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**TRADE LIBERALIZATION AND SMALL ECONOMIES**

WORKING PAPER

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## ***TABLE OF CONTENTS***

<b>A:</b>	<b>INTRODUCTION .....</b>	<b>3</b>
<b>B:</b>	<b>EXAMINATION OF THE MAJOR ISSUES RELATING TO SIZE AND VULNERABILITY.....</b>	<b>4</b>
<b>C:</b>	<b>CONSTRAINTS IN ADJUSTING TO CHANGES IN THE GLOBAL TRADE REGIME.....</b>	<b>5</b>
	<i>C.1: Adjustment and Transitional Costs: Impact of Liberalization.....</i>	<i>5</i>
	<i>C.2: Approach to Trade Capacity Development.....</i>	<i>8</i>
<b>D:</b>	<b>ASSESSMENT OF THE EFFECTIVENESS OF EXISTING AND PROPOSED MEASURES FOR SMALL ECONOMIES.....</b>	<b>9</b>
	<i>D.1: International Trading Arrangements .....</i>	<i>9</i>
	<i>D.1.1: WTO and Special and Differential Treatment.....</i>	<i>9</i>
	<i>D.1.2: Small Economies and WTO Restructuring.....</i>	<i>11</i>
	<i>D.1.2: Post-Lomé And Special and Differential Treatment.....</i>	<i>14</i>
	<i>D.1.3: FTAA and Special and Differential Treatment.....</i>	<i>15</i>
	<i>D.2: International Financial Arrangements .....</i>	<i>17</i>
	<i>D.2.1: New Approach by the Multilateral Financial Institutions.....</i>	<i>17</i>
	<i>D.2.2: Unfinished Agenda.....</i>	<i>18</i>
<b>E:</b>	<b>CONCLUSIONS AND RECOMMENDATIONS.....</b>	<b>20</b>
	<b>LIST OF REFERENCES.....</b>	<b>24</b>
	<b>ENDNOTES .....</b>	<b>26</b>

## **A: INTRODUCTION**

Small economies are found in all geographic regions, and, while there are some differences between them, they do share a fair amount of common features. The most common characteristic of these economies is that they have very open and undiversified economic structures that reflect a high degree of income and consumption volatility. The latter phenomenon is accompanied by limited technical and administrative capacity. Many small economies are susceptible to natural disasters and environmental change and some are isolated.

The growth of global integration through trade and investment liberalization poses major challenges to small economies. It forces them to integrate faster into the world economy and make significant policy changes at the macro-economic and structural level in order to take advantage of the opportunities. In that process they must build economies that rely on greater international competitiveness and on an increasing share of non-traditional products in their manufacturing, agriculture and services that invariably involve new markets and marketing strategies. Building international competitiveness is a long-term objective involving considerable risks and several stages of adjustment and transformation. It requires as well an international environment that does not produce frequent adverse shocks and is sympathetic to the plight of small countries.

The above environmental changes have triggered an intense policy discussion in the international community over the future of small economies. Central to this debate is the issue of vulnerability of these states to the new competition and risks and their possible marginalization<sup>1</sup>. A Commonwealth Secretariat-World Bank Joint Task Force was set up in July 1998 to examine the case for special treatment of small states in the global economy. More specifically, the aim was to study the relevance of the instruments of the World Bank for assisting these countries as well as to address the transitional problems associated with international trading arrangements. The reaction of international organizations such as the WTO, IMF, World Bank, European Union and the Commonwealth Secretariat to such proposals is presented in the Final Report of the Task Force<sup>2</sup>. Since then these institutions have been working to take into account the special circumstances of small states.

The Report found that small states are more vulnerable and experience greater income volatility than larger states, and that the sources of this vulnerability are often a result of the external environment. It offers a range of common relevant policy actions for small states themselves and the international community to deal with their special problems of volatility, vulnerability, transition to the changing global trade regime, capacity building and the challenges and opportunities from globalization. While emphasizing sound domestic policies, its focus is mainly on the financial and technical interventions for addressing these issues. Trade matters as well as the integrated nature of the problem are treated with less depth.

A significant divergence of opinion continues to persist as regards the nature and causes of the problems. In addition, even where there is some agreement on particular problems, disagreement remains on the policy approaches to resolving them. The effectiveness of existing and proposed provisions in international trading and financial arrangements that pertain to small states still therefore,

needs to be examined. Several proposals have also been made, especially by the small states in the Caribbean, the Pacific and the Indian Ocean to deal with the question of adjustment of these states to the new environment. Essentially, they take the form of longer transition periods, lesser international obligations, trade adjustment assistance, risk management assistance and greater security and predictability of market access<sup>3</sup>.

The purpose of this exercise is to shed some more light on this policy debate concerning measures for small states. Its focus is on international as against domestic policies, and in particular, the policies of the major multilateral institutions. The major issues and constraints facing small economies are first outlined in order to put into proper perspective the subsequent examination of the existing and proposed measures. Some recommendations are then offered in summary fashion.

## **B. EXAMINATION OF THE MAJOR ISSUES RELATING TO SIZE AND VULNERABILITY**

In general, no difference in growth rates has been found between small and large countries. The latter, however, does not indicate the measure of effort and circumstances that favour growth sustainability in small economies. Real per capita GDP growth rates tend to be more volatile in small states<sup>4</sup>. A main source of this volatility comes from the terms of trade, which are larger for small countries because of large trade shares in the economy and the specialization of their exports. Additional growth volatility (not due to terms of trade and specialization) is possibly attributed to hurricanes and other natural disasters.

It is suggested that openness will make small states more viable<sup>5</sup> since the positive effects of openness are expected to offset the negative effects of output volatility by 2.4 times<sup>6</sup>. The latter, however, does not capture the full picture. Greater volatility does imply a relatively greater policy effort to maintain the momentum of growth. If output volatility is one of the consequences of openness, greater openness on balance can only be positive if it provides larger market access on relatively secure terms. Whether greater openness leads to net positive results seems to depend on the context and nature of the openness. Measures of openness say nothing about market access barriers faced by countries or the type of products being exported and under what trade arrangements. Openness would appear to generate less volatility and more sustainable growth to the extent that market access is secure and predictable- a condition that is more likely to arise for a small state if it is highly integrated into a developed constituent region.

The high market risks faced by small countries if trade agreements with large states are broken have been underscored<sup>7</sup>. It implies that the more secure the trade arrangement, the greater the inducement to invest and to diversify<sup>8</sup>. By extending their domestic markets through trade integration small countries can better overcome the limitations of market size. The importance of secure trading arrangements for small economies in a developed constituent region has been underscored.<sup>9</sup>

The above argument can be extended in the sense that it is not surprising that many small countries (both developed and developing) enjoy a relatively higher degree of preferential integration with developed countries. For instance, a disproportionate amount of small states can be found to enjoy privileged market access beyond GSP in CBI, SPATACA, Lomé, CARIBCAN and free trade

or customs union arrangements with the EU. The benefits of integration for small states with a large autonomous region capable of sustained integration should not therefore be underestimated.

Most small developing countries are physically part of constituent regions that have no basis for sustained integration in terms of trade and capital flows. Hence, they tend to develop strong trade and financial relationships with large developed regions. The depth of this link with developed trade blocks has contributed to mitigating negative effects of volatility and acts as a positive factor as regards the sustainability of income.

In conclusion, since small countries are more in need of trade and investment openness than large states, then they should be integrating faster into the world economy. The faster they are able to integrate into the world economy on secure terms, the better would be their economic performance. The process of integrating into the world economy is a two-edged sword. While small economies need to keep extending their domestic markets through more market access, at the same time they are very vulnerable to shocks and the high cost of adjustment. It would appear therefore that the small countries that are able to obtain relatively more secure and predictable market access in areas of export interest by conceding low adjustment costs will most likely be the ones that will perform better.

## C: CONSTRAINTS IN ADJUSTING TO CHANGES IN THE GLOBAL TRADE REGIME

### *C.1: Adjustment and Transitional Costs: Impact of Liberalization*

Trade liberalization is exposing small states to greater competition and the need for diversification as a result. A sizeable amount of diversification in small states has occurred as a result of specific bilateral preferences<sup>10</sup> connected to their niche export strategies. Threats to these bilateral preferences from multilateral and regional trade liberalization as well as the consequences of adapting to a knowledge-based network economy imply major adjustment steps for these economies.

Small vulnerable economies are yet to achieve sustainability. They are in a state of transition that entails reforms geared to build sustainable competitive advantage in the long run. These reforms would cover a wider set of changes than those normally associated with trade and financial liberalization and focus more on institutions, competition and private sector development. They would also have a longer time horizon than that for adjustment reform which tends to go from 1 to 5 years. Transition is thus a broader concept than adjustment.<sup>11</sup>

Adjustment cost usually entails a wide range of potentially negative short-run outcomes that might result from trade liberalization. These results may consist of a reduction in employment and output, macroeconomic instability resulting from balance of payments difficulties or reductions in government revenue and the loss of industry-specific and firm-specific human capital. Adjustment costs are usually largest in the first year and terminate when workers find a job. They tend to progressively reduce after one to five years as efficiency gains grow over time and continue indefinitely.

A higher burden of adjustment in transition from import substitution to export promotion is believed to exist for small economies due to specific factors of production and special problems associated with transferring specialized skills to alternative uses in the short and medium term.<sup>12</sup> A

priori, higher social adjustment costs for small economies are expected due to the existence of fewer and smaller firms and the consequent need to establish new firms rather than expand through an existing branch of a firm. The high concentration of activity by one or a few firms in one location is also another contributing factor<sup>13</sup> The relative dearth of investment opportunities in small states<sup>14</sup> would also contribute to this as well as the general problem of narrow specialization that limits production-switching flexibility in response to rapid shifts in market demand.

A significant portion of resource reallocation after trade liberalization is accomplished through inter-industry and inter-firm shifts which move labour from import-competing to the export sector. This minimizes the dislocation of factors of production. Developing countries with a flexible, well-trained labor force and a comparative advantage in labor-intensive industries are favored in this regard. Small economies tend to have a small aggregate labor force and without the skill endowments that facilitate labor mobility.

It has been noted that very small states must specialize in higher value-added niche service areas appropriate to a small labor force. However, this requires exceptional skill and technological capabilities. Higher value added niches require high levels of vocational, technical and management training and education typically beyond the institutional capacity of small states and involving continuous knowledge accumulation. In addition, conversion to higher value-added services without the benefit of significant producer services from a strong manufacturing base also implies greater costs. Finally, adaptation to a knowledge-based network economy, without the advantages of clustering, domestic competition, technological innovation and knowledge accumulation (which tend to be absent in small states due to scale factors) also entails higher costs.

The movement from import substitution or externally-protected exports to competitive export promotion involves switching specific factors of production and transferring specialized skills to alternative uses in the short and medium term. Labour generally is more inflexible in small countries due to face-to-face relationships and the strength of tradition over formal regulation. On the other hand this cost could be mitigated because there is some flexibility in informal markets and in agriculture where large numbers of persons are employed. Inflexible underdeveloped capital markets also make for higher adjustment costs.

In addition, an important component of the adjustment costs that face small states consequent upon trade liberalisation is the loss of government revenue. In small states, which are very dependent on trade taxes, the problem of fiscal adjustment is acute and can outweigh the trade benefits of increased liberalisation. The higher dependence on trade taxes means that liberalization could have significant negative effects on Government revenue unless alternative tax measures can be quickly put into place. The latter is questionable in very small economies given their weak tax administrations and the absence of well established traditions of tax compliance. Negative effects on revenues can contribute to fiscal deficits with possible inflationary consequences. This is particularly so when tariff rates are already uniform and low to moderate. Small states also exhibit a higher dependence on trade preferences, which, if rapidly removed, could entail a large burden of adjustment.

A key aspect of the adjustment problem facing small states is the capacity of their small firms to meet the challenges of increased liberalisation and greater openness. Increased liberalisation will result in small firms facing an increase in competitive imports (in the domestic market) and an increase in export market size. Increased competition in domestic and foreign markets will induce a specialization process in which small firms will concentrate in sectors where they have a competitive advantage. The process of specialization and resource reallocation for small firms is not smooth and frictionless. There are significant adjustment costs. Small states must emphasize quality and product differentiation. They cannot compete on quantity and standardization. Such a strategy implies human capital and knowledge development. The acquisition of knowledge and specialized skills is relatively costly for small firms.

Trade liberalization results in increased market access but there is no instantaneous increase in market penetration as a result of the increased access. Market access does not mean market entry. Informational barriers, specifically marketing information, can act as a serious constraint to market entry, particularly for small producers. Small market size leads to the absence of production economies of scale but the problem of economies of scale can be overcome through exporting. It is accepted however, that it is more difficult for a small economy to achieve economies of scale this way than a large country on its domestic market. This has to do particularly with the question of marketing economies of scale. Given the high cost of entering foreign markets, small local firms cannot put out the huge lump sums needed to establish markets at times for 80 or 90% of their output in order to achieve economies of scale. This problem has been addressed by showing how small countries, where feasible, can use foreign firms whose cost of marketing is much less in order to overcome this problem<sup>15</sup> Many small countries however, continue to remain unattractive to foreign investors in spite of significant improvements in the investment climate. International investors seem to need security and predictability of access to large markets. The discussion on diversification has not taken adequate account of this particular factor.

A distinction between social and private costs is useful in assessing adjustment costs. Social costs of adjustment relate to the aggregate welfare effects of trade reform. Private costs refer to the loss for individual units within society. The distribution of those costs forms the basis of opposition to reform. Private costs is associated with workers with specific human capital accumulated in a few firms and industries that face the immediate prospect of job losses and tend to strongly resist reform. The burden is also large for poor households that cannot afford extended periods of unemployment among their members. The relatively greater poverty observed in small states, especially small multi-island states,<sup>16</sup> along with inflexible labour, provide the basis for inequitable distribution. Even though the social benefits of reform may outweigh the social costs, the skewed distribution of private adjustment costs could frustrate reform efforts. The private costs of adjustment associated with a few key firms and industries tend to outweigh the social costs in small countries.

In small economies, the time periods of adjustment are likely to be longer because of high dependence on preferences. Workers in these highly dependent industries also earn substantial rents and this increases their resistance to job mobility. The training and labour adjustment assistance needed to reduce the transition time for moving from labour-contracting to labor-expanding areas is also not easily forthcoming. In small economies such programmes are constrained by knowledge, institutional and financial limitations.

Current knowledge of the adjustment costs for small countries remains weak. It is even suggested in some quarters that it cannot be known. Admittedly, because of peculiar country constraints and opportunities, this cost is best understood by examining country strategy in the context of its own vulnerability profile.<sup>17</sup>

### *C.2: Approach to Trade Capacity Development*

In small economies there are many constraints which impact on the performance of trade and investment. In the main they affect many trade-related areas such as the trade policy environment and the policymaking capacities relevant to national, regional, and multilateral trade; export-related supply-side capacities and infrastructure; trade facilitation and support services; market access; the human resource and institutional capacity needs of all the actors such as Government policymakers and ministries, businesspeople, private sector associations, labour unions, NGOs, and other civil society groups and independent or university-based research entities. Limitations relating to knowledge, skill, information and resources make it difficult to establish a trade-friendly policy environment that would embrace improved trade policies; to create a stable and predictable legal and regulatory framework and rule of law; to negotiate effectively and implement trade agreements; to meet ongoing trade obligations; and to defend trade-related rights.

A wide range of obstacles makes it difficult for enterprises to produce goods and services that meet international design, quality, and packaging standards, or to move up the value chain to more sophisticated forms of export production. These obstacles, inter alia, include a weak, inefficient, and costly economic infrastructure, including telecommunications, utilities, ports and airports; limited availability of critical production inputs at competitive prices, due to import constraints and inadequate market leverage; limited access to up-to-date production technology and limited technical know-how; and scarcity of skilled and educated labor. Capacity building involves both the strengthening of the competitiveness of existing firms, promoting and facilitating the establishment of new firms that can hold their own in export markets, and a strongly supportive public administration, alert and oriented towards the new export thrust, working in conjunction with the private sector to create a truly dynamic business environment.

The importance of knowledge is still to be fully appreciated.. R & D designed to achieve product improvement and innovation must become, for virtually every enterprise, a way of life. R & D facilities and expertise should be available for problem solving in these areas. So far, this has not yet become a top priority in either the public or private sectors, except in a few instances. Neither is the development of indigenous R & D being embraced by the donor community, more comfortable

with contributing to conventional transfers of knowledge from abroad, through their technical assistance programmes.

## **D: ASSESSMENT OF THE EFFECTIVENESS OF EXISTING AND PROPOSED MEASURES FOR SMALL ECONOMIES**

### *D.1: International Trading Arrangements*

#### D.1.1: WTO and Special and Differential Treatment

##### D.1.1.1: Description of Existing Special and Differential Treatment in the WTO.

Currently in the WTO small developing states are covered by the provisions for special and differential treatment that relate to developing countries as a whole. In all, the various texts contain 72 of the 97 different provisions of special and differential treatment related to developing Members as a group. According to GATT 94, these provisions can be classified into five main groups: provisions aimed at increasing trade opportunities through market access; provisions requiring WTO Members to safeguard the interest of developing countries; provisions allowing flexibility to developing countries in rules and disciplines governing trade measures; provisions allowing longer transitional periods to developing countries; and provisions for technical assistance<sup>18</sup>.

##### D.1.1.1.1: Provisions aimed at increasing trade opportunities

Under Article XXXVII of GATT 1994 developed Members are required to accord high priority to the reduction and elimination of barriers to products currently or potentially of particular export interest to developing countries. The Enabling Clause also permits developed Members to provide tariff preferences to exports from developing countries, and also allows developing Members to reduce or remove trade barriers in regional or global arrangements among themselves.

Article IV of the GATS stipulates that the increasing participation of developing country Members in world trade shall be facilitated through the negotiations of specific commitments relating to the strengthening of their domestic service capacity and its efficiency and competitiveness through access to technology on a commercial basis; the improvement of their access to distribution channels and information networks; and the liberalization of market access in sectors and modes of supply of export interest to them.

##### D.1.1.1.2: Provisions that require WTO Members to safeguard the interests of developing country Members

WTO agreements contain many preambular references as well as substantive ones in the various texts that commit members to implement the agreements in ways which take into account the interests of developing and least developed countries. These references are of two kinds: (a) some are of a general nature and are expressed in broad "best efforts" terminology; and (b) in a few

cases there are more explicit provisions as to how developing countries are supposed to be treated more favourably or in ways which are least damaging to their interests. Preambular references can be found in the Agreement establishing the WTO, the Agreement in Agriculture, the TBT Agreement and the Anti-Dumping Agreement and SPS. Substantive references can be found in the prescribed levels contained in the Agreement on Subsidies and Countervailing Measures and in the Agreement on Safeguards.

#### D.1.1.1.3: Flexibility of Commitments

##### D.1.1.1.3.1: Exemptions from Disciplines and Protection of Industry

Flexibility in the implementation of certain rules and commitments is contained in many of the Uruguay Round agreements. In all, flexibility with regard to disciplines agreed in the Uruguay Round Agreements accounts for about 40 of the 72 provisions for special and differential treatment contained in the agreements. These provisions generally provide for greater latitude for developing Members, under certain circumstances and to a certain extent, in the application of agreed disciplines. For example, under the Agreement on Agriculture a longer timeframe and lower tariff and subsidy reductions apply for developing Members than for other Members. Similar exemptions from disciplines are to be found in the Agreement on Subsidies and Countervailing measures.

GATT 1994 under Article XXXVI and the Enabling Clause incorporated all the provisions on non-reciprocity in trade. In this context, an important flexibility provision was the acceptance that developing Members could bind tariffs at ceiling levels, often significantly higher than autonomously applied rates. The General Agreement on Trade in Services (GATS) in Article XIX: 2 also allows developing country Members to open fewer sectors and liberalise fewer types of transactions, while progressively extending market access in line with their level of development. Developing countries can also enjoy the flexibility of attaching conditions to the establishment of foreign suppliers. Greater flexibility in providing protection to domestic industry also exists through the provisions of GATT Article XVIII, which give developing countries the freedom to grant the tariff protection required for the establishment of a particular industry and to apply quantitative restrictions for balance of payments purposes even though the Uruguay Round resulted in the tightening of the use of restrictions for balance-of-payments reasons.

Finally, provisions exist which permit developing countries greater flexibility in meeting requirements: for example, the Enabling Clause calls for greater flexibility in determining adherence to the GATT provisions regarding the formation of free trade areas and customs unions among developing countries.

##### D.1.1.1.3.2: Transitional Time Periods

Flexibility in terms of longer time periods for implementation are provided for in all WTO agreements, with the exception of the Agreements on the Implementation of Article VI (Anti-Dumping) of GATT 1994 and on Pre-shipment Inspection. In most cases, flexibility takes the form of an agreed delay, on the part of developing countries, to phase-in or phase-out certain or all provisions

of the agreement concerned. Examples of agreements with longer transition periods for developing countries are the Agreement on Subsidies and Countervailing Measures, the Agreement on TRIPS, the Agreement on Customs Valuation, the Agreement on Trade-Related Investment Measures, and the Agreement on the Application of Sanitary and Phytosanitary Measures.

#### D.1.1.1.4: Technical Assistance

In the Uruguay Round Agreement special and differential treatment was extended to developing countries through the provision of trade-related technical assistance by developed to developing Members, either on a bilateral basis or through the WTO or other relevant international organisations. Such provisions exist, for example, in the WTO Agreement itself, as well as in the Decision on Notification Procedures, the Trade Policy Review Mechanism, the Understanding on Balance-of-Payments Provisions, the Decision on Measures Concerning the Possible Negative Effects of the Reform Programme on Least-Developed and Net Food-Importing Developing Countries, the Agreement on the Application of Sanitary and Phytosanitary Measures, the Agreement on Technical Barriers to Trade, the Agreement on Customs Valuation, the Agreement on Pre-shipment Inspection, the GATS, and the TRIPS Agreement.

In general, WTO technical assistance essentially provides information to developing country governments about their rights and obligations under the WTO Agreements, and strengthens their capacity to apply the agreements and participate in WTO discussions. Reflecting the nature of the agreements, WTO technical assistance is becoming increasingly technical and specialized, often using expert consultants or conducted in cooperation with other agencies. In addition, the WTO also provides technical assistance to help applicant countries to comply with the requirements for accession to the WTO<sup>19</sup>

#### D.1.2: Small Economies and WTO Restructuring

Inadequate differentiation and graduation among developing countries have been blamed for the slow progress on market access and generally on more favourable treatment from developed countries for small economies. At present, regardless of size and export capacity, all developing countries are given the same treatment in the WTO.

The principle of graduation is incorporated in the Enabling Clause provisions without any formal differentiation imbedded in the WTO agreements. It allows developed countries to unilaterally treat the developing countries differently in the implementation of GSP.<sup>20</sup> It is increasingly recognised that unless developing countries accept some type of differentiation in non-LDC treatment, the prospects for positive commitments in favour of more deserving categories of developing countries will remain dim in the WTO context<sup>21</sup> The Enabling Clause does not currently allow for differentiation between non-LDC developing countries and there is no clear precedent for differentiation among developing non-LDC countries<sup>22</sup>

Several studies have sought to draw up an index of vulnerability. In particular the United Nations and more recently the Commonwealth Secretariat have developed indexes that seek to

establish differentiation in the GSP in favour of vulnerable economies. No international consensus exists however on such measures and indexes which mainly capture very small states and do not deal adequately with the broader problem of adequately re-classifying non-LDCs in the WTO<sup>23</sup>.

One flaw with some of the above work is that it is assumed that a new category of vulnerable states ( in most cases small states below 1 or 1.5 million) would have to be given LDC status. However, the main issue is not whether LDC treatment should be granted to the countries classified according to a vulnerability index but whether another category of vulnerable countries can be created with an S&D package that is less than that for the LDCs but meets the needs of these countries with treatment that is transitional rather than permanent; and be accompanied by the graduation of more advanced developing countries. The probability that such an agreement could be obtained is greater since any increase, if at all, in costs that may result from this approach would be the minimal<sup>24</sup>

One approach is to separate the developing countries that can be immediately graduated to developed country status and consider the others as transitional developing economies. These transitional non-LDCs can then be divided into two categories based on the characteristics of smallness and vulnerability and be treated equally but differently in terms of S&D measures. Along with graduation mentioned above, an S&D package could be designed according to the peculiar development needs of each category of non-LDCs in order to minimize the costs of S&D measures.

One category, defined as the small vulnerable transitional developing countries would cover the countries that are exposed to higher risks and whose index of vulnerability is on average higher than that of the second group which would comprise the other transitional non-LDCs characterised on average by lower vulnerability. The transitional needs of each category would be different allowing for a different package of S&D measures discussed below.

Graduation criteria should also apply to all transitional developing countries. Such criteria should automatically be triggered once they reach a certain level of development. Such a new graduation approach would lend some dynamism to the present static system of differentiation and assist in minimizing the burden of S&D.

It has been observed that historically S&D was incorporated in the WTO in an ad hoc manner and without reference to any underlying consensus on trade needs of the various categories of developing countries. In addition, S&D was eroded in the Uruguay Round because it was addressed separately in each negotiating group without any underlying conceptual framework. As a result, the challenge for developing countries is to maintain S&D relevant to their development needs and to the impact of liberalization and globalization.

The above concern is addressed in terms of the three categories of countries discussed above. The guiding principle is for most favourable treatment to be preserved for the LDC category and relatively less favourable treatment to be provided equitably by balancing concessions between the small vulnerable transitional countries and the other transitional group. The aim is to provide a set of S&D measures for each category with little overall difference in treatment between categories in so far as they relate to the needs of the particular category.

As regards preferential treatment for non-LDCs, in order to take account of the dependence of the vulnerable transitional category on special preferences including commodity protocols, the preservation of these existing special preferences (Lomé, CBI, etc) is considered important for an acceptable duration of time. Such countries would have relatively more interest in some product-specific exports that dominate their export patterns. In this way they differ from other developing countries that have a broad interest in removing the remaining obstacles to existing and potential products of export interest to them. Both groups would not be entitled to any new GSP extensions for the LDCs in order to preserve the most favourable GSP treatment for the LDCs. Rather than specific preferences on particular products of current export interest, the non-vulnerable developing category would be expected to get duty-free access on products of existing and potential interests that would not be as complete and unlimited as the present extensions for the LDCs which would cover even sensitive products.

Small vulnerable economies attach special significance to secure and predictable market access in order to attract investment and reduce the risks on larger markets. Larger countries can arbitrarily change access conditions to the detriment of dependent investors in small countries. In the area of exemptions from disciplines which consists of flexibility in obligations and procedures and different thresholds for undertaking commitments, the concessions that would relate to secure market access of particular relevance to this category would be thresholds for anti-dumping and countervailing duties and emergency safeguards. The former area of contingent protection would appear to be the one in which small countries may be deserving of some special attention.

In terms of export promotion aimed at diversifying the export structure, some more flexibility in the use of export subsidies could also be helpful given the nature of high transaction costs small firms in small economies face in penetrating large ultra-competitive external markets and the need to counterbalance the advantages of established developed country producers. This would require some adjustment to the current differentiation on a per capita income basis incorporated in the Agreement on Subsidies and Countervailing Measures. As regards agricultural subsidies some redress of the current imbalance which allows developed countries to use non-actionable subsidies which are relatively more important for them as against actionable subsidies which are relatively more important for developing countries would be in order. Some greater flexibility on agricultural subsidies in the Agreement on Agriculture for the other non-vulnerable group of transitional developing countries could be a way forward in terms of balancing concessions.

In terms of time periods for implementing obligations, lack of institutional and human capacity can be expected to be a greater constraint among small vulnerable developing countries. This difference can be expressed in the form of a special waiver for this category for longer phase-ins for a particular set of agreements that are difficult to implement as against a case-by-case waiver for other transitional developing countries.

While the question of flexibility is still ambiguous in terms of exemptions and longer time frames, developing countries have not stated as a principle that they deserve the same treatment as LDCs. Complete exemptions from disciplines and more extended transition periods to implement agreements would continue to preserve most favourable treatment for LDCs in this area.

#### D.1.2: Post-Lomé And Special and Differential Treatment

The ACP and the EU agreed to a Framework Agreement for the Successor Convention to Lomé IV and the 'roll-over' of the present Lomé Trade Regime. The new 'Partnership Agreement' (Cotonou Agreement) provides for an eight-year rollover of the present Lomé arrangements. During this period a second post-Lomé phase of negotiations will take place beginning in September 2002 on the subject of WTO-compliant alternative trade arrangements. These negotiations will be concluded by 2008. The new agreements will then be implemented over a transitional period.

In broad terms three WTO-compatible options will be presented. The present Lomé-type arrangement or an extended GSP more favourable than the present GSP will be offered to all the LDCs both ACP and non-ACP. For the non-LDC ACP states, the choice will be between either the GSP (the current one or a version to be enhanced) which will not be as favourable as the one extended to the LDCs or the negotiation of an FTA. Based on the possibilities for differentiation among non-LDCs in the WTO, the EU will review the GSP in 2004 to determine the best offer it can make to ACP countries which do not wish to enter into an FTA.

The ACP and the EU however agreed to maintain special treatment for ACP LDCs and to take due account of the vulnerability of small, landlocked and island ACP countries<sup>25</sup>. How the latter would be accomplished for small economies is still not clear. The EU's "everything- but- arms" (EBA) offer of 2001, whereby 49 least developed countries received access to the EU free of tariffs and quotas for all products except arms with immediate implementation, except for transition periods for bananas, rice and sugar where tariffs are to be phased out over the next eight years, already poses a challenge to many small states. This measure is expected to result at the end of the transition periods in trade diversion at the expense of these countries that are currently supplying these products which will be liberalised in competition with those of EBA countries. Improving the GSP on the basis of the existing conditions in the Enabling Clause, i.e. without discriminating between beneficiaries, would thus work above all in favour of the non-ACP developing countries which in general have a higher level of international competitiveness than many small states in the products of export interest to these states.<sup>26</sup>

As regards the negotiation of EPAs, it is the EU intention to request reciprocity individually or from all members of an ACP region (including LDCs that may wish to accept an EPA) either already applying free trade effectively or planning to introduce free trade and which elects itself for such negotiation. This may, in particular, be the case in custom unions or (completed) free trade areas among ACP states.

Under an EPA the ACP small states are seeking to phase out the application of tariffs over an appropriate time frame and this may lead to tariffs being eliminated over a somewhat longer time-frame than that generally applied. Such flexibility should also involve some differentiation between individual countries within a regional group depending on their size and level of development. The approach would have to be fine-tuned and tailored to the particular circumstances of each region, bearing in mind the degree of integration and the impact on trade and investment flows.

The idea of an “asymmetrical or soft FTA” has been advanced to take care of the development needs of small countries. It is believed that Art 24 in the WTO is flexible enough to go beyond 12 years if necessary. According to one interpretation of Art. XXIV, a country only has to inform the WTO General Council that it needs more adjustment time (beyond 12 years) and that cannot be challenged in the WTO. Examples of FTAs such as in Latin America and other regions which have taken over 25 years or more to meet this Art. XXIV requirement abound and are used to buttress this legal position. At present, no one wants to challenge Art. XXIV in the WTO since the flexibility that is needed is felt to be already there.<sup>27</sup> On the basis of this flexibility, the EU believes that different transition periods could be arranged for different countries. The trend within the WTO however is towards a stricter, rather than a looser, interpretation of Art. XXIV. There is therefore a concern on the part of many ACP states that this flexibility could be challenged, and consequently, it would be prudent to formally obtain the necessary adjustments to Art. XXI.

There are several unsettled issues that bear on a choice between an EPA and some alternative non-reciprocal trade arrangement whether the latter refers to GSP, or some other (still to be defined) trade option. The proposed EPA is still broad and lacking in details. Its development context as well as the trade related areas (contingent protection, standards, process and production criteria, etc) that may accompany it have also not yet been spelled out. In addition, for many small ACP countries heavily dependent on Protocols and preferences in textiles, and for most of whom, the existing Lome preferences are far from equivalent under the existing GSP on existing exports, substantial enhancement of the GSP would be required to make it Lome-equivalent on current exports.

Some observers believe that the choice between an EPA and GSP for the Commodity Protocols is a non-issue since tariff quotas depend on the CAP and are likely to be placed on the agenda of the new WTO round<sup>28</sup>. Whether all of them would be placed on the WTO agenda remain a matter for negotiation. The experience with bananas would however, suggests that, as in the case of sugar, the securing of a waiver up-front is important to guarantee the continuation of these preferences and such a provision for the Protocols in new WTO Agriculture Round would be needed. In addition, and more importantly, the GSP will not cover the Protocols. Even though the Protocols are tied up in CAP Reform and the new WTO Agricultural Round, the continuance of the Protocols in some meaningful form can still be tied in an FTA arrangement since duty-free tariff quotas are permissible under the WTO Art XXIV.

The ACP small states have a much wider agenda in terms of trade and development assistance. In addition to longer time frames, flexibility of commitments and other issues discussed under the FTAA are also relevant to them.

#### D.1.3: FTAA and Special and Differential Treatment

The debate to incorporating special and differential treatment in the FTAA is basically centered around two approaches. The first is to institutionalize under an Enabling Clause lesser commitments in a permanent fashion through special exemptions, preferences, lesser obligations and longer times for fulfilling obligations similar to GATT. The second is to vary, on the basis of universally established

obligations, transitional arrangements for phase-ins and phase-outs on tariffs, market openings and sectors according to the differentiation criteria agreed upon<sup>29</sup>

The first approach, which is the most comprehensive, is usually spelled out in provisions for smaller economies. These can be summarised as asymmetrical treatment in terms of market access; measures that require larger Members to safeguard the interests of smaller Members, for example, in terms of constructive remedies in imposing anti-dumping and countervailing duties, etc; flexibility of commitments particularly in terms of exemptions from Disciplines regarding the protection of industry and the balance of payments; transitional periods in the form of asymmetrically phased implementation of rules and disciplines, permitting a longer adjustment period ; access to mediation due to the limited capability for dispute settlement; and technical assistance and training.<sup>30</sup>

In the second approach discussed above, in so far as the rights and obligations shall be shared by all countries, smaller economies are expected to implement all the provisions. A suitable transitional arrangement is needed for countries not yet ready to assume immediate and full FTAA provisions because of the level of development and/or the degree of liberalization commensurate with such obligations. They point to the Uruguay Round, NAFTA and Mercosur, where this was adopted in TRIMS, TRIPS etc where universally applicable obligations and disciplines are subject to asymmetrically phased time periods.. A case is also made for flexibility in some areas such as in time frames for tariff reduction, rules of origin, safeguards and trade remedy laws but not in investment, standards, SPS and customs procedures. Some observers caution against a web of exceptions and special measures that would significantly increase transaction costs of trade.

An assessment of the “smaller economies” approach cannot be done in isolation from other S&D approaches for other categories of developing countries in the hemisphere<sup>31</sup>. Although the underlying intent of the “smaller economies” approach is to be inclusive as possible, it is not necessarily perceived as such. For instance, the need to accompany the “smaller economies” approach with one that takes account of the other developing countries of the hemisphere has been stressed<sup>32</sup>. The latter approach seeks to complement the “smaller economies approach<sup>33</sup>” with the traditional ALADI differentiation approach<sup>34</sup>. It places the countries of Latin America and the Caribbean into three categories according to their "relative level of development" based on per capita GDP, their size and the degree of industrialization of the economies. The largest economies (Argentina, Brazil and Mexico) constitute one group; the economies of intermediate development (Colombia, Chile, Peru and Venezuela) would constitute another group; and the relatively less developed economies (Bolivia, Ecuador, Paraguay and Uruguay and the countries of the Caribbean and Central America) would comprise the third group.

In agreeing to take account of size and the level of development, FTAA authorities may well wish to first take a new look at graduation and differentiation in the WTO along the lines discussed above and align this exercise with their own. The WTO position that respects the most favourable treatment for LDCs would appear to be inviolable, and on this basis, some categorization of low income FTAA member enjoying the maximum concessions could be established. Vulnerability could then be next and could be based on size and other considerations and could embrace countries whose concessions would be mainly transitional with some lesser obligations and exceptions to take account mainly of limited human and institutional capacity.

The WTO established the pattern of demanding reciprocity from developing countries on the basis of flexibility of time frames and the acceptance of a universal set of obligations in trade and trade-related matters. The WTO approach is being considered for the FTAA where the intention, judging from one of the principles being established, seems to be the sharing of all reciprocal obligations on a contractual basis. Preferential treatment that does not go against the basic reciprocal obligations would be either non-binding or partially binding.

The recognition of S&D in the WTO in terms of legally binding and enforceable provisions is one way to provide a solid juridical framework that could be enforceable and not be contingent on bilateral political negotiations. Any WTO-plus effort in the FTAA and Post -Lomé must be based on such tighter disciplines. The FTAA and Post-Lomé will also have their own autonomy to decide on preferences. S&D however, to be more meaningful, cannot be on a case-by -case basis and must be given on verifiable conditions for graduation.

## *D.2: International Financial Arrangements*

### D.2.1: New Approach by the Multilateral Financial Institutions

As a result of the concerns recently raised by small states, multilateral agencies have adopted new or modified development approaches and instruments. The World Bank framework centers on helping small states develop and implement effective strategies to reduce poverty. Its flexible approach that was earlier adopted caters for different development policies in the context of each country's reality, and thus allows the Bank to accommodate in a large measure the policies and instruments that take care of the challenges posed to small states. This approach, by emphasizing full consultation with all the stakeholders, facilitates the adoption of a Country Assistance Strategy (CAS) that should take full account of the vulnerabilities and the policies and programmes best suited to deal with them.

Sustainable development in small vulnerable states requires a comprehensive approach. The Comprehensive Development Framework (CDF) of the World Bank offers a useful basis for tackling the development tasks. Its policy goals of poverty alleviation and environmental sustainability give it an adequate strategic focus. It also allows a holistic matrix to be effectively developed to meet the needs of small vulnerable states in particular their country-specific situations.

The World Bank is stressing an integrated approach among development institutions. The approach, which is based on rewarding good management and a careful assessment of timing and sequencing of issues, includes financial support to ease adjustment costs, and technical assistance to improve limited institutional capacity. It explores for small states the full flexibility in the use of its new lending instruments. The Bank uses a wide range of instruments to deal with adjustment. Essentially they are Structural Adjustment Loans, Sector Adjustment Loans, and Rehabilitation

Loans. Recently, the creation of the Adaptable Program Loan and the Learn and Innovation Loan has extended the range of instruments of the Bank by offering more possibilities to small states.

It is well recognized that an appropriate macroeconomic framework must underpin all efforts at adjustment. The CDF acknowledges this link. In small vulnerable states, even more than in large ones, however, macroeconomic stabilization is more closely linked to the structural, social and human side of development. Its significance for small states needs to be more fully appreciated in terms of establishing priorities as well as the timing and sequencing of action. Volatility of export earnings constantly puts macroeconomic stability at high risk in these fragile environments and tends to set back the pace of structural reform. The essential complementarities and the real obstacles that must be overcome initially then easily get lost. In such a turbulent environment protecting the social advances particularly in education and health must be given uppermost priority. The increasing focus of the World Bank on social impacts in adjustment lending augurs well in this regard. Its finetuning with safety nets adapted to small vulnerable countries in these critical social areas has been a useful step forward. The current poverty focus of adjustment lending would also be important for small states with high levels of poverty as well as the mainstreaming of gender concerns.

The Bank framework is emphasising country ownership, participation, partnership and a holistic approach to diagnosis and policy development. The linking of lending and non-lending services is also considered important along with the targeting of aid to modernize the economy rather than to delay adjustment. Aid for budgets and programs rather than individual projects is also being stressed coupled with the adaptation of instruments to deal with institutional capacity.

In terms of tackling volatility, the World Bank is suggesting the use of hedging instruments, such as futures and options. This suggestion falls within the wider context of assisting developing countries to manage risks associated with commodity price fluctuations. The Bank is laying emphasis on efforts to spread information about the use of hedging instruments and lower interference with market mechanisms that reduce the incentive of private sector agents to pay for the cost of hedging. In addition, in designing social security systems tailored to their realities, risk diversification considerations suggest that investing funds abroad is a much safer strategy than investing them at home.

The main response to limited technical capacity in small states is to support the pooling of administrative and technical resources at the regional level. The Bank and other international organizations are also engaged in the development of programs of capacity building for trade including capacity to engage in trade negotiations.

Similarly, new mechanisms to address the mitigation of natural disasters involve disaster prevention and management as well as insurance. In addition, by stressing a flexible approach to graduation policy, the World Bank framework also hopes to take into account the special circumstances of small states to ensure that none is graduated prematurely.

#### D.2.2: Unfinished Agenda

The decline of ODA flows has been a source of concern to small states which have a higher cost of providing public goods due to fixed costs and scale economies, adverse terms of trade shocks,

high transport costs, the need to employ highly skilled personnel from abroad and environmental fragility. In the present context, special concessions from Development Banks, which were previously secured for infrastructure projects, now appear to be under threat. Small states are also concerned with the absence of support to cover the adjustment costs associated with the loss of trade preferences as well as income volatility.

The capacity of these states to access international capital markets also needs to be enhanced. Higher transaction costs due to the absence of information and lack of institutional capacity and higher risks associated with the volatility of exports and a narrow economic base tend to raise the cost of borrowing.<sup>35</sup> International capital markets perceive small states to be riskier than otherwise comparable large states. In a good policy environment, more aid can compensate for this tendency by international capital markets to perceive small states as relatively risky places in which to invest. The idea of maintaining a high level of external support and official assistance in cases where appropriate policies are in place, to compensate for the perceived riskiness and the difficulty in attracting investment flows, has not however, fully materialized with the present decline of concessionary assistance.

As regards the range of financial instruments, IMF provides the Compensatory and Contingency Facility (CCF) which offers balance of payments support in the event of a shortfall in export earnings. ESAF for eligible IDA small states is also available. There is however a question of the terms and conditions of the CCF as well the accessibility by deserving non-IDA small states to ESAF. On financial assistance, the IMF framework notes that, like all member countries, small states that face balance of payments difficulties are eligible for all of the IMF's financial facilities and loans and that all programs take into account country-specific circumstances, including size. Thus, small states that are vulnerable to natural disasters or have a higher degree of export concentration have opportunities to avail themselves of emergency assistance for natural disasters and the Compensatory Financing Facility. Small states that have low per capita income are eligible for the IMF's concessional loan facility, the Poverty Reduction and Growth Facility (PRGF). Eligibility for the use of PRGF resources has tended to follow closely the World Bank's decisions on eligibility for loans under the International Development Association.

Graduation policies, both IBRD and IDA, are therefore central to the debate on the provisions for small states. Despite the assurances of the Bank that a flexible policy will be pursued and that the critical issue is whether its member country can access international capital markets, many small states see themselves as disadvantaged in either not being able to access concessional loans or due to the uncertainty that surrounds their eligibility. For instance, UNCTAD at present is working to try and stop any attempt that may be made to graduate four small islands from the IDA. It appears desirable therefore for the Bank to review its criteria especially in the light of the high transition and adjustment costs facing many small states that are likely to lose preferences. This would introduce a greater measure of predictability in the system.

The above must also be viewed in the context of the limited progress so far as regards the development of hedging instruments. Effective participation in financial markets abroad is seen as requiring specialised skills and institutions that may be expensive to develop and go well beyond the capacity of small vulnerable states. As the Bank itself acknowledges, assistance to provide regulation,

build capacity and restructure and manage pension systems will be needed. In spite of commitments to provide such assistance, a fair amount of scepticism still persists as to the scope for hedging in small economies.

Over the last decade donors have been paying more attention to aid effectiveness in the context of improved economic management. The aim has been to focus aid on key sectors that are supported in a sustainable way with a coherent policy package. Even though country-specific approaches are optimal, there are some general rules for small states. The circumstances that allow structural reforms to accompany macroeconomic adjustment need to be better understood. In addition too many simultaneous reforms can have a negative impact due to a lack of administrative capacity. Specific attention has also been paid to building institutional capacity and creating greater partnerships with the private sector and civil society to increase aid efficiency. However, highly fragile and poorly staffed institutions are still a major constraining factor in the development of small states. The area of Private Sector Development in small states is clearly one where capacity-building, particularly at the regional level to overcome scale problems is still very important.

In addition, local universities and other tertiary institutions in a position to contribute should be given the necessary backing to work out tripartite programmes of R & D with the private and public sectors. The donor community should be strongly urged to support such programmes with resources and with assistance in networking with appropriate institutions in their countries. Without the development of a sustainable R & D capacity, geared towards the local productive sectors and export development, the achievement of greater international competitiveness will remain elusive.

Finally, policy coherence in global economic policymaking requires a structure to be put in place by the Bretton Woods Institutions that would monitor and evaluate vulnerabilities of small states as they progressively integrate into the multilateral system and respond with an appropriate set of trade and financial policies<sup>36</sup>. CAS needs to be more linked with the WTO in such a way that small economies could be better integrated into the multilateral trading system and their institutional capacity for participating in international trade negotiations enhanced.

## **E. CONCLUSIONS AND RECOMMENDATIONS**

### **TRADE**

- S&D provisions in the WTO agreements should be re-negotiated between developed and developing countries with the aim of seeing flexibility as part of reciprocity and linked to S&D provisions that are legally enforceable. Priority should go the Revision of the Enabling Clause, GATS IV, and the preambular and substantive best endeavour commitments in terms of market access and preferences as well as the variants of the GSP discussed below to make them legally binding and free from contention;

- A new categorization of non-LDCs based relatively more on vulnerability than on per capita income should be negotiated under the Enabling Clause. Two distinct categories of transitional developing countries, each being accorded an S&D package of balanced concessions, should be established. The transitional needs of each category would be different allowing for a different package of S&D measures. Treatment for these two categories would be temporary as compared to that of the LDCs whose S&D treatment would be the most extensive and permanent. Both transitional categories would be subject to built-in graduation criteria as a way of introducing some dynamism into the system and minimizing costs;
- Specific transitional preferences with appropriate waivers on particular commodities are considered important for an acceptable duration of time for the small vulnerable group whose members would have relatively more interest in some product-specific exports that dominate their export patterns. In this way they differ from other developing countries that have a broad interest in removing the remaining obstacles to existing and potential products of export interest to them. Both groups would not be entitled to any new GSP extensions for the LDCs in order to preserve the most favourable GSP treatment for the LDCs;
- The international community has made a special effort to address the problems faced by the LDCs. LDCs are exempted completely from disciplines or are provided with more extended transition periods to implement agreements. In the area of exemptions from disciplines which consists of flexibility in obligations and procedures and different thresholds for undertaking commitments, the concessions that would relate to secure market access of particular relevance to the vulnerable category would be thresholds for anti-dumping and countervailing duties;
- Greater dependence on trade taxes by small vulnerable countries would also suggest some more flexibility in further tariff reduction for tax purposes;
- In terms of time periods for implementing obligations, lack of institutional and human capacity can be expected to be a greater constraint among small vulnerable developing countries. This difference can be expressed in the form of a special waiver for this category for longer phase-ins for a particular set of agreements that are difficult to implement as against a case-by-case waiver for other transitional developing countries;
- Technical and financial assistance should be increased and placed on a sound legal footing in terms of commitments. It should target capacity building to implement WTO agreements and criteria should be introduced to focus the assistance;
- Post-Lomé negotiations (second phase) should be pursued in the wake of revised WTO S&D provisions. The new proposed WTO framework if accepted along the lines discussed above makes provision for both an enhanced contractual GSP that could offer equivalent Lomé-type access on existing exports and preserve the Protocols over a reasonable time frame through waivers. Depending on the outcome of the WTO round, small countries would be in a better position to make an informed choice between an EPA and GSP;

- An assessment of the “smaller economies” approach in the FTAA cannot be done in isolation from other S&D approaches for other categories of developing countries in the hemisphere. There is scope for complementing the “smaller economies approach” with the traditional ALADI differentiation approach;
- In agreeing to take account of size and the level of development, FTAA authorities may wish to first take a new look at graduation and differentiation in the WTO in terms of a new classification of non-LDCs and align this exercise with their own. A new WTO model based on the recognition of longer time frames to fulfil obligations, some exemptions from disciplines and some exclusion of sensitive products under Art. XXIV could form a useful basis of future FTAA WTO-plus negotiations. It would have to be supplemented by appropriate autonomous FTAA decisions on S&D;
- The recognition of S&D in the WTO in terms of legally binding and enforceable provisions is one way to provide a solid juridical framework that could be enforceable and not be contingent on bilateral political negotiations. Any WTO-plus effort in the FTAA and Post -Lomé must be based on such tighter disciplines.

## FINANCE

- The response of the Bretton Woods Institutions to the issues raised by small states so far has been positive. They have modified existing policies and instruments and introduced new initiatives to take care of the challenges posed to small states;
- The present discussion is lacking an appropriate institutional framework for coherent policy making at the global level that would facilitate the integration of small states in the multilateral system. An integrated framework with the appropriate coordination that includes but goes beyond aid effectiveness is needed. The CAS could provide the basis for such an approach if it incorporates more the WTO;
- Greater Policy Coherence between the Bretton Woods Institutions should be promoted to cover not only the specific vulnerable country but also a grouping of small states in order to exchange information on policies and experiences;
- Graduation policies, both IBRD and IDA, are central to the debate on the provisions for small states. Despite the assurances of the Bank that a flexible policy will be pursued, many small states see themselves as disadvantaged in either not being able to access concessional loans or due to the uncertainty that surrounds their eligibility;
- The area of Private Sector Development in small states is clearly one where capacity-building, particularly at the regional level to overcome scale problems is still very important;

- The donor community should be strongly urged to support tripartite programmes of R & D of local universities and other tertiary institutions with the private and public sectors;
- Trade capacity development and support particularly for trade-related infrastructure and institutional strengthening should be more effectively mainstreamed in the operations of donors with vulnerable states.

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## ENDNOTES

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<sup>1</sup> The Commonwealth Vulnerability Index (CVI) (Atkins et al, 2000) defines economic vulnerability in terms of the incidence and intensity of risk and threat and the ability to withstand risks and threats and to bounce back from external economic and environmental shocks.

<sup>2</sup> (Commonwealth Secretariat-World Bank Joint Task Force, 2000).

<sup>3</sup> These proposals are outlined in the Commonwealth Advisory Group (1997).

<sup>4</sup> Easterly and Kraay (1999)

<sup>5</sup> Alesina and Spolaore (1997)

<sup>6</sup> Easterly and Kraay (1999)

<sup>7</sup> Helleiner (1994)

<sup>8</sup> A similar observation has also been made by Belassa (1967) and Scitovsky (1960) as they noted that economic integration reduces external uncertainty of small states through closer trade links and greater economic interdependence with neighbouring states

<sup>9</sup> Armstrong and Read (1995). Small states are seen to depend on the economic strength of their larger neighbours. The success of Western European Small States to whom the EU has generously given trade concessions are explained in this way and globalization as compared to regionalism is seen as less significant for small states.

<sup>10</sup> It is of interest to note that the US administration mainly justified the adoption of the CBI on grounds of the high costs of diversification facing small Caribbean Basin States. See Gonzales, A "US/Caribbean Economic Relations" Capitulos. SELA. 1984

<sup>11</sup> This exercise is confined to examining adjustment costs for the moment.

<sup>12</sup> UNECLAC (POS) (1995)

<sup>13</sup> Michaely and Papageorgiou (1998).

<sup>14</sup> Milner and Westway 1993

<sup>15</sup> Lall and Ghosh (1982)

<sup>16</sup> Commonwealth Secretariat-World Bank Joint Task Force (1999)

<sup>17</sup> In examining commitment to trade liberalization Michaely and Papageorgiou (1998), using size classified by territory, found small countries to be more interested in liberalization due to the expected higher gains from trade. As regards transition costs, using export performance and the rate of growth for countries in the Latin American and Caribbean region, they found no difference between small and large states. However, Finger (1998) recently noted that the recent growth performance of the small Caribbean countries has been modest, almost two percentage points behind growth across all of Latin America and even farther behind the growing list of countries that have effectively used international trade as a vehicle for development. In addition in relation to openness, trade restrictions in the small Caribbean countries are higher.

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<sup>18</sup> Additional provisions within these five groups relate specifically to the least-developed countries.

<sup>19</sup> In the Uruguay Round Agreements there are 17 provisions applicable specifically to LDC Members, in addition to those that are applicable to all developing Members. These 17 provisions, however, contain additional benefits for them. Under the 1979 Enabling Clause special treatment of the least-developed countries in the context of any general or specific measures in favour of developing countries was enshrined. In the provisions on non-reciprocity in trade negotiations in GATT 1994 as well as GATS greater emphasis is placed on not seeking contributions from the least-developed Members.

<sup>20</sup> The more advanced of the developing countries can compete in the products in which they have comparative advantage with developed countries. Already they are subject to graduation in the GSP on products in which they enjoy comparative advantage. Leaving the definition of graduation to the developed countries allows extraneous arbitrary considerations to determine which countries get which preferences and how much.

<sup>21</sup> As Michalopolus (1999) however notes “this poses tremendous political difficulties in the developing countries themselves since developing countries find it politically easier to pretend that they all should be treated the same; and developed countries pretend to provide more favourable treatment to all developing countries, but in practice primarily do so only regarding the LDCs”.

<sup>22</sup> Under the export subsidies agreement, a per capita income of \$1000 has however, been used which widened access to some non-LDCs. In Textiles and Clothing, small suppliers are recognized with more favourable treatment. In the most recent Seattle Third WTO Ministerial, developing countries attempted to broaden this criterion to include all Lower Middle Income Countries. In addition, in the preparation of the Seattle Ministerial, it was reported that there were suggestions, especially by the World Bank and the IMF that improved market access benefits be considered for the LDCs be extended to countries eligible under the HIPIC debt reduction initiative. These countries arguably had as much need of these benefits as LDCs (Michalopolus 1999). Both of these initiatives did not bear fruit as a result of the failure of the Ministerial. It could however, come under review in the context of the forthcoming multilateral negotiations.

<sup>23</sup> Because of the difficulty in establishing a universally accepted vulnerability index, differentiation on the basis of a share of world trade lower than 0.03% was attempted. 70 countries were identified on this basis (EC Commission, 2000). For the ACP countries, LDC status on this criterion would go to 19 ACP non-LDCs among whom only 8 would continue to enjoy “globally equivalent” treatment in the GSP to that under the Lomé Convention if the Commodity Protocols are not retained in a revised GSP. Other criteria have been proposed. Grynberg (2000) for instance suggested the use of WTO membership budgetary contributions as they pay respect to a size dimension.

<sup>24</sup> . Developed countries usually respond on the basis of the potential ‘costs’ they will have to face in terms additional imports from developing countries that would stem from such measures.

<sup>25</sup> The EU also has a programme for Small Island Developing Countries .EC (1999)

<sup>26</sup> It must also be borne in mind that for many products, any improvement in preferences may be wiped out by the outcome of the forthcoming round of multilateral trade talks in 2000.

<sup>27</sup> The EC has not said that WTO rules should be changed. Some EC officials have indicated that the EU would argue for a long transition period for the ACP (e.g. 15 to 20 years), as well as the exclusion of many sensitive products (e.g. up to 20 per cent of their imports from the EU). It is not clear how the latter will be secured. In addition, there is no precedent for such an “asymmetrical” FTA and the trend within the WTO is to tighten rules for regional agreements

<sup>28</sup> INZET “Introduction by Dr. Christopher Stevens” in “Trade Arrangements in a New EU-ACP Partnership: Is an Improved Generalised System of Preferences a Viable Option?” Amsterdam, 27 May 1999

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<sup>29</sup> Another approach is prepare countries to enter the FTAA through technical assistance and then when they are ready, if required, use the second option above. (Salazar and Sperisen 1997<sup>29</sup>). Accompanying this approach is a fair amount of financial assistance to deal with competitiveness problems. S&D in this approach would essentially be in financial and technical assistance and longer transitional time frames. Variants of the above approaches have also been examined. For instance, in OAS (1997)<sup>29</sup> and Kotschwar (1999), the second approach could be accompanied by technical assistance. Kotschwar (1999) adds some flexibility in the implementation of certain rules and disciplines due to the lack of legislative, administrative and human resource capacity to implement FTAA commitments in complex areas such as rules of origin, government procurement and antidumping and countervailing duties. Similar to longer time frames, these would be specific and negotiated on a case-by-case basis.

<sup>30</sup> Bernal (1997)

<sup>31</sup> For a recent account of S&D measures in regional integration schemes in this hemisphere and elsewhere, see the following: FTAA Tripartite Committee. Treatment of the Differences in the Levels of Development and Size of the Economies in Trade and integration Agreements. March 2000

<sup>32</sup> ALADI S&D Treatment 1999

<sup>33</sup> In this approach the group of smaller countries is regarded as defined for Technical Co-operation purposes within the framework of the talks being held prior to the negotiation of the FTAA (see the summary of the Eighth Meeting of the Working Group on Smaller Economies, Mexico City, October 14th - 16th, 1997).

<sup>34</sup> The categories end up being the same as those proposed by LAFTA since the 1960's and which are still used by ALADI

<sup>35</sup> Commonwealth Secretariat-World Bank Joint Task Force 1999

<sup>36</sup> This basic idea of integrated and coordinated policy framework is in conformity with the Marrakesh Declaration on the Contribution of the WTO to Achieving Greater Coherence in Global Economic Policymaking