangements implications for certain ACP exporters would be potentially devastating. However, while the *Lomé Protocol* might have been successful in maintaining exports, it has provided little incentive to improve the competitiveness of ACP bananas. Costs of production and marketing are high and quality variable. In some cases, the returns to banana growing have encouraged expansion of production into unsuitable areas causing environmental damage – clearing of rain-forest and consequent flooding in the Windwards, for example. The need to improve competitiveness

must be taken seriously by the ACP exporters. There have been a number of attempts to improve quality in the Windward Islands, and producers have made some progress towards meeting the requirements of export markets. However, the UK is effectively the only market and market share has been lost even there. Fruit quality has struggled to reach the standards required by the multiples which account for ninety per cent of retail banana sales. Under the EU's common banana regime retailers now have the option of turning to dollar supplies if these better meet their needs, so ACP quality and quality control have got to be competitive. EU Regulation 2686/94 provides for assistance in the adaptation of ACP production conditions, and there has been a quality improvement scheme in the Windwards. STABEX funds might also be used for this kind of purpose. However, progress is slow and time is short.

The traditional ACP exporters are almost totally reliant on the EU market: the Caribbean exporters export 100 percent to the EU, while the West African exporters export some 95 percent. This compares with the 25-30% of dollar exports which go to the EU market. EU imports from different sources are shown in Figure 12.1. Within the EU market, most ACP supplies are to the UK: by 1996, for example, the UK was taking all of the Windward Island exports.

The importance of the banana trade to the economies of the ACP countries varies from one exporter to another. The Windward Islands of St Lucia, Dominica and St Vincent are a special case of extremely high dependency with 50-60% of their export earnings coming from bananas. For Somalia, bananas have accounted for more than 20% of total exports. Elsewhere the extent of dependency is less. Bananas are also a major source of income and employment for St Lucia, St Vincent and Dominica. In these three Windward Islands, bananas provide 16-17% of GDP. In Dominica and St Lucia a third of the labour force is involved in the banana industry, while in St Vincent the figure is as high as 70%. Obviously, such dependency means that the

Figure 8.1 EU Banana Supply 1988-94 by Source



Source: Eurostat.

Note: The Dominican Republic is a non-traditional ACP banana exporter. Her exports have increased markedly after 1991 and are plotted separately on the chart above.

economies concerned are particularly exposed to the risk of exogenous shocks to their production and market opportunities. Any variations in the preferences accorded to them by the Lomé protocol are potentially disastrous.

Measures to reduce dependency on bananas in the Windward Islands have frequently been discussed and implemented. However, the profitability of banana production has militated against diversification. In some ways the islands are captives of the banana trade. This is not only because the returns to bananas cannot be matched by alternative export crops, but also because the regular weekly harvesting and shipping schedule for bananas is a significant part of any diversification strategy. The dilemma was summarised by the former Prime Minister of St Lucia, John Compton: 'Without ships there can be no diversification, and without bananas there can be no ships'. In any case, alternative export crops suggested, such as exotic fruits and vegetables, would face stiff competition on uncertain world markets from high quality exports. Scope for the development of manufacturing industry is limited, while the economic and social benefits of tourism are not generally agreed upon.

While yields of the Caribbean exporters have increased, the prevailing smallholder production and ecological conditions mean that they remain substantially lower than those achievable on the plantations of Latin America. Without continued preferential trading arrangements to guarantee markets for higher cost ACP supplies production, at least on the current scale, could not be sustained. Given the topography of the Caribbean islands, plantation production and the possibility to reap economies of scale is not generally possible. Plantation production on a medium to large scale has been developed in the more favourable locations of Cameroon and Côte d'Ivoire, mainly under multinational control. These locations can compete in husbandry, harvesting and packing and volumes produced allow a regular shipping schedule, but shipping costs remain high and fruit quality variable (Fabre, 1994).

Precise inter-country comparisons of costs between dollar and ACP exporters are problematic because of limitations in the quality of the data. Exports to the EU market in 1994 from Ecuador, Colombia and Costa Rica received f.o.b. prices of \$4.2/box, \$5.1/box and \$5.2/box respec-

tively. Guatemala received \$3.7/box and Honduras received \$3.8/box. Caribbean ACP producers received f.o.b. prices of around \$9/box, and African ACP producers received around \$8/box. The price gap between ACP exporters and even the least competitive dollar exporters is up to 80%. While in the longer term there may be some scope for improving the competitiveness of ACP production, preferential trade arrangements appear to be essential for the foreseeable future. These average figures mask significant variation from farm to farm in efficiency and costs. Even in the Windward Islands there are growers who could compete at little more than world prices.

8.5 The WTO Case

It is clear that the Lomé protocol is vital to the ACP banana exporters. Its fate is inextricably tied to that of the EU banana regime, since without the regime in something like its current form, it is not clear that the Lomé commitment could be delivered. However, the regime, and hence the Lomé commitment, has been under threat from internal as well as external sources ever since its introduction. Much of this was predictable. It was clear that the Single European Market would require a single banana trade policy, and given the limited competitiveness of ACP supplies it was clear that a regime similar to that actually introduced would be necessary to meet the Lomé commitment. Such a policy would inevitably provoke a challenge by dollar exporters, and would be unpopular with Germany. It is therefore, surprising that the EU and ACP exporters should have been so apparently unprepared for the WTO case, and its likely outcome.

Given the hostile environment, it is inconceivable that trade preferences for ACP banana exporters might be enhanced. The best scenario from an ACP exporter point of view would be maintenance of the status quo. The alternative would presumably be some kind of preferential tariff arrangement, perhaps as part of free trade areas. The worst scenario would obviously be the

removal of the current regime with little time to adjust. Unfortunately, the ACP exporters will have little influence on the continuation or otherwise of the preferential trade arrangements for bananas. That is largely in the hands of the WTO.

Obviously, the final outcome of the WTO case is crucial. Previous GATT rulings have already been against the regime. In January 1994, a GATT panel established at the request of Colombia, Costa Rica, Guatemala, Nicaragua and Venezuela found that the EU policy violated GATT. The operation of the b-licence system was regarded as against mfn provisions and it was also judged that preferences for ACP bananas could not be justified. The 'Framework Agreement' of March 1994 meant that four of the five complainants dropped the case, and the EU was able to block Guatemala's efforts to have the report adopted by the GATT Council. In December 1994, the EU obtained a GATT waiver until 29th February 2000, allowing certain preferential treatment required to meet the Lomé commitment. The EU takes a wider view of the application of the waiver to include the banana protocol while the US argues that its applicability is limited to a waiving of the tariff preferences provisions of Article 1.1. The b-licences are particularly problematic. If the ruling against the particular mechanisms of the policy is eventually confirmed, then this does cast doubt on the ability of the EU to deliver the Lomé commitment.

The WTO challenge began in September 1995 when Guatemala, Honduras, Mexico and the US requested consultations on the regime. This request was based on the view that the regime was inconsistent with Articles I, II, III, X and XIII of GATT 1994, Articles I and III of the Import Licensing Agreement and Articles II, XVI and XVII of GATS. The consultation period ended in November 1995. In February 1996, the same countries plus Ecuador again requested consultations on legal grounds which now included the Agriculture Agreement and the TRIMS Agreement as well as those cited previously. The

complainants requested a panel at the Disputes Settlement Body in April 1996 but the EU objected. However, a panel was established following a further request in May.

The WTO complaint argued that the mfn provisions of GATT Article 1 were violated in that the EU regime discriminated against Latin American exporters by higher tariff rates than were chargeable on non-traditional CAP exports. The allocation of country specific quotas to traditional ACP, non-traditional ACP and BFA exporters, but not to other exporters was regarded as a violation of Article XIII on 'Non-discriminatory administration of quantitative restrictions. It was further argued that the resulting allocations do not reflect the situation which would have ruled in the case of a free market: allocations to Ecuador and certain other Latin American exporters outside the BFA were regarded as unjustifiably small. The licensing system was the object of particular concern and criticism. This was seen as discriminating against Latin American bananas in being unnecessarily administratively burdensome contrary to GATT Articles I and X and the Licensing Agreement. The b-licenses transferring quota rents and market share to EU distribution firms were seen as discriminating against US firms in violation of the provisions of GATS.

The Interim Report of the Panel appeared later than expected in April 1997. While the general principle of preferential treatment, in the form of zero tariff rates, for traditional ACP exporters was not an issue, the mechanisms by which the preferences are delivered have been found to be inconsistent on sixteen counts with the EU's obligations in GATT and elsewhere. The country specific tariff quota allocations other than those for traditional ACP exporters have been found inconsistent with GATT Article XIII notwithstanding the fact that these were written into the Agreement on Agriculture. As expected, the b-licenses and activity function rules have been particularly criticised as inconsistent with GATT Articles I, III and X, the Licensing Agreement, and GATS Articles II and XVII.

The panel decided that the licensing system discriminated in favour of traditional ACP exporters and that the EU's obligations were not waived by the Lomé waiver as far as these aspects of the regime were concerned.

The US claimed after the judgement that it wanted a solution which would allow WTO-consistent trade preferences for the Caribbean exporters, but did not make clear what form such preferences might take. President Clinton has suggested enhancement of the Caribbean Basin Initiative, but the value of this to the Caribbean states is regarded as limited.

The EU has exercised its right of appeal to the WTO's Appellate Body. Appeal proceedings should be completed within a maximum of 90 days. However, appeals are limited to 'issues of law covered in panel reports and legal interpretations developed by the panel'.

The WTO case is not the only legal challenge to the EU banana regime. Challenges have been brought in the European Court of Justice by Chiquita Banana Company in 1993, the German Government (supported by the Netherlands and Belgian Governments) in the same year, and by the German Government on three occasions in 1995. All these challenges failed, but this does not imply the end of opposition to the regime within the EU. Outside the EU, the US opened an investigation of the EU regime in 1995 under the unfair trade practices provisions of Article 301 – the so-called '301 Action'.

8.6 The Future for ACP Banana Trade

The detailed effects of a loss of the current EU regime would obviously depend upon the regime introduced to replace it. However, there is little doubt that in any changes to the status quo, ACP exporters would lose out to dollar exporters, and that Caribbean exporters would suffer most. For traditional ACP banana exporters, therefore, the preferred option must be continuation of the current EU banana trade regime to maintain the Lomé commitment. However, there is little that the ACP states can do to secure this option

beyond working to ensure that the strongest possible response to the WTO Panel's Report is made, both within WTO and outside.

While continuation of the status quo might be the best scenario from an ACP exporter point of view, the probability of this option materialising is uncertain, especially against the background of multilateral trade liberalisation, and an apparent desire by the EU to strengthen links with Latin America. In any case, the current arrangements are less than perfect. The protocol and the EU regime only concern *traditional* ACP exporters, and the Caribbean exporters at least are relatively wealthy. Non-traditional exporters, such as the Dominican Republic, have enjoyed little benefit. Traditional exporters have benefited from the protocol in the form of market access, although their position has become less favourable since the introduction of the EU common banana regime, and they have typically been unable to achieve their full quotas. The existence of the protocol arguably has militated against serious efforts at raising competitiveness and diversification. There may be some argument for quotas to be reallocatable to those best able to fill them. How the benefits of preferential trade have been divided between growers and importers is beyond the scope of this chapter, but the case for trade preferences may also be weakened if it is not clear who benefits. Windward Island growers have recently received less than 10% of the UK retail price. The question of quota rents has been discussed in Chapter 7.

If the Interim Report findings are upheld then the question is raised whether the preferential treatment to ACP exporters can be delivered without the specific mechanisms – the licensing arrangements and country specific allocations – of the current regime. Clearly this needs to be considered, but it is not apparent how ACP exporters could compete without the subsidy element offered by the b-licenses. Whether this could be delivered in some other way which is compatible with the WTO needs to be addressed. Quotas alone would not necessarily guarantee a market for ACP fruit, and prices would not nec-

essarily be such as to allow profitable exports up to quota levels.

If the current regime is overthrown, one possible replacement would be some form of tariff system. The income of the traditional banana exporters is such that they would be excluded from non-reciprocal arrangements, although if the banana trade is lost this might no longer be the case. There may be a case for arguing for a different basis for permitting non-reciprocal preferential trade arrangements – dependency or vulnerability, for example.

Tariff preferences alone, at least at realistic rates, would not be sufficient to offset the competitive advantage of the dollar exporters. The tariff preference would have to be enough not only to offset the differences in costs of production, but also to offset the premium which dollar bananas appear to earn on EU markets. This has been estimated at around 20% (Raboy *et al*, 1995). Again, it is clear given the hierarchy of production costs, that Caribbean exporters would require the greatest tariff preferences to survive, while West African exporters might be competitive with significantly lower preferences. Whether a sufficiently large tariff preference could be engineered would depend upon the tariff equivalent of the current regime. However, it seems likely that the tariff equivalent would be too high to be politically acceptable.

If the extent of tariff preferences was insufficient to ensure that ACP exporters could find a market for their bananas, then some kind of subsidy might be used to bridge the gap. Such schemes have been favoured by a number of authors (see, for example: Read, 1994; Raboy *et al* 1995). In this scheme tariff revenues could be transferred, for example, as subsidies to ACP exporters. There is some precedent for such transfers, since compensation for income losses due to the EU policy was included in Regulation 2686/94. However, it is unlikely that such a scheme would be acceptable to the WTO, and it may maintain uneconomic and unviable production. A further problem with this approach is that where ACP and dollar supplies are available

at similar prices, it is likely that dollar bananas would be preferred by many European consumers, and ACP exporters would find it difficult to maintain market share against the multinational importers of dollar bananas. Prior to the introduction of the EU policy, for example, ACP bananas could enter Belgium and the Netherlands duty free, while dollar bananas faced a 20% tariff, but even so dollar bananas took all the market. The trade preferences accorded to ACP exporters might therefore have little practical benefit. The issue of the competitiveness of ACP bananas arises again. Whatever the trade policy in operation, it is vital that ACP competitiveness is raised. Any transfers to ACP exporters therefore should be tied to quality improvement.

The creation of free trade areas with the EU with the attendant possibility of non-reciprocal trade preferences has been discussed in the Commission's Green Paper and elsewhere in this report. For Caribbean countries the analysis here indicates quite minor import increases and little overlap with EU products. The creation of such a free trade area might include the adoption of the EU banana policy for its domestic producers, putting ACP exporters in the same position as Martinique and Guadeloupe. However, such a policy would be expensive for ACP countries to operate unless some acceptable means of providing EU funds to subsidise it could be found. There would also be no guarantee that bananas produced with the support of the policy would find a market for the same reasons as outlined above.

If the appeal is unsuccessful, the WTO judgement comes into force. At least until recently it appears that the EU had not made contingency plans for this possibility. In the short term the ACP states might wish to press the EU for proposals in this regard, and specifically how the preferences can continue to be delivered if the current mechanisms are unlawful. Whatever the outcome of the WTO case there will continue to be a question mark over the EU policy.

Whatever the future of trade arrangements for ACP bananas, the issue of competitiveness

must be addressed. Obviously this applies *a fortiori* in the case of reduced trade preferences, but Windward Island bananas have lost market share recently even in the UK, their last remaining market, and in spite of the operation of the EU regime. Even if the status quo was maintained, competitiveness must be improved. The ACP exporters need to press for further assistance in raising competitiveness and diversification, and the trade development provisions of Lomé need to be stressed. Efforts in this direction in the past have been disappointing, not least because of the high returns guaranteed by the Lomé protocol. The introduction of the EU policy exposed ACP exporters to a greater degree of competition from dollar suppliers, and the loss of the regime would remove the safety net further. Competitiveness will best be achieved if the incentives for higher quality are available down through the banana production and distribution system. Quality control systems are open to abuse, and these too might best be implemented earlier in the production and marketing chain, perhaps through inspection and approval of producers. If a tariff system replaces the current regime, then the ACP exporters need to explore the scope for alternative forms of subsidy compatible with WTO. Again, if these are to be of lasting benefit they should be tied to quality improvement.

The urgent need for quality improvement will inevitably mean a contraction in the size of the industry in the Windward Islands. This then raises the question as to whether the volumes of high quality fruit which could be produced would be sufficient to justify a regular shipping schedule. It is vital that any contraction in the industry should take place in a managed way rather than catastrophically and the ACP exporters need to argue for adjustment aid.

Smaller volumes of ACP bananas especially from the Windwards might be marketed in different ways to exploit their particular characteristics such as their 'greener' or more 'organic' or 'integrated' production system. As such they might find profitable niche markets

throughout Europe, but again quality is essential. The potential size of such markets should be investigated. There may be some scope for market diversification. Central and Eastern European countries, and the countries of the former Soviet Union offer rapidly growing markets for bananas. However, dollar supplies are already established on these markets. Markets in other developing countries are limited since all tropical countries have their own production. Product diversification out of banana production is necessary, but as noted earlier, the options are limited. Export markets for alternative horticultural crops would be problematic for many of the

same reasons that exports of bananas are problematic, notably competitiveness. Tourism development offers some potential, but so far has arguably contributed little, given the high import content of all-in package tourism. The scope for increasing the sales of local agriculture into tourism needs to be raised by enhancing the quality and service element of local food supplies and encouraging the hotel trade to buy local. However, tourism markets for agricultural products cannot support the scale of agriculture associated with banana production. Furthermore, diversification can take years. ACP banana exporters may have months.

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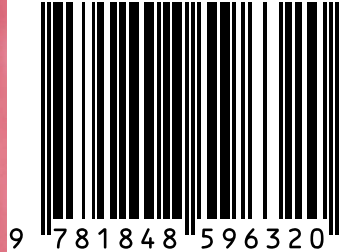
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