

Free Trade, Regional Integration and The Smaller Economies of Latin America and The Caribbean

Hubert Escaith*

Microeconomic restrictions due to small market size imply that smallness is somewhat an economic disadvantage, at least for developing countries. Smaller economies are also the most vulnerable to external shocks. These characteristics, in turn, dictate a certain and style of macroeconomic policy. Globalisation regional free trade areas present opportunities to overcome the handicaps of small domestic markets; however, the distribution of benefits and costs is not always equitable nor deprived of risks. Ultimately, the outcomes of integration depend on certain domestic

*Head of the Macroeconomic Analysis Unit, Economic Development Division of ECLAC in Santiago, Chile. Comments by Kye-woo Lee and colleagues from ECLAC –in particular Len Ishmael and José Antonio Ocampo- on previous drafts of this paper are gratefully acknowledged. This document was not submitted to formal editing and the opinions here expressed do not necessarily coincide with those of the institution to which the authors is affiliated.

preconditions and on the right policies: as long as they are not fulfilled, the imposed external global conditions can weaken a country's ability to benefit from openness. Trade negotiations should take into consideration these specificities. In any case, during the transition period, financial and technical assistance remain a necessity for these developing economies characterised by a structural vulnerability. The present article reviews the principal characteristics of Latin American and Caribbean smaller economies, the specific challenges presented by regional integration and economic globalisation, and delineate some policy options for the coming decade.

Population, natural resources endowment and size of domestic market have historically been factors that classical economists thought important in determining the wealth of nations. The emphasis put by the neo-classical growth theory on decreasing returns, convexity of production functions and convergence led to some neglect of this issue. The recent trends in growth theory revived the interest in the effect of economic size, and the empirical evidences gathered through comparative studies tend to suggest that it is one of the determinants of growth potential, at least in the early stage of development and integration into the world economy. On the other hand, things may be changing; with globalisation all countries are becoming smaller and even large ones are increasingly dependent on external conditions. The relative importance of large national markets has decreased parallel to the increasing importance of access to bigger markets.

Changing patterns of wealth creation and technological progress also contribute to the relative erosion of the importance of a nation's size; wealth depends less and less on natural resources or physical capital and more on human capital and capacity to adapt to changing environments.

Smallness might even present advantages –at least potentially– in the sociological and political senses, meaning more room for achieving better social cohesion and governance. In fact, there is no formal consensus between theoretical schools on the eventual outcome of free trade when participating economies are strongly asymmetric in size and development level.

The later is particularly important in America, considering that intra-regional trade has been one of the most dynamic component of Latin American and Caribbean (LAC) exports during the 1990s and involves usually non-traditional exports, supporting the diversification of the domestic productive structure. In this context, small economies are particularly anxious to make sure that the conditions of their integration into large free trade areas bring them access to larger markets for their exports and do not jeopardise their sustainable growth potential.

This article presents the main characteristics of LAC smaller economies (SMEs) and their implication on growth and styles of economic development policies. The second part deals with the challenges and opportunities facing SMEs, in particular with respect to globalisation and regional free trade areas. In view of these challenges, some policy options are presented in guise of conclusions.

Main Economic Characteristics of Smaller Economies in the region

There is no accepted unique definition of what a small economy is. The study of the influence of economic size in international trade theory is generally approached by defining small economies as those that are price takers in world market. A related, but more operational criteria when

considered in an increasingly globalised world, would be to define SMEs as countries which lack autonomy in their economic policies and are forced to adjust to those carried out by larger ones. ¹

On an empirical basis, these concepts are of limited use, in particular because they are difficult to observe and do not allow to classify and rank economies. For practical reasons, country size is usually measured in terms of population, area or domestic income. While earlier works in the first half of XX century focused on supply side –natural resources and other factor endowments–, modern approaches tend to consider potential markets, using demographic measures possibly weighted by a national income or an index of human capital (Perkins and Syrquin, 1989 ; Damijan, 1997). There is a strong correlation among various indices in the LAC region, which supports the classification of SMEs in terms of population only (Gutierrez 1996).

Taking a definition of Smaller Economy based on population (less than 10 millions at the beginning of the 1990s), most Latin American and Caribbean countries can be considered as SMEs: all the Caribbean countries, with the exception of Cuba; the Central American Isthmus and, in South America, Bolivia, Ecuador, Paraguay and Uruguay. Many Caribbean islands have a very small population, and constitute a special case, especially in terms of their vulnerability.

Objectively, apart from having a relatively small population and even when they share many structural characteristics, these countries are very different in terms of resource endowment, per capita income, culture and history. For reasons of space, the present text emphasises the common features, but one should be aware of the specificity of each country to avoid over simplification.

SMEs Growth and Competitiveness

New theories of international trade and endogenous growth insist on positive externalities generated by the technology used in the industrial sector. In opposition with the mainstream point of view that SMEs benefit more from globalisation, allowing them to overpass the restriction imposed by their small domestic market, these theories show that this disadvantage may persist –or worsen– even when they access the international market. If a country has even a small comparative advantage over another one before opening the borders, externalities will generate a technological advantage that will be accumulated through time. History matters even in the long run and non convexities in the production function (e.g., decreasing marginal cost) preserve and reinforce the pattern of specialisation.

National market size is pivotal to explain the initial pattern of specialisation. Because of high initial costs in technology intensive productions, it might not be viable to produce domestically capital intensive goods. Increasing marginal returns (even locally) tend to promote monopolistic outcomes when free trade is allowed, even if factors are free to move. Thus, these theories tend to indicate that some kind of bifurcation is at work there, with some countries specialising in regressive type of activities while other find a niche market and ripe the benefit of globalisation (Ros, 2000).

On the empirical side, cross-country regressions using world-wide data do not indicate a strong influence of country size on income when pooling all countries together. More significant results are usually obtained when controlling for development level: Large developing countries do have a much higher per capita income than small developing ones; but their

average income does not differ significantly from very small countries' one. The same patterns may be found when analysing growth rates, indicating that being a small developing country (albeit not a very small one) involve probably some disadvantage. This handicap is contingent to development level, and no such difference exists among the three groups of countries for high income economies (Salvatore, 1997). As Perkins and Syrquin (1989) concluded after reviewing theoretical literature and analysing international data, "Size, therefore, makes a difference to economic structure and performance. On balance, large countries appear to enjoy some advantages not shared by small nations" (p. 1747).

This global pattern seems to fit, albeit loosely, the regional reality. The higher income group of LAC countries corresponds to medium to large, or to very small countries² (see table 1).

As far as growth is concerned, on average during the last 20 years, very small countries (less than one million habitants) experienced rate of growth comparable or higher than medium and large countries (more than ten million habitants). Small countries (between one and ten million habitants) showed in average slower economic expansion than the two other groups (see Table 2). This pattern is basically caused by the mediocre growth registered by small countries during the 1980s, which was not compensated by a significantly higher than average recuperation during the 1990s.

Table 1. Income, debt and country size, 1999:

| LOW INCOME | | MEDIUM HIGH: |
|-------------------|--|----------------------------------|
| | Haiti ^{ab} | Antigua and Barbuda ^a |
| | Honduras ^{ab} | Argentina ^b |
| | Nicaragua ^{ab} | Barbados ^a |
| MEDIUM LOW | Belize ^a | Brazil ^b |
| | Bolivia ^{ab} | Chile |
| | Colombia | Grenada ^a |
| | Costa Rica ^a | Mexico |
| | Cuba ^b | St. Kitts and Nevis ^a |
| | Dominica ^a | St. Lucia ^a |
| | Dominican Republic ^a | Trinidad and Tobago ^a |
| | Ecuador ^{ab} | Uruguay ^a |
| | El Salvador ^a | Venezuela |
| | Guatemala ^a | |
| | Guyana ^{ab} | |
| | Jamaica ^{ab} | |
| | Panama ^a | |
| | Paraguay ^a | HIGH: |
| | Peru ^b | Canada |
| | St. Vincent and the Grenadines ^a | United States |
| | Suriname ^a | |

Notes: a/ Small Country; b/ Highly indebted country

Source: ECLAC, World Bank

Table 2. Latin America and the Caribbean: Growth and country size, 1980-1999

| Countries | 1980-1989 | 1990-1999 | 1980-1999 |
|-------------------------------------|-----------|-----------|-----------|
| Total region | 1.2 | 2.8 | 2.0 |
| Latin America | 1.8 | 2.8 | 2.3 |
| Caribbean | -0.4 | 2.0 | 0.8 |
| More than ten millions habitants a/ | 1.7 | 2.6 | 2.1 |
| One to ten million habitants a/ | 0.8 | 2.9 | 1.8 |
| Less than one million habitants a/ | 2.5 | 2.8 | 2.6 |

Note: a/ Simple average

Source: ECLAC

Size effect is just one of the many factors that influence growth. Table 3 shows results obtained using data from a recent research (Escaith and Morley, 2000) on the relative influence of structural, policy and reform variables that contribute to “explain” per capita growth rate in the region. Time series cover 17 Latin American and Caribbean countries for the period 1971-1996. Even if the authors insist that the results from cross-section analysis should be taken with due care, the results illustrate that large (small) population size is found to affect positively (negatively) the rhythm of growth, once controlling for other factors.

Among the later, international trade and macroeconomic stability seem to be the most significant variable to boost growth. Structural reforms have no clear effects but their speed is clearly a negative factor. When desegregating structural reforms into their respective components relative to trade, tax, financial liberalisation, privatisation and capital account opening, Escaith and Morley (2000) find that the speed of trade liberalisation is definitively one of the main culprit of the negative impact of implementing non gradual reforms. This aspect is clearly relevant for

SMEs when considering their negotiation options with respect to Free Trade Areas (see infra).

Table 3: Empirical estimation of growth determinants in the region, 1971-1996 *a/*

| Variable | Coefficient | t-Statistic |
|--|-------------|-------------|
| Constant | 3.237 | 0.96 |
| LOG(population size in 1971-75) | 0.261 | 2.02 |
| Share of rural population in 1971-75) | -0.033 | -2.50 |
| Per capita income at the beginning of each 5 year sub-period | -0.001 | -7.71 |
| Investment relative to GDP | 0.060 | 1.94 |
| Growth of LDC exports to OECD countries | 0.175 | 8.51 |
| Share of primary sector in GDP | -0.125 | -4.16 |
| Change in export coefficient to GDP | 0.127 | 2.46 |
| Share of international assets in M2 | 0.007 | 1.72 |
| Fiscal balance relative to GDP | 0.154 | 2.97 |
| Fluctuations of real exchange rate | -0.097 | -4.55 |
| Change in credit to private sector relative to total credit | 0.037 | 2.83 |
| Average Reform Index, beginning of each sub period | 0.084 | 0.93 |
| Squared Average Reform Index, beginning of each sub period | -0.001 | -1.19 |
| Change in the Reform Index during each sub period | -0.097 | -2.88 |

Note: *a/* Dependent variable: Annual variation of the Per capita GDP; Method: GLS (Cross Section Weights), using White Heteroskedasticity-Consistent Standard Errors & Covariance. Total observations: 85 (17 countries, 5 sub-periods), R-squared: 0.83

Source: Author's calculations, data description and sources: Escaith and Morley (2000)

Microeconomic considerations explain most of the observed divergences from the neutral outcomes predicted by standard growth theories and the results observed in many empirical works. Small economic size implies that economies of scale and scope cannot be

attained, leading to higher production costs and unfavourable competitive position. These higher costs affect both public and private sectors and are quite diverse:

Indivisibility, Public Goods and Infrastructure Services

Most public goods and infrastructure services are usually characterised by their indivisibility. Because the cost of many public goods are not fully divisible (think, for example, of the obligation of maintaining a full range of diplomatic missions or the minimum critical mass for developing scientific university and research facilities), cost of public services per habitant are usually bigger than in larger economies. This might explain why LAC SMEs have, in general, bigger government spending, taxes and deficit relative to their GDP. The relative indivisibility of the provision of many public services and the necessity of controlling public costs means that public administration in SMEs tend to suffer from small staffing relative to needs. Limitation of scale economies may force states to provide –often on a subsidised basis– a wide array of goods and services that would normally be offered by the private sector in larger economies. As we will see in the following sections, shallow markets in SMEs call for additional regulation, putting further pressure on the public sector.

Firm Size and Production Costs

Private activities are faced with the same difficulties, because the smallness of the domestic market implies that economies of scale cannot be achieved internally. This especially true for the non-traded sectors, for

which market is by definition domestic. High costs and small scale of operation lead to a reduced diversification of enterprises and to monopolies. In the production of tradables, foreign markets offer the opportunity to overcome smallness. Nevertheless, even in this context, economies of scale or of scope are difficult to attain, because (i) even large enterprises in SMEs are small to medium sized compared with their regional competitors, (ii) they have to rely on domestic providers of non-tradable services that cannot achieve scale-efficiency, and (iii) must fight an uphill struggle when it comes to incorporate technology and compete on global scale. Successful insertion in the world market for these small firms call for specialisation to attain the minimum efficient size, at the cost of economies of scope and loss of complementarities with the rest of the domestic economy (it should be noted that the export multiplier of SMEs is usually smaller than for large economies).

When the territory and natural resources are reduced, diversification is further reduced because some of the potential activities are mutually exclusive (for example, between tourism and petro-chemical industries, or even between different kinds of tourism). Mutually exclusive choices raise complex problems of co-ordination and inter-temporal optimisation that call for a close co-operation between public and private sectors.

Concern about how small firms can adapt to a context of global competition is widespread in the region, even in larger economies. The concern is even more pressing in SMEs, where nearly all productive activities are carried out by small firms. In these countries, the role of public policy is especially important, because small firms are highly dependent on the quality of the context in which they operate (Peres and Stumpo, 2000).

Market Structure

Smallness also determines production and market structures. Being mainly composed of small firms, the domain of viable production alternatives is naturally more limited in SMEs. On the market side, high unit costs and small market size tend naturally to create situations of monopolies. Because entry costs are high compared with normal (i.e., non monopolistic) expected utilities, monopolies are usually less contested than in large countries. This cost in terms of welfare calls for stronger market regulation, which poses a specific challenge to public authorities because of the complexity of the problems and the high skills (and budgets) required to cope with them.

Size of labour markets matters too, and has adverse consequences for both suppliers and demanders. To copy a term widely used in finance, labour market in SMEs lacks liquidity. Because the pool of human capital is naturally limited, firms should compete for scarce skilled labour. On the other hand, specialised workers are faced with a monopsonistic market, because of the natural concentration of industrial activities. This is particularly acute when industries have to restructure: social costs associated with structural adjustment are not transitional in small economies, because alternative employment for industrial workers is at best scarce, at worst non-existent. As a matter of fact, emigration –and its collateral braindrain on domestic human capital as migrants from SMEs are mainly young skilled workers– is common in most SMEs.

Public and private governance

Small market size has also some microeconomic advantage, especially

when it come to scale diseconomies in transaction and supervision. The smallness of the population involved promotes better information on economic partners (clients, suppliers or partners) and reduces risks associated with information asymmetry and moral hazard. Reputation and peers pressure to behave according to established ethical standards substitute partially for regulation and law enforcement. *Ceteris paribus*, smallness favours also better social cohesion, and facilitates the relationship between the state and its citizens, leading to the implementation of better policies. Nevertheless, these advantages materialise only when a minimum of governability conditions are guaranteed, which has not always been the case in the region. The civil wars that ravaged Central America during most of the 1980s, and the ethnic and religious conflicts present in some Caribbean countries, undermine such an advantage of smallness.

Vulnerability

We saw that small (including very small) countries form a very heterogeneous group with regard to income or growth performance. Yet, transcending development level, smaller countries are consistently more vulnerable to external shocks than larger ones. Thus, vulnerability is the other relevant facet –besides growth and income– for analysing the relationship between country size and economic welfare in the context of open economies. Indeed, many small developing countries are lobbying for an extension of WTO's Least Developed Countries differential treatment to the group of vulnerable small developing countries.

Vulnerability is caused by three sets of interrelated factors: geographical

(country size and its location), demographic and economic dimensions.

Geographic and Demographic Dimensions

The conjunction of geographical and demographic factors leads to higher population density and increases the pressure on already limited domestic resources, in particular water and arable land, and threatens the fragile eco-systems. Haiti is a case in point, but ecological vulnerability is a constant feature of most small and densely populated SMEs.

Geographical location in tropical areas, prone to natural disaster (hurricanes, earthquake or volcanic activities) compounds the problem: In many of the region's SMEs, those natural disasters are recurrent and affect a large proportion of the national population and economy. Because of the small country size, the scope of the damages inflicted to human, natural and productive resources covers almost 100% of the national territory.

In the face of such disaster, the capacity of national authorities to deal with the emergency and cope domestically with the costs of reconstruction is almost irrelevant. The case is exacerbated for the regional small islands developing states (SIDS), where in some cases cost of damages may be higher than GDP (see Box 1).

Readiness

The eventual balance between these costs and benefits depends in a large way of the particular situation of an economy in terms of internal stability, competitiveness, institutional framework, etc. Measuring this “readiness” is a way to evaluate ex ante the capacity of a particular economy to minimise the costs and increase the benefits from joining a FTAA. An

empirical study prepared by ECLAC for the preparatory works of the Free trade Area of the Americas (FTAA) revised a large number of economic, structural and social indicators (ECLAC, 1996 ; Escaith and Perez, 1999). The significant differences that may be observed between the hemisphere's smaller countries on the one hand and the larger countries of Latin America on the other one lead to the conclusion that, mainly because of structural impediments, the small countries run the risk of not being able to take practical advantages of the potential benefits of their integration into a more global and freer economy. Latin American and Caribbean SMEs "suffer", *inter alia*, from a larger agricultural sector (relative to total GDP) and lower level of urban development, lower export diversification or low value added of exports which do not facilitate their linkages with the hemispheric market. Lesser institutional capacity might also hamper their capacity to adapt to a changing international environment governed by principles of strict reciprocity (see Box 2).

Identifying the potential weaknesses of SMEs in front of the challenges of globalisation and hemispheric integration allows to delineate some policy options, in terms of both domestic policy and negotiation strategy.

Some Policy Options

Domestic Policy ³

As mentioned, vulnerability is one of the central feature of SMEs, thus reducing it should be among the first priorities. Moreover, trade integration and greater capital mobility should involve (at least during the transition period) higher instability of commercial and financial flows and

calls for higher reserve ratios to bridge transitory shocks. Higher exposure to financial and legal risks as well as more stringent international rules request also strengthening the banking sector regulatory framework and a greater supervision from domestic authorities. This is especially important for off-shore banking, which is becoming an international concern for reason of money laundering and tax evasion.

In those countries still heavily dependent on trade duties for their fiscal revenues, the priority should be to implement a tax reform and strengthen domestic based revenue (sale and income taxes) to prepare for deeper integration into regional and world markets. This tax reform, allied to a pluri-annual fiscal policy to correct the pro-cyclical biases common to most LAC countries, would be also the best way to increase domestic savings, one of the weak points of SMEs.

Improving the quality of the economic and institutional context in SMEs is particularly important for existing productive activities due to the role of small firms in these economies. Because the impact on small firms of trade liberalisation is as diverse as the segment is heterogeneous, there are in this sector both opportunities and challenges. Small firms undoubtedly will have to acquire new capabilities and adopt different strategies. It would be a policy mistake to avoid small firms' failures at all cost. Nevertheless, it cannot be expected that a competitive group of small firms surge spontaneously in small economies, due to, inter alia, path-dependency and learning processes. Policy intervention is called for to facilitate the creation of new enterprises (by improving and simplifying the business environment for start-ups) and to stimulate strategic change among existing small firms.

This may be done by taking initiatives in several directions. Modification and simplification of the legal framework and tax policies;

support for human resources training; funding for technological modernisation and export promotion are among the main areas where specific measures for small firms have successfully been undertaken at national and regional levels. Free trade zones and the promotion of clusters are especially relevant in the context of SMEs.

The co-ordinating role of public authorities has to be strengthened in those SMEs where scarcity of land and competition for natural resources mean that some potentially profitable activities are mutually exclusive.⁴ A clear idea of long term development strategy, strict land use planning and enforcement are necessary to avoid paying a high cost in lost opportunities for short lived economic or political advantages.

In order to compete in a more global market, SMEs that suffer from geographic isolation and high transaction costs –especially the SIDS– should try to foster their natural and dynamic advantages to increase the value added to their traditional exports and manage them in a sustainable way. This is in particular the case for tourism, but also covers agro-industry or other primary products based activities.

Investment in human capital and its orientation towards building market advantage in high value added niches is one of the key solution.⁵ Geographical situation, education and cultural specificity for the Caribbean islands can be the basis for successful diversification in niche markets in services, especially information based activities (data processing, international trade services, finance). Obviously, another area of priority is in developing a state-of-the-art public telecommunication system and designing a market-friendly regulatory framework to lower transaction costs.

The new decade may in fact offer greater margin of manoeuvre for

SMEs to design efficient supply-side policies. A new trend in technological innovation that allow for low costs even without massive volumes of production, seems to favour SMEs, or at least to help levelling the playing field with their larger partners⁶. Electronic commerce, in particular, can offer new perspectives to geographically isolated SMEs.

Nevertheless, the high level of public investment required by these policies, and the active role of "broker" taken by public bodies in the promotion of industrial clusters surpass generally the financial and staff possibilities of developing SMEs. Their successful insertion into regional and international trade goes first through the preservation of the much needed official assistance to development and a break in the present trend of reducing it.

Foreign assistance is also required with regard to natural disasters. As high risks and uncertainty translate into problems of insurance coverage, disaster emergency funds should be put in place. Yet, SMEs domestic capabilities are insufficient to cope with this challenge, and international co-operation is required. National efforts should be focused on mapping of vulnerable areas, modernisation of building codes, strict land use planning and enforcement.

Negotiation Strategy

In the new global deal, it is increasingly believed that levelling the playing field will not occur by a massive transfer of resources to SMEs, but by an ability to analyse their own economies, understand what is at stake in trade negotiations and be able to defend their interest (Bouchard and Robinson, 2000). From an institutional point of view, SMEs have more difficulties than larger states to represent their interests at international fora. The

developing countries are already over-stretched in the WTO with their limited resources, and face real difficulties to follow other negotiations. These countries are further handicapped as they do not have adequate technical resources either in their missions in Geneva or in their capitals.⁷ The issues negotiated are diverse and extremely complicated. It is difficult for them to be prepared adequately to safeguard their interests and to take initiatives from their side.

They have also a more limited capacity to shoulder the international commitments in the field of employment, environment and property rights required by global integration. In view of the anterior, special and differential treatment should be granted to SMEs when negotiating multilateral free-trade agreements, and in particular during the present FTAA negotiation. It should involve, *inter alia*, the grant of longer transition periods to meet new policy demands, more flexibility in setting the thresholds or defining the legal and institutional obligations, and the provision of technical assistance during and after the negotiation process.

Under FTA, free access to regional market for members exports is conditioned to a minimum content of regional value added. The weakness of international linkages means that small countries have more difficulties than big ones in complying with the rules of origin. This clause can be a particular problem for those LAC SMEs that have a diversified extra-regional trade structure (basically the Caribbean countries). Too high minima might increase trade diversion and deter foreign investment from extra-FTA countries.

While these aspects are generally acknowledged, little has been achieved so far in the international or regional free trade negotiation fora. The insistence in imposing strict symmetry in commitments and trade

reciprocity among countries of hugely different development levels was one of the contributing factor to the failure of the last WTO Seattle meeting. The approach to SMEs under regional schemes is potentially more friendly.

During the Second Summit of the Americas (18-19 April 1998) and the Toronto Fifth Trade Ministerial Meeting (4 November 1999), Governments reiterated the need to ensure that the differences and opportunities in the level of development and size of the economies be taken into consideration during the negotiation process of the FTAA. Nevertheless, one year later uncertainty still prevailed among SMEs as no such “special and differential treatment” had been granted nor its provision formally guaranteed during the on-going negotiation process.

We saw before that SMEs are particularly vulnerable to unilateral trade measures, once they have integrated a FTA. Of particular relevance for them should be to negotiate rules that will help to control the larger countries temptation to backslide. Smaller countries might insist that end-users (industrial or consumers) be recognised as interested parties in antidumping and safeguard cases, and insist for transparent⁸ and rule-based (instead of *ad-hoc*) dispute settlements arrangements.

Resource constraint on small economies call for a sub-regional approach of the trade negotiations, for countries sharing the same objective interests to put in common their scarce financial and expertise resources. These initiative should be supported by adequate multilateral and bilateral technical assistance, to help building negotiation and implementation capabilities.

The Caribbean countries participating in the “Lomé conventions” with the European Union are faced with a specific problem. The Lomé

convention was a “development cum trade” package that included aid and technical assistance to enable least-developed, land-locked and island ACP states to utilise fully the provisions of this co-operation agreement (see annex 1). Caribbean countries have relied in a very large measure upon preferential trade regimes for their economic survival. While the Lomé style agreements are ill-fated in the post-Uruguay Round world, ACP countries formally signed in Cotonou with the European Union a transitional covenant whose technical aspects were agreed, after long and difficult negotiations, in February 2000.

Unfortunately, new obstacles to successful economic integration are now being added to the long list of natural handicaps. The present trend of frustrating SIDS of their preferential access to selected markets (e.g., the banana export regime to the European Union) or the intent of limiting their capability of diversifying into new activities through active incentive policy (off-shore banking) deprives them of much needed economic opportunities.

Annex 1

Lomé and the GSP : Aid Through Trade vs. Reciprocity Under WTO

Since 1975, Lomé has represented one of the most important instrument of international cooperation through trade. Under Lomé convention, products originating in the “ACP” countries were exempted from custom duty when imported into the Community. Nevertheless, agricultural products under the CAP were submitted to import regulations. Special regimes (protocols) were created for banana, rum, beef and sugar. Yearly, it represented an assistance of some 2.5 billions of euros to the 71

beneficiary ACP countries.

The old-Lomé was not in tune with the new world order set by the post-Uruguay Round negotiations. Initially, the ACP position was that the EU should help developing countries to force a modification of the WTO to include a special and differential treatment clause. The EU defended the position that the existing agreement should be changed in favour of a more reciprocal treatment. Naturally, the question of reciprocity and conditionality was one of the most difficult aspects of the negotiations.

The new post-Lomé partnership agreement between ACP and EU came into effect 1 March 2000, taking in 8 years to change from a preferential access to new trading agreements in full accordance with WTO. In addition, 25 billions of euros will be made available for assistance during this period. In the new framework, least developed ACP countries will keep their free access to the European market for almost all their product, while other ACP have accepted to gradually align their privileged access to be in conformity with WTO standards. The transitions to the General System of Preference (GSP), starting in 2002, should be completed in 2008.

The current GSP defines four categories of products: very sensitive (paying 85% of the Most Favoured Nation tariff), sensitive (70%), semi-sensitive (35%) and not sensitive (0%). Products outside GSP do not benefit from any preference. Since March 1998, the EC Council extended to non-ACP LDCs advantages equivalent to those under the Lomé convention.

The new system represents a potential loss of revenues for ACP countries, which can be evaluated by the difference of tariff collected by EC on ACP imports between the old Lomé and the GSP system. According to 2000 trade figures and custom tariff, the additional GSP-

based custom receipts which should have been collected in relation to the Lomé system (excluding protocols) amounted to 1.9% of the imports (ACP Group, 1999). The transition to GSP will also increase competition in the EU market with non ACP developing countries.

The graduation principle, latent in the GSP, is another potential threat to ACP countries under the new agreement. It could be applied to Trinidad and Tobago for its exports of fertilisers; other ACPs are close to the graduation level in some sectors (Jamaica). This clause could deter further investment in the most dynamic sectors of these economies.

Within the Caribbean ACPs, the countries of the Organisation of the Eastern Caribbean States (OECS) represent a special sub-group within CARICOM. The economy of these countries are dominated equally by an economic monoculture of bananas and tourism. Historically, these countries have been highly dependent on preferential trade arrangements and the protection of their local industries.

It is predicted that with the generalisation of the euro, economies of scale, lower transaction costs and harmonisation of rules and procedures in Europe should give a boost to ACP exports, if –and this is a big if– they are able to seize the opportunities. In particular, the present dynamism of the US market, together with the depreciation of the Euro, do not act in favour of LAC-ACPs export diversification to the European market. On the European side, since 1989, the Central and Eastern European countries are attracting an increasing interest, for both economic and geo-political reasons.

Box 1. The Special Case of Small Island Developing States

Approaches to the concept of sustainable development that embody intergenerational equity and environmental factors have taken a very specific and urgent connotation for the Small Island Developing States (SIDS). While sharing the characteristics presented above, their capacity for sustainable development is severely undermined by a series of unique factors that increase their vulnerability as underlined in a recent work by ECLAC (2000):

While development level and per capita income varies widely in the Caribbean islands, where coexist together the poorest (Haiti) and the richest (Bahamas, Barbados) countries of the western hemisphere, all share a large exposure to external risks. It is particularly in relation to the observed limited capacity of SIDS to cope with the impact of these events that the term "fragility" is often applied to capture the essence of this extreme vulnerability.

In particular, one of the main risk factor is the frequency of recurrence of specific natural events such as hurricanes, volcanic eruptions and earthquakes. Ecological context is also particularly fragile, and the concentration of economic activities in the coastal areas induce very serious damage to the littoral.

The small population, which in absolute terms may be quite small, and the limited diversification of economic activities create an adverse social environment. Job opportunities are reduced and

concentrated in a very few sectors of activities, leading to job insecurity and persistent unemployment. Thus, SIDS present in general high level of emigration, especially of young and highly skilled personnel.

With respect to these aspects of social vulnerability, particular attention needs to be paid to the use of SIDS as transit points in the international drug trade and laundering place for the drug money. The crimes associated with illegal drug traffic and consumption severely undermines the judicial and the financial systems, and affect the entire apparatus of governance. The social fragility of Caribbean SIDS and its implication on governance are worsen by the social and cultural cleavages that exist, based on highly skewed income distribution or ethnic and religious affiliations.

Box 2. Scorecard on readiness to enter into a Free trade Agreement

A total of 55 indicators were calculated for 33 countries participating in the FTAA negotiations. These indicators were measured for the initial situation before the beginning of the negotiation process (1994-1996) and organised along four basic criteria:

Eligibility (conditionalities that lie outside the negotiation agenda)

Fundamentals (conditions of domestic supply)

Fundamentals were subdivided into Economic and sectoral aspects; Infrastructure; Human capital; Export diversification and dynamic.

Policies (set of policies to strengthen eligibility and fundamentals)

Three types of policies were identified: Macroeconomics; Supply-side and changing production patterns ; Trade.

Vulnerability (capacity to face the changes and assume the commitments connected with integration)

This item was subdivided into Macroeconomic vulnerability, and Trade risks and exposure.

Main Results

The score for each country and each criterion was defined as its average ranking (from 1 to 33) for the relevant indicators. 31 out of 55 indicators showed a significant deviation between large and small groups of LAC countries.

Eligibility: In average, there is no large difference as far as macroeconomy is concerned: small countries are better at monetary and exchange rate levels, worst in fiscal and balance of payments. Non macroeconomic eligibility is not as good, especially as far as international labour and environment conventions are concerned.

- *Fundamentals:* Small LAC countries look less prepared than larger ones. This is generally linked to inferior development levels. In average, exports are less diversified.
- *Policies:* As for the eligibility criterion, there is no large difference between the two groups of countries. Yet, tax revenues in Central America and the Caribbean are still very dependent upon trade tariffs. Also, because of the relative deficit in structural readiness, one should have expected a stronger commitment (and not just a comparable one) to policies geared at transforming production patterns and improving fundamentals.

- *Risks:* Greater openness means greater risks for small countries, especially when exports are concentrated in few or conflictive (garment) products. They tend to run bigger trade deficit, too and it leads to smaller internal savings. This risk is compounded by smaller net reserves. On the other hand, they have more predictable exchange rate strategy.

Source: Based on Escaith and Perez (1999)

Bibliography

- ACP, Group (1999) *Conséquences pour les Pays ACP de l'application du système de préférence généralisées* ACP/00/177/99, 20 avril.
- Banco Central de la República Dominicana (2000) *Informe de la economía dominicana enero-junio 2000*, August.
- Bouchard, Pierre and Nobina Robinson (2000) *The smaller economies of the Americas: Making a case for hemispheric integration*, FOCAL (Canadian Forum for the Americas) FPP-00-09, May.
- Damijan, J. (1997) "Main Economic Characteristics of Small Countries: Some Empirical Evidence" In *Development and International Cooperation*, Vol. XIII. June-December, p. 43-84.
- De, Sierra (1994) *Los pequeños países de América Latina en la hora neoliberal* (coordinator), Nueva Sociedad, Venezuela.
- ECLAC (2000) *Equity, Development and Citizenship* LC/G.2071, March.
- ECLAC (1996) *Readiness of Small Countries to Participate in the Free Trade Area of the Americas* LC/L.932, March.

- Escaith, H. and E. Pérez (1999) "Los países pequeños y la integración hemisférica", *Nuevas dimensiones de la integración*, A de la Reza y R. Conde (coord.), México.
- Escaith, H. et Sam, Morley (2000) *The impact of Structural Reforms on Growth in Latin America and the Caribbean: an Empirical Estimation*, ECLAC series on macroeconomía del desarrollo, November.
- Finger J. Michael, Francis Ng and Isidro Soloaga (1998) *Trade Policies in the Caribbean Countries: A Look at the Positive Agenda* Paper presented at the meetings of the Caribbean Group for Cooperation on Economic Development, Washington D.C, 8 June.
- Gutierrez, Mario A. (1996) "Is Small Beautiful for the Economic Integration: The Americas." *Journal of World Trade*, Vol 30 No4 p.173-215, August.
- Hufbauer, Gary et J. Schott (1994) *Western Hemisphere Economic Integration*, Institute for International Economics, Washington.
- Frankel Jeffrey, Ernesto Stein, Shang-jin Wei (1995) "Trading Blocs and the Americas: The Natural, the Unnatural and the Supernatural" *Journal of Development Economics*, vol 47 61-95.
- McLaren, J. (1997) "Size, sunk costs and Judge Bowker's objection to free trade" *American Economic Review* 87 (3) p. 400-420
- Park, Jee-Hyeong (2000) "International trade Agreements Between Countries of Asymmetric Size" *Journal of International Economics* 50 p.473-495.
- Peres, W. and G. Stumpo (2000) "Small and Medium Sized Manufacturing Enterprises in Latin America and the Caribbean Under the New Economic Model" *World Development*, Vol. 28 No 9, September p. 1643-1656.

- Perkins, D.H and M. Syrquin (1989) "Large Countries: The Influence of Size" *Handbook of Development Economics*, Vol. II edited by H. Chenery and T.N Srinivasan, Elsevier Science Publishers B.V.
- Rodriguez, F. and D. Rodrik (1999) *Trade Policy and Economic Growth: a Skeptic's Guide to the Cross-National Evidence*, University of Mariland and Harvard University, January.
- Ros, J. (2000) *Development Theory and the Economics of Growth*, Ann Arbor Michigan Univ. Press.
- Salvatore, D. (1997) "The Economic Performance of Small Versus Large Nations" *Development and International Cooperation*, Vol. XIII. June-December, p. 21-42.

Notes

1. Such a definition is used in political economy analysis (for an example, see De Sierra, 1) or in game theory approach of trade negotiations, as mentioned later in this paper.
2. There is no obvious reason why very small (Caribbean) countries fared better, but one may advance their macroeconomic stability and export specialisation towards dynamic market niches (tourism), in addition of receiving preferential treatment under the Lomé agreements.
3. This section draws from chapter 11 in ECLAC (2000).
4. Tourism is a typical case: its development is quite demanding in terms of land use planning and depends on the preservation of the environment.
5. The development of high-tech maquiladora or eco-tourism in Costa Rica is an example.
6. For example in infrastructure services (electricity generation, telecommunication).
7. The European Union finances the ACP country representation in Geneva.
8. *Id est*, simple rules: Complexity works against transparency and especially difficult and costly to manage for small countries.