

## CHAPTER 3 : THE EXTERNAL CLIMATE

3.1 The external trading environment in which the OECS countries operate has changed substantially over the past decade, and stands to change considerably over the medium term. If the sub-region is to accelerate growth through a sustained expansion and diversification of exports, it is important to understand the environment in which the economies and firms will have to operate.

3.2 Perhaps the most salient feature of the external trade environment facing the OECS to date has been *special and differential treatment* (SDT) granted to the sub-region by its major trading partners – CARICOM, the European Union including the UK, Canada and the US under various special arrangements. However, as globalization marches ahead, these arrangements are being reexamined and reworked to fit within the emerging broader regional and global trade agreements.<sup>1</sup> The sub-region and many of its small country counterparts around the world have consistently argued that any dismantling of current forms of SDT would gravely impact their ability to compete in the emerging trade arrangements, given the special characteristics of small states. Others (DeRosa, 2000 and UNECLAC, 2003) argue that the specific SDT received to date has in fact hindered export diversification and weakened the export performance of small states. This section looks first at what has been the impact of past SDT on OECS growth and competitiveness. Then it reviews challenges and opportunities for the OECS under the emerging trade agreements: the Caribbean Single Market and Economy (CSME), the Free Trade Area of the Americas (FTAA), the Economic Partnership Agreement (EPA) with the European Union and the World Trade Organization (WTO). Finally it examines the performance of other small states in the global economy for lessons and strategies that may be pertinent to the sub-region.

### A. Special and differential treatment

3.3 Special and differential treatment of the OECS has generally taken three forms: (i) *preferential access* for the sub-region's exports, (ii) maintenance of *non-reciprocal protection* within preferential trading arrangements, and (iii) *longer adjustment periods* within which to implement the agreed trade liberalization.

3.4 Regarding preferential access, UNECLAC (2003) argues, in general, that this type of treatment has hampered export diversification and weakened export performance in small open economies by shaping a pattern of export specialization and import substitution that do not match either the structure of production or the external demand facing these economies. Indeed, the preferential access for OECS banana exports to Europe does not appear to have delivered sustained benefits, less so because of the recent erosion of preferences, than the sub-region's geography that is simply not competitive in this product. In addition, broader preferential access under arrangements like the Caribbean Basin Initiative (CBI) and Caribbean Canada Trade Agreement (CARIBCAN) have limited benefit for the OECS because the sub-region's small size precludes competitiveness in manufactured products that require economies of scale. Moreover, rules of origin under these arrangements often prevent the type of vertical specialization in smaller parts of the production chain that would be feasible for the sub-region. Regarding non-reciprocity, Ozden

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<sup>1</sup> In particular, CARICOM is advancing the implementation of the Caribbean Single Market Economy in preparation for the emerging Free Trade Area of the Americas, which in turn is expected to subsume the Caribbean's arrangements with Canada under CARIBCAN, and with the US under the Caribbean Basin Initiative and associated legislation. The EU has already made adjustments to the Lomé/Cotonou Agreements with African, Caribbean and Pacific (ACP) countries to bring them in line with recent WTO rulings, and has initiated bilateral negotiations with CARICOM.

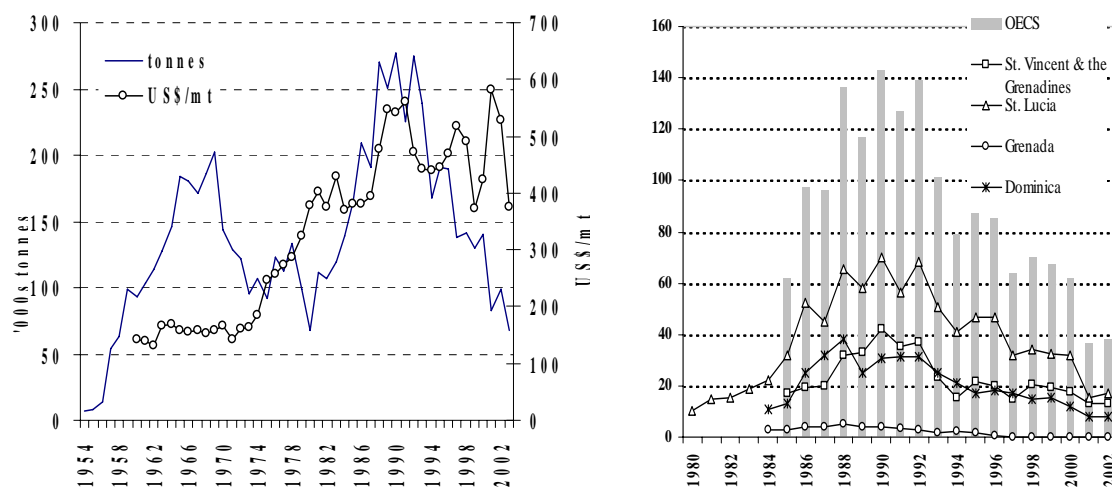
and Reinhardt (2004) show that countries that receive unilateral preferences tend to have more restrictive trade policies because they have not been subjected to the reciprocity-based trade regimes and that export growth often takes off only after countries are removed from preference schemes. Without preferences and with greater trade liberalization, producers face prices that are closer to world prices, and hence will make more efficient investments needed to raise long-run growth.

**3.5 The case of bananas.** The OECS has had preferential access to the European and UK markets for its banana exports since before independence, starting with the Lomé Convention in 1975 in which African, Caribbean and Pacific (ACP) countries enjoyed duty free access while other importers were subject to tariffs and non-tariff barriers. Yet an agriculture sector dominated by this crop only contributed 0.2 percentage points of the average 5.9 percent real growth experienced by the sub-region between 1977 and 1990. Tourism earnings and other service exports, which do not benefit from trade preferences, have grown faster than merchandise exports in recent years (Table 2.1), and likely would have grown even faster had preferences—which attracted resources to other sectors—not been in place.

**3.6** It is important to acknowledge that the OECS banana export volumes did experience rapid and sustained growth, on average 6.1 percent per year, during the Lomé Convention period, 1975-93. However, this expansion also coincided with sustained increase in world banana prices, which grew on average 6.8 percent per year between 1970 and 1990 (see Figure 3.1). In a recent report, NERA (2004) estimates that the supply of bananas by the Windward Islands has been in fact very responsive to these price increases, with elasticities ranging from 4.8 to 11.2 across the individual countries, even after taking into account the impact of the trade regime.

**3.7** In 1993, the EU switched to country specific quotas and tariff preferences under the Cotonou Convention's 'Banana Protocol' but these did not significantly affect OECS preferential access as the quotas were sufficient to cover current exports. However, during 1994-98, the sub-region only managed to fulfill 56 percent of its annual quota. OECS banana producers had already started to contract production by reducing acreage, employment and investment in response to price fluctuations and growing competition from other producers. Meanwhile, lower ACP cost producers in Africa, namely Cameroon and Cote d'Ivoire, filled their quotas and have since then increased production by 33 percent and 26 percent, respectively.

**FIGURE 3.1: VOLUME, VALUE AND PRICES OF BANANA EXPORTS, 1954-2002**



Source: World Bank (2004i).

3. 8 In 1999, under a WTO ruling, the EU moved to a general ACP quota but with country specific import licenses that continued to favor Windward Island producers. However, despite this continued protection and a temporary recovery in world prices, the sub-region's banana producers further contracted output to pre-Lomé lows (Figure 3.1) reflecting their assessment that with low yields (on average 11 tonnes per hectare and 4 tonnes per worker, compared with 32 and 26 tonnes, respectively for Central American producers)<sup>2</sup> and higher wages and transport costs, they could not compete in this sector even under SDT. During 1993-2001, the number of registered banana farmers had fallen by 70 percent. At the end of the period, the banana sector accounted for only 6 percent of goods and services exports and only 8 percent of the working age population.

3. 9 The EU will move to a tariff-only regime in 2006, with a proposed tariff of €30 per tonne. This tariff is not sufficient to fill the price-gap between the OECS and the dominant Latin American competitors, estimated at around €259<sup>3</sup>, and based on the supply elasticities mentioned above could cause a further 40 percent contraction in OECS production.

3. 10 *The Caribbean Basin Initiative and CARICOM.* Under these two arrangements, the OECS has preferential access to the US since 1984 and Caribbean markets since 1973. While the share of OECS merchandise exports going to the US increased from 14 percent in the early 1990s to 22 percent in 1996 and to 27 percent in 2003, the share of US-destined exports entering under the CBI program actually fell from 48 to 41 percent over the same period. In general, Dean (2002) testing for both direct and indirect effects of the Caribbean Basin Economic Recovery Act (CBERA) on Caribbean and Central American countries finds that the trade arrangement did not result in trade-induced investment-led growth, beyond that which resulted from the trade and foreign exchange reforms of the countries themselves.

3. 11 On the other hand, initial membership in CARICOM has yielded gains for the OECS. The sub-region's share of intra-CARICOM trade rose from 15 in the early 1980s to 31 percent in the early 1990s. However, as the sub-region progressively implemented the CET, that share fell by almost half to 14.6 percent in 2000-02. Meanwhile, Egoumé-Bossogo and Mendis (2002) show that controlling for membership in CARICOM, the OECS itself has not been trade-creating among members.

**TABLE 3.1: OECS SHARE OF INTRA-CARICOM TRADE, 1980-2002**

(%)	1980-85	1985-90	1990-95	1995-99	2000-02
<b>Dominica</b>	2.4	5.2	4.8	3.0	2.8
<b>Grenada</b>	3.3	5.5	5.9	1.6	2.9
<b>St. Kitts and Nevis</b>	1.9	3.5	3.4	2.2	1.5
<b>St. Lucia</b>	4.6	8.7	10.3	4.5	4.0
<b>St. Vincent and the Grenadines</b>	3.2	5.4	6	2.1	3.2
<b>OECS (wgted avg)</b>	<b>15.3</b>	<b>28.3</b>	<b>30.5</b>	<b>16.2</b>	<b>14.6</b>

Source: Egoumé-Bossogo and Mendis (2002) and Caricom Statistics various years.

3. 12 While preferential access did encourage export growth in the banana sector and the OECS did benefit marginally from the CBI and CARIBCAN, there are several reasons why these arrangements may not have served the sub-region's long run interest. Most of these arrangements were not designed explicitly to build export competitiveness based on the sub-region's productive

<sup>2</sup> NERA/OPM (2004).

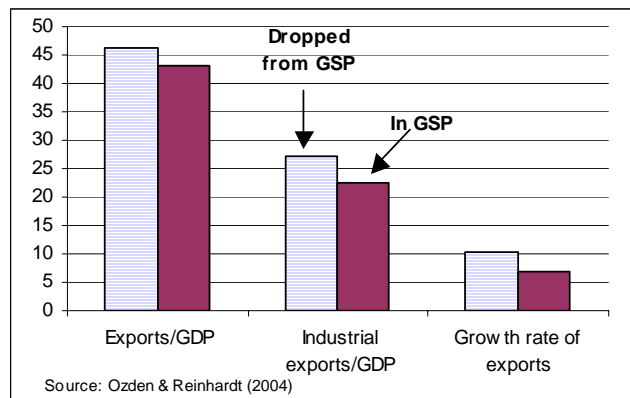
<sup>3</sup> NERA/OPM (2004).

structures and sources of comparative advantage. As a result, they steered resources to sectors that were not necessarily the most competitive internationally. Over time, this raises the costs of adjustment, for example, by creating a labor force that is now ill-suited to new innovations in other sectors.

3.13 **Non-reciprocal protection.** The second element of Special and Differential Treatment is non-reciprocal protection which allows beneficiary countries to maintain higher tariff rates and other trade barriers than yielded to them by their trading partners. The treatment was consistent with the now-defunct strategy of import substitution, in which industrial development was engineered through trade barriers (and often directed credit) aimed at creating selected industries. Growth from such a strategy has been shown to be limited on several fronts. The choice of sectors and industries often turns out to be inefficient. Resources are allocated to sectors in which the country either cannot or does not achieve efficiency or competitiveness over time. This raises costs for domestic consumers and exporters, and channels rents to the protected producers. Moreover, in small economies, import substitution ties up limited entrepreneurial capital in inefficient sectors and because of the small domestic market is more likely to result in local monopolies or oligopolies who later become a powerful interest group lobbying for maintenance of these preferences.

3.14 Ozden and Reinhart (2003) show that economies that have been left out of the reciprocity-based system show lagging progress on their own trade liberalization. Figure 3.2 shows how exports and export growth are generally higher for countries that have been removed from the Generalized System of Preferences (GSP).<sup>4</sup> Closer to home, Egoumé-Bossogo and Mendis (2002) show that trade liberalization within CARICOM, specifically, the gradual lowering of the CET has, in fact, fueled trade with the rest of the world in part by raising the competitiveness of Caribbean exports because exporters are now able to get their imported inputs at closer to world prices.

**FIGURE 3.2: TRADE RECIPROCITY IMPROVES EXPORT PERFORMANCE**



3.15 **CARICOM's Article 56.** Perhaps the most liberal example of non-reciprocal protection for the OECS is CARICOM's Article 56<sup>5</sup> under which the sub-region (designated Less Developed Countries (LDCs) despite their higher-than average income levels) can suspend common market tariff treatment and impose quantitative restrictions on imports from member

<sup>4</sup> The GSP is an international system in which developed countries provide non-reciprocal market access through tariff preferences to developing countries in a range of goods.

<sup>5</sup> Found in the Chapter VII of the CARICOM Treaty.

states.<sup>6</sup> A close examination of the continued use of the tariff and non-tariff barriers to trade in the OECS reveals a much more fragmented and protected trading space than the exceptionally high levels of trade-to-GDP would indicate in terms of openness. Table 3.2 illustrates this point. Broad implementation of the CET has yielded an important degree of harmonization within the OECS – average tariff rates are tightly grouped and there is little deviation in the number of tariff lines. However, the CET itself with its higher tariff rates reserved for agricultural and final manufactured products is firmly based on an import-substitution model ill-suited to the increasingly service-based and import-intensive OECS economy (WTO, 2001b). Moreover, regional implementation has allowed for a large number of exceptions. The wide variation in maximum rates and the prevalent use of import licenses and quotas shown in Table 3.2 reveal that the OECS still makes active use of protection as industrial policy. Even within the OECS, there are reports by firms of intermittent and irregularly applied trade barriers between the member countries. For example, between September 2003 and April 2004, St. Kitts and Nevis imposed a 25 percent duty on OECS goods in an effort to raise revenues.

3.16 Although implementation of the CET brought weighted average tariffs in the OECS down from 21 percent in 1996 to 14 percent in 2001, all the countries introduced customs service charges ranging from 2 to 5 percent and other surcharges (in one case up to 15 percent) on imports intended to mitigate the impact of falling tariffs on revenues, but which had the effect of maintaining protection. Consequently, imports as a share of GDP actually declined from 51 percent in 1996 to 47 percent in 2001 and exports have been contracting by 1 percent per year over the same period. In general, this is consistent with evidence presented above of the growing inward orientation of the sub-regional economy (see para. 2.4).

**TABLE 3.2: TARIFF AND TRADE BARRIERS**

Country	Simple average Tariff	Average weighted tariff	Maximum tariff	No. of products on which import quotas exist or import licenses are required		
				CARICOM	Non-CARICOM	
Antigua and Barbuda	6363	9.6	14.3	70	12	51
Dominica	6334	11.9	14.8	165	11	32
Grenada	6317	11.2	15.9	40	0	41
St. Kitts and Nevis	6339	11.5	12.2	70	11	45
St. Lucia	6367	10.1	12.2	95	26	83
St. Vincent and the Grenadines	6330	10.9	11.5	40	16	42

Sources: UN Trade Analysis and Information System, Finger *et al* (1998), DeRosa (2000) and WTO (2001a, 2001b) and IMF estimates.

3.17 In addition to the high tariffs, import licensing continues to be widely used by all six countries for trade both within CARICOM and with third countries. While many of these licenses are required for sanitary, phytosanitary and safety reasons, there are numerous examples where the explicit intention is to protect domestic producers from external competition. Import quotas are also maintained for a variety of goods. Finally, all the countries have a national

<sup>6</sup> By exception, reciprocity on these trade barriers is granted only to other LDCs like Belize and Guyana, and to Barbados.

agency that retains the monopoly on the importation of selected food items, usually bulk rice, wheat, powdered milk and/or sugar.<sup>7</sup>

3. 18 In addition to the authorized exceptions to the CET, a number of OECS countries has applied unilateral trade barriers to OECS and CARICOM imports. For example, in October 2004, CARICOM reported that:

- St. Kitts and Nevis was applying unauthorized duties to imports of beer, pasta and aerated beverages from St. Lucia;
- St. Vincent and the Grenadines was applying an unauthorized import equalization tax on CARICOM rum imports from within CARICOM and maintaining quantitative restrictions on certain agricultural products from Grenada, Jamaica and Trinidad and Tobago;
- Antigua and Barbuda, Grenada, Dominica, and St. Vincent and the Grenadines were applying discriminatory environmental surcharges or levies on selected CARICOM imports, mainly bottled beverages; and
- Antigua and Barbuda, St. Lucia and St. Vincent and the Grenadines were maintaining unauthorized importing licences for various CARICOM imports.

3. 19 A notable and widespread case of non-reciprocal protection is that of beverages, one of the most protected sectors in the sub-region, with tariffs averaging 29 percent<sup>8</sup> and almost universal import licensing requirements in the individual member countries. Indeed beverages and tobacco are the only categories for which average tariff rates in the OECS did not decrease between 1996 and 2001. Imports of beer and malt from third countries and CARICOM non-LDCs are also subject to quantitative restrictions, even though the latter have been found to be inconsistent even with CARICOM Article 56. These trade barriers may protect both domestic investors and employees in local breweries from external competition, but they also reduce the competitiveness of the tourism and hospitality sectors for which imported beverages are an important input and which have to compete with operators in other countries that get their inputs at world prices. Although some countries have been prompted by this consideration to issue duty exemptions to hotels, in many cases this does not extend to local bars and restaurants which may also serve tourists. Moreover, breweries are increasingly capital intensive rather than labor-intensive activities, so continued protection does not give rise to significant amounts of local employment. In another case, a monopoly paint manufacturer in one country with only 50 employees benefits from tariffs in the order to 144 percent.

3. 20 By maintaining these non-reciprocal protections, the sub-region has also prolonged the misallocation of domestic investment resources in particular entrepreneurial capital, reduced the competitiveness of its exporting sectors by raising domestic costs, and increased the eventual cost of adjustment. One of the consequences of the unfinished trade liberalization agenda is that, despite the small domestic market, the majority of firms continue to focus on the domestic market. In a recent survey of Grenadian firms conducted for the Diagnostic of the Investment

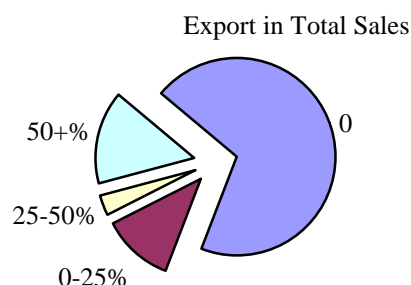
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<sup>7</sup> Governments in the sub-region argue that these public import monopolies are necessary to protect low income consumers from private importers who may emerge as natural monopolies because of small market size. However, given the low minimum efficient scale and low fixed costs of trading firms, it is likely that even the domestic markets in the OECS would support some competition, and at the least could maintain contestability in this area.

<sup>8</sup> For beverages and tobacco.

Climate,<sup>9</sup> it was found that two thirds of the Grenadian firms serve only the domestic market (see Figure 3.3). Of the 29 companies or 15 percent of the respondents which indicated significant exports - more than 50 percent of their total sales – a third are foreign companies and 45 percent are in tourism-related activities.

**FIGURE 3.3: IMPORTANCE OF EXPORT SALES IN GRENADA**



Source: World Bank (2004e).

3. 21 ***Longer transition periods and transition assistance.*** The third element of SDT has been longer transition periods to achieve the required trade liberalization in the respective trade agreements and the provision of technical and financial assistance to help beneficiaries adjust over time. There are often tradeoffs between non-reciprocity and transition periods. UNECLAC (2003) points out that invariably these transition periods are extended giving the impression to private operators that the status quo will be maintained overtime regardless of the initial agreement. The time and resources provided are spent in an effort to maintain the status quo rather than undertaking the adjustment that is an essential part of achieving the gains of trade liberalization. Recent evaluations of the EU's Special Framework of Assistance for Traditional ACP Suppliers of Bananas Special Framework of Assistance (SFA) note that large amounts of money have been used to support producers throughout the ACP whose eventual viability remains questionable. In the OECS, both the regional leadership and development partners continue to expend significant efforts – scarce negotiating capacity in international trade discussions and a substantial share of aid flows, on propping up an increasingly uncompetitive banana sector.

3. 22 Among the elements of special and differential treatment, transition periods and transition assistance remain potentially the most useful as they provide a positive incentive to proceed with trade liberalization.

3. 23 ***SDTs are increasingly unreliable.*** There appears to be a general feeling within the OECS that the sub-region's smallness will allow for a perpetuation of Special and Differential Treatment within international trading arrangements. However, the recent experiences with bananas and sugar has shown that SDT may not be a reliable basis on which to plan long term economic development. Whether or not SDTs will be maintained, the sub-region needs to question the long term benefits of such treatment.

3. 24 As seen in the above analysis of the banana sector, the advantage conveyed by the special and differential treatment, in particular, preferential access, depends not only on the relative administrative treatment by importing countries (tariffs or other trade barriers) of OECS exports versus Most Favored Nation (MFN) goods, but also on the changes in the underlying cost competitiveness of OECS exports vis-à-vis other producers. Indeed, many of the industrial

<sup>9</sup> See Annex 1.

estates established across the sub-region to support a development strategy based on CBI and CARIBCAN preferences, or protection of domestic markets and other incentives, have seen a revolving clientele as the trade and investment climates have changed. The St. Lucia Development Corporation was first occupied in the 1970s by garment and electronic assembly firms, and later in the 1980s by low-end data entry firms. As it became clear that St. Lucia could not maintain international competitiveness in these areas due to high wages, the foreign investors were gradually replaced by regional firms operating behind the CET. Now, however, the agenda within the CSME is to reduce internal barriers to trade. Already, quantitative restrictions under Article 56 must be converted to tariffs by end 2005. And all three trading partners – Canada, EU and the US have signaled their intention to dismantle bilateral preferential trading arrangements with the Caribbean in favor of regional agreements with reciprocity.

## **B. Emerging trading arrangements**

3.25 The following section looks at overarching issues<sup>10</sup> in the four main emerging trading arrangements in which the sub-region is negotiating: the Caribbean Single Market and Economy (CSME), the Free Trade Area of the Americas (FTAA), the Economic Partnership Agreement (EPA) with the European Union, and the World Trade Organization (WTO). These evolving trading arrangements provide opportunities as well as challenges for the OECS. Upcoming liberalization through these arrangements provides a chance for countries to remove distortionary policies, to improve efficiency by retreating from essentially uncompetitive activities, and to strengthen existing and emerging areas of competitive advantage. However, the adjustment process is generally painful as the Schumpeterian process of creative destruction takes place and resources are reallocated from previously protected but uncompetitive activities, in search of emerging nodes of competitiveness that are sustainable. Nonetheless, if managed effectively, the long run growth effects will be positive.

3.26 *The CSME.* Within CARICOM the movement toward trade liberalization has accelerated because of advances in the hemispheric and global trade negotiations under the FTAA and WTO, respectively. The emerging CSME has already established nine new protocols under the CARICOM Treaty with the objective of introducing free trade in goods and services, labor and capital mobility, coordination of foreign exchange and interest rate policies, tax and incentive regimes, among other things. While implementation has lagged in most areas, steady progress is being made in trade liberalization (although exceptions remain which may perpetuate the non-reciprocal protection by the OECS countries) and in the area of labor mobility, where legislation has been implemented in all member states except Antigua and Barbuda and St. Kitts and Nevis to allow the free movement of certain categories of skilled workers.

3.27 *Impact of labor mobility.* There is general concern in the smaller states that the free movement of labor in the CSME will accelerate emigration of already limited skilled labor and increase inflows of unskilled workers from lower income countries. However, recent evidence (see Table 5.7) indicates that the OECS currently has higher nominal wages for skilled labor than its Caribbean counterparts. Even after adjusting by purchasing power parity factors to take into account local prices, the OECS skilled labor wages generally remain higher or are roughly similar to those in other CARICOM countries. With regards to semi and un-skilled workers, wages in the OECS are in fact lower (with the notable exception of Antigua and Barbuda where the government has pursued a full employment policy over the last decade<sup>11</sup>) both nominally in US

<sup>10</sup> More specific sector issues will be covered in Chapter 7.

<sup>11</sup> However, implementation of the recently announced civil service reform program should put downward pressure on wages in that country.

dollars, and once adjusted for purchasing power parity. Combined with already higher unemployment rates than its CARICOM neighbors, the OECS should, therefore, not see a significant inflow of unskilled labor as a result of the CSME. Moreover, a substantial amount of authorized and unauthorized migration has already taken place within the sub-region in terms of farm and other unskilled workers in the tourism and construction sectors.

3.28 *Impact on the manufacturing sector.* The other major concern with the OECS regarding the CSME is that their domestic manufacturing sectors will not be able to face competition from larger producers within CARICOM, such as Trinidad and Tobago and Jamaica. Given the history of protection described above, it is likely that a number of currently protected manufacturers in industries where there are significant economies of scale will face difficulties in maintaining their current operations. Indeed, this may only be a prelude to the impact of further liberalization under the FTAA and WTO.

3.29 Experience from Jamaica in the late 1980s and early 1990s, when the rapid depreciation of the currency radically and quickly changed the operating environment for local firms, shows that, rather than going directly out of business, companies can pursue a strategy of gradually, but steadily, diversifying their activities away from producing solely for the protected domestic market into export sectors. What was essentially different in the Jamaica situation is that the signal and incentives were very clear. In the face of the depreciation, firms got the message – export or die!

3.30 In the OECS, efforts to maintain LDC treatment even behind the already substantial protection of the CARICOM CET and to shore up uncompetitive sectors has sent a message to firms that the status quo can somehow be maintained. In a survey of firms in Grenada, the largest group of respondents (32 percent for the CSME and 41 percent for the FTAA) expects no impact of these regional liberalization efforts on their sales (see Table 3.3). As a result, some manufacturing firms which benefit heavily from current levels of protection continue to aim only at maintaining their competitiveness in domestic and sub-regional markets, where they expect to exploit already established brand loyalties and, perhaps, to intensify pre- and post-market service in order to compete against imports from CARICOM and beyond.

**TABLE 3.3: GRENADIAN FIRMS' PERCEPTIONS OF LIKELY IMPACT OF CSME AND FTAA ON SALES**

% of respondents	Potential Effect on Sales			
	No Effect	Decrease	Increase	No response
<b>CSME</b>	32	21	28	19
<b>Manufacturing</b>	27	38	19	16
<b>Tourism</b>	45	8	35	13
<b>Domestic</b>	32	21	30	18
<b>Foreign</b>	31	25	22	22
<b>FTAA</b>	41	20	18	20
<b>Domestic</b>	42	18	21	19
<b>Foreign</b>	36	29	10	26
<b>Manufacturing</b>	34	37	17	14
<b>Tourism</b>	23	3	34	43

Source: World Bank (2004e.).

3.31 However, there is already an emerging group of manufacturers in the sub-region who are looking increasingly to the international market place. Of the respondents in manufacturing in the Grenada survey, 19 and 17 percent expect an increase in sales coming from the CSME

agreement and FTAA agreement respectively (see Table 3.3). Some of these are existing producers who dominate local markets but who recognize that the environment has changed and are pursuing brand development, product diversification and upgrading aimed at establishing niches in international markets. Others are new entrepreneurs that uncovered sources of competitive advantage in the manufacture of higher-value-added products, like specialty foods and herbal preparations. Some of these are targeted to ethnic markets overseas, while others are building on the growing cultural reputation of the Caribbean in North American and European markets to reach mainstream consumer. Several have been able to capitalize on the local tourism sector as a channel for introducing their products to overseas customers. In all the cases, the additional value being captured by the specialty product is sufficient to offset the higher production and transportation costs associated with manufacturing in, and exporting from, the OECS. The key for the governments of the OECS is to facilitate this type of transition rather than entertain the defense of untenable positions.

3.32 ***The FTAA and trade in services.*** With a combined population of 800 million and a GDP of US\$9 trillion, the FTAA would be the largest free trade area in the world. Despite the recent set-backs in the negotiations, related mainly to agricultural products, there are indications that an eventual agreement will see good progress on liberalization of trade in services.<sup>12</sup> Indeed, access to services markets has been one of the driving factors in the proliferation of regional trade arrangements, worldwide and liberalization of trade in services has been deepest in North-South trade agreements such as the FTAA (GEP, 2005). This provides both an opportunity and a challenge for the OECS.

3.33 Services have been the fastest growing component of world trade over the last 15 years and is now estimated to account for over one-fifth of world trade in goods and services. More than half of annual world FDI flows are now in services – both market- and efficiency-seeking investments. These trends have been driven by both technological progress in information and communication technologies, and by a broad trend toward liberalization in key service industries – transport, utilities, finance, telecoms.

3.34 Within the FTAA, the OECS countries are among the most specialized in services exports, although the sub-region's market share has been stagnating since the mid 1980s (UN ECLAC (2004a)).

3.35 Trade in services under the FTAA is intended to be consistent with the General Agreement on Trade in Services (GATS) under the WTO. GATS sets out 4 possible modes in which services can be traded between countries:

- Mode 1: *Cross Border Supply* where the service crosses the border but neither provider nor supplier does; such as a lawyer reviewing documents for a client in another country.
- Mode 2: *Consumption Abroad* where the service is consumed in the territory of the supplier, such as tourism;
- Mode 3: *Commercial Presence* where the supplier establishes a service point in another country to supply that country's resident(s) with the service, such as the overseas campus of a university; and

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<sup>12</sup> Current outstanding issues relate to whether the establishment of services firms in countries should be covered under the services or by investment chapters. However, these are less relevant for the OECS countries that are likely to concentrate initially on Modes 1, 2 and 4 exports.

- Mode 4: *Temporary Movement of Persons* where the supplier travels to another country to provide a resident there with the service.

3. 36 Given its small population and geographic size, the sub-region precludes the economies of scale necessary to be competitive in traditional agriculture and manufacturing production, and given that the services sector is already the driving domestic growth in the OECS, the sub-region may want to focus its energies on building competitive advantages necessary to benefit from the growing trade in services worldwide. The sub-region has already proven its potential for Mode 1 (offshore financial services and internet gambling) and Mode 2 service exports (tourism and offshore education), although the performance of the main services exports has been lagging over the past decade. In addition, any further concentration on tourism would only increase the sub-region's vulnerability to external shocks. The challenge facing the OECS will be to revitalize the performance of existing service exports, to convert the growth in services driving the domestic economy, albeit in communications, finance and construction, into sources of additional export growth, and to lay the groundwork for the emergence of new areas of competitive advantage. Chapter 7 points to some of the challenges in revitalizing tourism, and the potential already emerging in offshore education and health services which build on the sub-region's strategic location, climate, English language and cultural similarity to the main North American markets.

3. 37 ***The EU Economic Partnership Agreement and transition assistance.*** The OECS countries are part of the wider CARIFORUM grouping (CARICOM plus the Dominican Republic) which have commenced detailed negotiations with the European Union on an Economic Partnership Agreement that will eventually replace the Cotonou Agreement between the EU and the African Caribbean and Pacific (ACP) countries. Negotiations will focus on reinforcement and deepening of the regional integration process within the Caribbean as an important starting line for the EPA.

3. 38 Recognizing that there will be significant costs to the Caribbean, and especially to the OECS, of pressing forward with trade liberalization, implementing new trading rules and arrangements and continuing the transformation from traditional agricultural exports to new areas of international competitiveness, the EU has committed to continue providing substantial development assistance to the sub-region as part of the EPA. However, these resources will be geared toward the process of deepening sub-regional and regional integration. The challenge for the OECS will be to use these resources effectively in making the needed transition. Within the EU, effective use of the structural funds provided to new members of the Community has often differentiated which countries have benefited most from accession. Given the difficulties faced by the OECS in absorbing existing levels of committed development assistance from the EU, it will be critical for the sub-region to strengthen its aid coordination efforts between the member countries.

3. 39 ***The WTO and rules-based international trade.*** Achieving success in service exports will involve not only addressing supply side constraints at home, but also securing market access overseas. In turn, market access will depend on the establishment of appropriate trading rules. Multilateral arrangements like the FTAA and WTO are therefore crucially important for small states because they provide the rules-based systems that can best protect the rights of small states. The recent WTO ruling in favor of Antigua and Barbuda and against the United States in a dispute over internet gaming is proof of the benefit that such arrangements can provide. Bernal (2004) contrasts this to the less representative and transparent influence which the OECD's FATF have had in applying its own standards to offshore financial sectors, worldwide. Preferential arrangements, such as those from which the OECS has benefited, exist only at the behest of the benefactor countries and leave the beneficiaries at risk of changing political and economic

influences outside their control. Multilateral systems also provide small states with the opportunity to raise their negotiating leverage by teaming up with different countries as their interests coincide.

3.40 **Regional efforts.** In this trade climate, the OECS also stands to gain from the joint regional negotiating mechanisms and the joint regional preparation of a variety of harmonized behind-the-border rules necessary for accessing the emerging hemispheric and global trading arrangements. Although the Caribbean Regional Negotiating Machinery has been established to facilitate CARICOM member countries' participation in FTAA, EU-CARICOM and WTO preparations, it has not been delegated negotiating power on behalf of the member countries. The recent initiative by the OECS to establish a true sub-regional negotiating body is an important one in this regard.

3.41 Behind-the-border rules and regulations such as standards, licensing requirements and competition rules will play an important part in helping exporters of both goods and services establish and maintain competitiveness in international markets. Preparation of harmonized rules for the Caribbean is already taking place under the CSME protocols. One notable example is the regional accreditation of health professionals by the Regional Nursing Body and the Caribbean Association of Medical Councils. Participation in these regional undertakings by the OECS can save the sub-region considerable resources meanwhile paving the way for establishing competitiveness in a range of emerging areas, in particular services.

### **C. Globalization and the prospects for small states**

3.42 There is a broad literature on the challenges facing small states in an increasingly integrated global economy, namely, remoteness leading to high transportation costs; openness resulting in exposure to external shocks; limited access to external capital that view small states as inherently risky; susceptibility to environmental shocks; narrow resource bases that constrain possibilities for diversification; limited institutional and organizational capacity exacerbated by migration; and diseconomies in cost of social services and infrastructure.

3.43 While the OECS countries faces many of these challenges, they are, in fact, among a handful of micro states and a larger group of small states that have performed relatively well over time on economic, external and social fronts. Indeed, the OECS appears to have overcome a number of the vulnerabilities identified above, including the additional vulnerability of being in the hurricane belt. The sub-region has sustained access to external capital – through FDI, remittances, ODA and commercial borrowing. It has demonstrated resilience to both environmental and external shocks. Cooperation at the sub-regional level has already helped to reduce the cost of some public services, and has the potential to do so in many others. Other vulnerabilities such as remoteness and narrow resource bases are more critical for merchandise trade than service exports, which are already driving the OECS' external performance. The sub-region is in fact strategically located at the center of a huge regional market and still has some scope for cooperation to reduce transportation costs. Moreover, for large and small economies alike physical resources are no longer a major constraint on diversification. The acquisition of knowledge and technology which are susceptible to economies of scale and distance are key factors in today's economy.

3.44 As such, the outlook for the OECS in the global economy need not be a pessimistic one. In thinking about the way forward we look for lessons from other small states that have developed positive strategies for coping with the global environment. Among the noteworthy examples of Singapore, Mauritius, Iceland and Ireland, the latter was chosen as a useful example

because at the onset of its reform program in 1987, its initial conditions and external performance were quite similar to those in the OECS today (see Table 3.4).

3.45 *The Celtic Tiger*.<sup>13 14</sup> In 1987, the Irish economy was plagued with high unemployment at around 17 percent. Persistent fiscal deficits averaging 10 percent of GDP over the previous five years had driven public sector debt to a high of 117 percent of GDP. Growth rates had slowed throughout the 1970s and there were some years of actual contraction in the early 1980s. Inflation, however, was moderate - around 3 percent - while the real exchange rate which had seen some appreciation in recent years, was undergoing a small correction and was not thought to be out of line with its long run equilibrium.

3.46 Ireland had joined the European Community a decade earlier and pursued trade liberalization within the Community's policy. The country had benefited from both the Common External Tariff and the Common Agricultural Policy - exports had grown rapidly from 38 percent of GDP in 1973 to 48 percent in 1987. At that time, the country was in the midst of a transition from agriculture to low-end manufacturing spurred by cheap labor, its comparative advantage within the European Community. Agricultural had stabilized at around 10 percent of GDP from a high of 18 percent in 1973, but still accounted for 29 percent of exports. The majority of trade was concentrated with the EU and the UK. Membership in the EU also entitled the country to official development assistance transfers (called structural funds) on the order of 2-6 percent of GDP per annum. A strong tradition of social welfare had maintained high social spending at around 6 percent of GDP on education and 7 percent on health, which produced good social indicators, in particular, education outcomes, but also contributed to the fiscal imbalances.

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<sup>13</sup> Talon and Kraemer (1999).

<sup>14</sup> McCarthy (2001).

**TABLE 3.4: A COMPARISON OF IRELAND AND THE OECS**

	OECS, today (2003)	Ireland in 1987	Ireland in 2000
	(in % of GDP, unless otherwise specified)		
<b>Population (million)</b>	0.6	3.4	3.9
<b>GNI per cap (US\$)</b> <sup>15</sup>	5,056	7,790	22,970
<b>Growth rate</b>	3.6%	4.6%	11%
<b>Inflation (%)</b>	1.8%	3.2%	-3.2%
<b>Agriculture</b>	7.4%	10%	4%
	19.8% of employment	14.7% of employment <sup>b</sup>	7.9% of employment
		29.2% of exports	4.8 % of exports
<b>Manufacturing</b>		31.8% of merch exports	70.4% of merch exports
<b>Tourism</b>	70% of exports of goods and services		
<b>Government spending</b>	35%	46%	4.3%
<b>Public debt</b>	113%	117 %	39%
<b>Fiscal balance</b>	-5.5%	-8.2%	4.7%
<b>Primary balance</b>	-1.2%	-2%	7%
<b>Unemployment</b>	16.1% of work age pop	16.9% of labor force	4.3% of labor force
<b>Social spending</b>	Educ: 7.1%	Educ: 5.8 %	Educ: 4.3 %
	Health: 5.4%	Health: 6.6 %	Health: 4.7 %
<b>ODA</b>	3% <sup>a</sup>	2-6%	..
<b>FDI</b>	9.0%	0.3%	24.0%
<b>Exports of goods and non-factor services (GNFS)</b>	50.7%	54.6%	98.0%
	Growth 11%	Growth 10%	Growth 17%
<b>External balance on GNFS</b>	19%	4.4%	13.6%

a. not including undisbursed balances of EU commitments,

b. 1981

Source: World Bank (2004i), McCarthy (2001)

3. 47 In 1987, Ireland embarked on a major Program for National Recovery. The turnaround in the last decade and a half has been remarkable. GDP grew at an average rate of 7 percent, unemployment plummeted from 18 percent to near full employment, the debt/GDP ratio fell from around 120 percent to 40 percent, and the primary balance went from a deficit of nearly 2 percent to a surplus of nearly 7 percent. Today, Ireland enjoys a per capita income of nearly \$23,000. Like all success stories there has been enormous debate on the key determinants of Ireland's achievements. The following are key lessons gleaned from this debate:

- **Strong early focus on fiscal adjustment** emphasizing expenditure reductions, and wage moderation in exchange for tax cuts, was facilitated by a broad social pact (including the opposition and trade unions). Fiscal deficits were virtually eliminated within the first three years of the reform program and expenditure reduced by 10 percent of GDP. Notably, there was no early focus on rapid reduction of the debt stock. Instead, lower financing needs and higher growth rates allowed for a smooth reduction over time.
- **Careful use of the EU structural funds** to help sustain infrastructure and social investments, and to reduce the debt burden during the adjustment period. These included **active labor market policies** to retrain and retool the chronically unemployed for the new demands of the business sector. Ireland is considered by the EU Court of Auditors to have been one of the more effective users of this aid.

<sup>15</sup> Atlas method.

- **Early adaptation of the educational system to the needs of the business sector.** A 1963 report by the OECD highlighted the poor condition of educational facilities in Ireland. Fewer than half of all national schools had piped water and more than half of all children did not complete secondary schooling. A couple of decades of reforms reduced the dropout rate significantly while simultaneously increasing levels of tertiary education. Technical colleges and universities were refocused on the needs of the business sector producing technical degrees and *bilingual* graduates. By the late 1990s, Ireland graduated, proportionally, the highest number of scientists and engineers in the OECD, and is now ranked as the second best educational system in the world in terms of responsiveness to the needs of a competitive economy.
- **Establishment of a transparent and favourable corporate tax regime** – low uniform tax rate of 10 percent for the manufacturing and service sectors, supported by double taxation treaties with key FDI sources countries. Ireland learned early on that simply offering the conventional time-bound financial incentives and tax concessions only attracted footloose sub-assembly operations that employed little skilled labor, hardly traded with local suppliers, and subsequently did not leave any technological ‘footprint’ on the domestic economy.
- **Participation in the EU** provided an institutional framework which both constrained and provided guidance to the macroeconomic investment and trade policies in a way that gave credibility to the reform program.
- **Well-coordinated investment promotion efforts** with a focus on: (i) targeting flagship FDI that led to key spillovers to the domestic economy and (ii) strengthening the capacity of domestic firms. In the mid 1990s, the Irish authorities realized that technological spillovers were lagging, with still low levels of IT use by domestic firms and households. The agency responsible for promoting domestic investment began to offer a range of technology services including audits and technology transfer programs to local firms.
- **An expansive and evolving vision of Ireland’s sources of competitive advantage.** An unwavering and forward-looking focus on external competitiveness has allowed the Irish authorities to stay ahead of structural changes and put in place the necessary supports needed. In addition, although Ireland focused on the IT industry as a cluster, it has explored a broad range of activities that built on its initial competency – starting from assembly, mass market software manufacturing, niche software design, aftermarket customer care through call centers, and more recently targeting itself as the ideal location for the European headquarters of overseas firms.

3.48 **Relevance for the OECS.** Most of the lessons outlined above are broadly relevant for the OECS. However, two are worth discussing further. While participation in the European Union is not an option for the OECS, increasing integration both within the sub-region and within broader regional trade arrangements can not only provide a larger market space, it can also help to provide the same checks and balances on macroeconomic, trade and investment policies that the EU institutional framework provided to Ireland. Full participation in the CSME and FTAA can give a sense of credibility and permanence not just to trade reforms, but the broader range of behind-the-border reforms embodied in these agreements.

3.49 The second issue relates to the formulation of a strategic vision that guided the sectoral direction of Ireland’s development. Ireland’s precise path, in terms of sectors and industries, is not likely to be the appropriate one for the OECS, given differences in population, location, and endowments. The key lessons from the Irish experiences are: (i) their position role in the global economy was based in part on existing comparative advantages and in part on competitive

advantages that had to be carved out in new areas and (ii) it was necessary for the society as a whole to formulate a precise vision for growth and competitiveness. Ireland started from the comparative advantage of cheap labor and an already established manufacturing base and seized the opportunity to provide foreign firms a favorable production site within the EU, and later moved up and across the value chain. The OECS may start from the basis of strategic location, good climate, and a service orientation, to work toward a vision of a cluster of offshore services provided around the tourism industry.