

# Small States in the World Trading System

## — The Case of CARICOM —

Mari MINOWA

### I. Introduction

The Ministerial Declaration, adopted on November 14, 2001 at the closing of the Fourth Ministerial Conference of the World Trade Organization (WTO) in Doha, contained a paragraph on “Small Economies”. The paragraph states that the ministers agree to a work program to examine issues relating to the trade of small economies. The objective of such work program would be “*to frame responses to the trade-related issues identified for the fuller integration of small, vulnerable economies into the multilateral trading system, and not to create a sub-category of WTO Members*”. (Ministerial Declaration, para.35) WTO agreements contain special provisions, referred to as “special and differential treatment,” which give developing countries special rights and allow developed countries the possibility to treat developing countries more favorably than other WTO Members.<sup>1</sup> The Doha ministerial declaration referred to above was a statement of the view of the members that, although acknowledging special circumstances faced by small economies, no new sub-category of preferential treatment should be created for that group, outside of the already existing “special and differential treatment” for developing countries. In response to the mandate given by this Doha declaration, the General Council agreed on the framework and procedures of the work program on small economies, and substantive work is under way in the dedicated sessions of the Committee on Trade and Development (CTD).

Small states are concerned that implementation of WTO rules and consequent erosion of the existing preferences they enjoy would have a serious negative impact on the socio-economic development of their economies. The ongoing discussion at the dedicated

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<sup>1</sup> These special provisions include: (i) longer time periods for implementing agreements and commitments; (ii) measures to increase trading opportunities for these countries, (iii) provisions requiring all WTO members to safeguard the trade interests of developing countries, (iv) support to help developing countries build the infrastructure for WTO work, handle disputes, and implement technical standards, and (v) provisions related to Least-Developed country (LDC) Members.

sessions of CTD reflects their concern, and the outcomes of which will have an important implication for their future. Small economies claim that the multilateral trading system needs to identify and implement special responses in order to offset the inherent economic disadvantages faced by small, vulnerable developing economies.<sup>2</sup> Does the small states' claim for a special preferential treatment have any merit? What makes small states different? What can be their strategy for survival and development in a rapidly integrating and global world economy?

This paper attempts to summarize the issues related to "small vulnerable economies" particularly in the process of their integration into the world economy, with the special reference to the case of small island economies of the Caribbean. Section II summarizes the definition of small states and characteristics that make small states different. Section III reviews the existing evidence on whether these characteristics of the small states really create disadvantages in the world trading system which might justify special preferential treatment. Section IV reviews the experiences of the members of CARICOM (Caribbean Community and Common Market) to see whether and how these small island states have benefited from existing preferential treatment provided under various trade agreements. Section V concludes.

## II. Definition and Characteristics of Small States

### *What Is a Small State?*

Small country issues have been analyzed for more than four decades since the early works of Kuznets (1960), Scitovsky (1960) and de Vries (1973). However, there is still no general agreement on what "small" means. There is no single definition of a small country because size is a relative concept. Population, territory size, or GDP have all been used as indicator. Although these indicators are often closely correlated among themselves, no single indicator can satisfactorily capture all of the important factors for all of the small economies. Davenport (2001) recently suggested using "share in world trade" as an indicator for smallness. This indicator reflects two things: the economy's size (as large economies tend to trade more) and the economy's openness. It has been found, however,

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<sup>6</sup> 2 For example, see the "Concrete proposals to address certain specific concerns and problems affecting the Trade of Small Economies," (June 28, 2002) a communication presented to the WTO Committee on Trade and Development from Barbados, Belize, Bolivia, Dominican Republic, Guatemala, Honduras, Mauritius and Sri Lanka.

that “share in world trade” is closely correlated with GDP, but not with the population size.

Among different indicators of the size of the economy, a most widely used proxy indicator is population. Even when we agree to use population as indicator, however, there is no special significance in the selection of a particular threshold. For example, Kuznets (1960) used an upper limit of 10 million people in his analysis of small nations. Others used 5 million (Streeten 1993, Collier and Dollar 1999). The Commonwealth Advisory Group (1997) used 1.5 million people as the threshold. The Commonwealth Secretariat/World Bank Joint Task Force on Small States (Joint Task Force) (2000) also used 1.5 million people as the threshold in its report: *Small States: Meeting Challenges in the Global Economy*.<sup>3,4</sup>

Using the criteria of the Joint Task Force, for example, 45 developing countries are small, accounting for about one third of the total number of developing countries. The total population of these 45 countries amounts to only about 20 million, which accounts for less than 0.4 percent of the total population of developing countries. The GNP per capita of these countries ranges widely from less than US\$400 in several African countries to more than US\$9,000 in countries like Bahamas, Brunei, Cyprus, Malta and Qatar. This shows the diversity that exists among “small countries” defined by any single variable, such as population. As shown in Table 1, many of these small countries are island nations in the Caribbean on the Pacific and in Africa.

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<sup>3</sup> 3 The Commonwealth Secretariat/World Bank Joint Task Force on Small States (Joint Task Force) was created in 1998 with the objective of addressing the request for special treatment advance by the Commonwealth small states. The Joint Task Force was also requested to address the transitional problems arising from changes in the international trading system, including the implementation of Uruguay Round Agreements and the expected expiration of the European Union’s Lome IV Convention in year 2000.

<sup>4</sup> 4 Joint Task Force report includes in its analyses those countries eligible for official aid as listed in the *List of Aid Recipients Used for 1997 and 1998 Flows*, issued by OECD Development Assistance Committee with a population of less than 1.5 million. A few larger states (Jamaica, Lesotho, Namibia and Papua New Guinea) are also included because they share many of the same characteristics of small states.

Table 1 Small States with Population of Less Than 1.5 Million

Country	Population(thousands)	GNP Per Capita(US\$)
<i>Africa Region</i>		
Botswana	1,562	3,070
Cape Verde	416	1,200
Comoro	531	370
Djibouti	636	C/
Equatorial Guinea	431	1,110
Gabon	1,180	4,170
Gambia	1,216	340
Guinea-Bissau	1,161	160
Mauritius	1,160	3,730
Sao Tome and Principe	142	270
Seychelles	79	6,420
Swaziland	989	1,400
<i>East Asia and Pacific Region</i>		
Brunei	315	a/
Cook Islands	20	—
Fiji	790	2,210
Kiribati	86	1,170
Marshall Islands	62	1,540
Micronesia, Fed. Sts.	113	1,800
Nauru	11	b/
Niue	2	—
Palau	19	b/
Samoa	169	1,070
Solomon Islands	416	760
Tonga	99	1,750
Tuvalu	11	1,150
Vanuatu	183	1,260
<i>Latin America and the Caribbean Region</i>		
Antigua and Barbuda	67	8,450
Bahamas	294	a/
Barbados	266	b/
Belize	239	2,660
Dominica	73	3,150
Grenada	96	3,250
Guyana	849	780
St. Kitts and Nevis	41	6,190

St. Lucia	152	3,660
St. Vincent and the Grenadines	113	2,560
Suriname	412	1,660
Trinidad and Tobago	1,285	4,520
<i>Other Regions</i>		
Bahrain	643	7,640
Bhutan	759	470
Cyprus	753	11,920
Estonia	1,450	3,360
Maldives	263	1,130
Malta	377	10,100
Qatar	742	a/

Note: Countries with a population of less than 1.5 million are listed. In addition, Jamaica, Lesotho, Namibia and Papua New Guinea are included among the Commonwealth small states.

Classification is according to 1998 GNP per capita, using World Bank Atlas method.

a/ high income economy (per capita GNP \$9,631 or more)

b/ upper middle income economy (per capita GNP \$3,031–\$9,630)

c/ lower middle income economy (per capita GNP \$761–\$3,030)

d/ low income economy (per capita GNP \$760 or less)

Source: Commonwealth Secretariat/ World Bank Joint Task Force on Small States, Small States: Meeting Challenges in the Global Economy, April 2000.

### *What Makes Small States Different?*

What are the characteristics of small states that define the challenges they face? The following list of characteristics of many of small countries is extracted from the Joint Task Force Report (2000):

- \* **Remoteness and isolation:** Of the 45 small states, 34 are islands, many of which are located far from major markets (as in the case of Pacific islands) and some are widely dispersed multi-island micro states;
- \* **Susceptibility to natural disasters and environmental change:** Many small states are in regions frequently affected by adverse climate, which often affect the entire population and the economy (e.g. hurricanes and cyclones in island states);
- \* **Limited institutional capacity:** Because of the fix cost of providing public services, such as policy formulation, regulatory activities, education and social services, costs per capita of these services are high in small states unless such costs are pooled at the regional level;

- \* **Limited diversification:** Because the resource base is narrow and the domestic market is small, diversification is difficult. Capacity in the private sector is also limited;
- \* **Openness:** Small economies tend to rely heavily on external trade and foreign investment to overcome the limitations in scale and resources. While openness has its benefits, it also makes small states vulnerable to external shocks;
- \* **Poverty:** Evidence seems to suggest that poverty level are higher and income distribution is more unequal in small economies than in larger ones;
- \* **Income volatility:** As a result of the factors discussed above, income volatility of small states tend to be very high;
- \* **Limited access to external capital:** Although it is important for small states to have access to external capital to compensate for adverse shocks and income volatility, small economies are considered more risky. Hence their access to external capital in the private capital market is limited and the cost of any available capital is high.

### III. Do Small States Need Special Treatment?

Special attention is devoted to small states in the multilateral discussion of trading system, as it is generally believed that they are especially vulnerable and can be easily hurt in the process of globalization due to their particular characteristics as discussed in the section above. However, no agreement yet exists among researchers on whether smallness is really a drawback or an asset as these countries pursue economic development through integration into the world trading system. Some focus on the fact that small states cannot enjoy economies of scale both in production and in public administration, and argue that they are not internationally competitive and cannot pursue import substitution policies. Others argue that smallness is an asset in a changing and dynamic world, since they can respond quickly and flexibly to the adjustments required by a changing international market. Conclusions in the empirical literature tend to be contradictory and inconclusive in a number of important points.<sup>5</sup>

*Remoteness and Isolation:* It has been sometimes argued that many small states are less competitive in the world market because they are situated far away from major

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<sup>5</sup> WTO Secretariat, "Small Economies: A Literature Review" (July 2002) summarizes the existing research on small economies. It reviews analyses on the economies of scale, vulnerability to both economic and natural external shocks, consequences of remoteness and isolation, and also the measurement of vulnerability.

centers of trade and commerce. Remoteness increases transportation costs for both imports and exports. Transportation costs are influenced by various factors including: geographical distance, mode of transport (i.e. overland or sea freight), whether or not inter-modal transport is required (which adds transfer costs), quality of port administration and infrastructure, and the composition of goods transferred. Analyses of data on "CIF/FOB ratio" find that landlocked countries face particularly high transportation cost disadvantage. Island economies are also found to have higher transport costs than other economies, although not as high as those for landlocked countries. On average, however, no particular relationship is found between the size of countries as defined by population size and transportation costs. This finding can be explained by the fact that landlocked and island economies are distributed across population size.<sup>6</sup>

*Limited Diversification:* It has also been argued that smallness limits an economy's possibility to diversify local production. Small economies, as a result, rely heavily on imports to support local consumption, and their export is characterized by lack of diversification. Data on the "ratio of trade to GDP" confirm that smaller economies are more open to trade.<sup>7</sup> On the benefit side, high degree of openness brings benefits to the consumers in small states as they can consume a greater variety of goods at lower prices, and to the producers as they can sell in the larger world market, assuming that an access to such market is secured. Does the lack of diversification, however, result in a higher volatility in export earnings as some analysts have argued? Data do not seem to support this argument. A comparison of export earnings volatility and population size does not show any correlation. (WTO 2002b) Easterly and Kraay (2000) as well as the Joint Task Force (2000) also found that the terms of trade of small countries are not significantly more volatile than those of other developing countries.

*Income Volatility:* Although export earnings may not be any more volatile for small economies, however, because of the greater share of exports and imports in the domestic economic activity, even a small fluctuation may have a significant impact on a small economy. Easterly and Kraay (2000) analyzed volatility of the "weighted terms of trade" using share of exports and imports in GDP as weight to capture the importance of trade in domestic economy. Their findings show that the standard deviation of their measure is indeed higher for smaller economies, with about 30% increase in average volatility for

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<sup>6</sup> WTO, "Trade and Economic Performance: The Role of Economic Size?" October 2002.

<sup>7</sup> Ibid.

small economies. Small economies' export earnings are not significantly more volatile than those of larger countries. However, since trade represents a much more important part of economic activity, overall GDP volatility tend to be higher in small countries. Furthermore, many small states are in regions susceptible to natural disasters, such as hurricanes, cyclones, drought and volcanic eruptions. Because of the small size of the country, these natural disasters can easily affect the entire economy, thus again leading to higher fluctuations in GDP.

*Measuring Vulnerability of Small Economies:* There have been several attempts to measure the degree of vulnerability of small states deriving from different sources. The objective of such attempts is to see if small states are particularly vulnerable to external shocks and, hence, if they are more penalized than larger developing countries because of their small size. For example, the vulnerability index proposed by the Commonwealth Secretariat takes into account three determinants of income volatility: the lack of export diversification (measured by the UNCTAD export diversification index,) the extent of export dependence (measured by the export to GDP ratio,) and the impact of natural disasters (measured by the share of total population affected by natural disasters). These three indices are combined and weighted by GDP to calculate the final vulnerability index. As shown in Table 2, 26 out of 28 most vulnerable countries are small states according to this index.

We can summarize the findings so far as following: small states are characterized by higher GDP volatility, greater openness to trade, and more concentrated production and export structures. Small states also receive higher international aid per capita. Interestingly, however, it has also been found that small states do not necessarily perform poorly in

Table 2 Country Groups According to the Commonwealth Vulnerability Index

High Vulnerability	Higher Medium Vulnerability	Lower Medium Vulnerability	Low Vulnerability
Antigua & Barbuda*	Angola	Bolivia	Algeria
Bahamas*	Bahrain*	Cameroon	Argentina
Belize*	Barbados*	Congo, Dem. Rep.	Bangladesh
Bhutan*	Benin	Costa Rica	Brazil
Cape Verde*	Botswana*	Cote d'Ivoire	Chile
Comoros*	Burkina Faso	Cyprus*	China
Djibouti*	Burundi	Dominican Rep.	Colombia
Dominica*	Central Afr. Rep.	Ecuador	Egypt
Equatorial Guinea*	Chad	El Salvador	Guatemala



Fiji*	Congo	Ethiopia	India
Gambia*	Gabon*	Ghana	Indonesia
Grenada*	Haiti	Guinea	Iran
Guyana*	Honduras	Jordan	Libya
Kiribati*	Jamaica	Kenya	Malaysia
Lesotho	Malawi	Madagascar	Mexico
Maldives*	Mali	Nepal	Morocco
Mauritania	Malta*	Oman	Myanmar
Samoa*	Mauritius*	Panama	Nigeria
Sao Tome & Principe*	Mozambique	Paraguay	Pakistan
Seychelles*	Namibia	Senegal	Per
Solomon Islands*	Nicaragua	Sri Lanka	Philippines
St. Kitts & Nevis*	Niger	Sudan	Singapore
St. Lucia*	Papua New Guinea	Trinidad & Tobago*	South Africa
St. Vincent & Gren.*	Rwanda	Tunisia	Syria
Suriname*	Sierra Leone	Uganda	Thailand
Swaziland*	Tanzania	Yemen	Turkey
Tonga*	Togo	Zimbabwe	Uruguay
Vanuatu*	Zambia		Venezuela

Note : \* = small state

Source : Commonwealth Secretariat and World Bank Joint Task Force (2000)

terms of GDP levels (GDP per capita,) growth rates, social, health and educational indicators, cohesion variables and flexibility in the decision-making process.<sup>8</sup> Furthermore, there is also some ambiguity about the impact on small states of globalization and their integration to the international economy. For some, globalization means an opportunity for countries that suffer from remoteness and isolation. The development of information and communication technology and improvements in transportation make remoteness and isolation less stringent and allow small economies to take advantage of new opportunities. For others, small economies are too weak and vulnerable to survive if integrated into the global economy without any form of protection.<sup>9</sup>

Such differences in the emphasis placed and conclusions drawn for the issues characterizing small states mostly reflect the heterogeneity of circumstances faced by different groups of small economies. For example, small island economies in the South Pacific and small land-locked countries in Asia can have very different sets of problems, while sharing some of the common difficulties deriving from their small population size. Therefore, it is necessary to look at specific circumstances of countries or groups of

<sup>8</sup> WTO (2002a), p. 13.

<sup>9</sup> Ibid.

countries when we assess the implications of their integration into the global trading system. In the next section, we will look at the case of small island economies of CARICOM members.

#### **IV. Trade Agreements and Small States - Case of CARICOM**

Many small economies are involved in regional multilateral integration agreements. Some of the most important ones are the arrangements between the European Communities and the African, Caribbean and Pacific (ACP) countries, the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA) between Australia, New Zealand and Pacific islands, and the Caribbean Community and Common Market (CARICOM).

Schiff (2001) examines the advantages and disadvantages for small states of being part of these regional groups. He identifies three types of regional agreements: (1) South-South Regional Integration Agreements; (2) South-South Regional Cooperation (on public goods and international negotiations); and (3) North-South Regional Integration Agreements. Regional cooperation on public goods and international negotiations (Type (2)) can be considered beneficial for small states, as the creation of a regional group of countries sharing the same needs increases the bargaining power of states that would be weak on their own, and helps reducing the fix costs of negotiations. However, regional integration agreements of Type (1) may not be necessarily beneficial to small states. It has been widely recognized that members of a regional integration agreement may suffer welfare loss due to trade diversion when trade policies with respect to the rest of the world remain unchanged. In this section, we will look at the specific case of such a regional integration for the case of CARICOM.

Before we discuss CARICOM, however, it is necessary to take note of the important North-South regional integration agreements (type (3) agreement) between the European Communities and African, Caribbean and Pacific (ACP) countries, since CARICOM members also benefit from these conventions. The first of Lomé Conventions between European Communities and ACP countries was signed in 1975 and the last one, Lomé IV, was signed in 1995 and lapsed in 2000. Through these conventions, extensive duty-free market access was granted to ACP countries in the EC market. As a successor to Lomé IV, the new Cotonou Partnership Agreement was signed on June 23, 2000. The objective of the Cotonou Agreement is the gradual and full integration of the ACP

countries into the world economy through the enhancement of their production, supply and trading capacity as well as their capacity to attract investment. It is important to note that these objectives are underlined by certain principles, such as: WTO conformity; building on regional integration initiatives; and progressive removal of trade barriers between the European Union (EU) and ACP. Most importantly, the reciprocity and WTO conformity principles of the Cotonou Agreement signify a fundamental change in the ACP's relationship with the EU and pose a significant challenge to these small economies. ACP countries need to complete the negotiations on reciprocal arrangements before the expiration of the preparatory period granted through December 31, 2007.

### *Small Island States in the Caribbean*

The establishment of the Caribbean Community and Common Market (CARICOM) dates back to 1958 when the British West Indies Federation was established. Although a plan for customs union was drawn at the time, no progress was made during the four-year existence of the Federation. The end of the Federation brought more serious efforts on the part of the leaders of the Caribbean nations to strengthen ties among them. The idea to create a Free Trade Area in the Caribbean was proposed in 1965, and in December, heads of governments of Antigua, Barbados and British Guiana signed an agreement to set up the Caribbean Free Trade Association (CARIFTA). The new CARIFTA agreement came into effect on May 1, 1968 and subsequently in 1972, a decision was made to transform CARIFTA into a Common Market and to establish the Caribbean Community.

The Caribbean Community and Common Market (CARICOM) was established by the Treaty of Chaguaramas, which was signed by Barbados, Jamaica, Guyana and Trinidad & Tobago, and came into effect on August 1, 1973. Today, CARICOM consists of fifteen member countries and four associate members.<sup>10</sup> From its inception, CARICOM has focused on the promotion of the integration of the member economies. In 1989, CARICOM heads of government developed a work program to deepen integration process and to strengthen the Caribbean Community into a single market and economy. The CARICOM Single Market and Economy (CSM&E) is intended to advance integra-

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<sup>10</sup> Member states are: Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, St. Kitts and Nevis, Saint Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago. Associate members are: Anguilla, British Virgin Islands, Cayman Islands, Turks and Caicos islands.

tion within CARICOM and move CARICOM as a trading block and a customs union, toward the free movement of factors of production between the member countries without restriction.<sup>11</sup>

### *Trade Performance of CARICOM*<sup>12</sup>

Member states of CARICOM are given unrestricted access to each other's market for goods meeting the Community Rules of Origin criteria. Under such provisions, intra-regional trade among member states is expected to perform strongly. However, the actual performance has been rather disappointing. The intra-regional imports as percentage of the region's total import accounted for 8–10% over the period 1990–1998. The intra-regional export as percentage of the region's total exports accounted for 12–23% over the same period. Although the share of intra-regional trade has remained rather small, it is noteworthy that the growth of intra-regional exports was much stronger at an average of 8.5% annually compared to -1.1% for the extra-regional exports. It is possible that significant amount of trade diversion occurred among CARICOM member countries, although these figures alone are not sufficient to establish that fact. During the same period, the region's total exports grew only at 4% while the total imports grew by 55%. Imports from non-CARICOM sources grew much faster than exports to those destinations.

Although the performance of intra-regional trade relative to the region's total trade remained moderate during 1990s, for some of the member states, the regional market was a significant destination for their exports, ranging from 30 % for Barbados and St. Vincent and the Grenadines to 78% for Dominica in 1998. The significance of intra-regional trade is much larger for "Less Developed Countries" within the region than for "More Developed Countries".<sup>13</sup>

The value of CARICOM exports to the US market hardly increased during 1990–1998 period. Mexico's participation in NAFTA, with its lower costs of production and less restrictive rules of origin, has had a very adverse effect on exports of CARICOM

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<sup>11</sup> The most current status of the key elements to establish the common single market can be found at: <http://www.caricom.org/expframes2.htm>.

<sup>12</sup> Extracted from CARICOM, Caribbean Trade and Investment Report 2000.

<sup>13</sup> CARICOM designates the following countries as "More Developed Countries": Barbados, Guyana, Jamaica, Suriname and Trinidad and Tobago. All other member states, other than the Bahamas, are designated as "Less Developed Countries".

members to the US market. CARICOM manufacturing exports to the US had risen sharply from US\$284m in 1990 to US\$509m in 1994. However, since 1995, the export declined every year to reach US\$422m in 1998. Similar poor performance has been observed with the export to Canada. These poor export performances are in spite of the preferential access that the CARICOM members maintained to these two markets. The US-Caribbean Basin Initiative (CBI), which had benefited 27 Caribbean and Central American countries since 1984, was enhanced via the passing of the "US-Caribbean Basin Trade Partnership Act" in the US Congress on May 18, 2000. The preferential treatment was extended through the end of September 2008, which coincides with the end of the transitional period of the ACP-EU Cotonou Agreement and also with the expected coming into effect of the Free Trade Area of Americas (FTAA) Agreement. Based on the limited success of the agreement in expanding exports to the US market during the preceding years, it is not clear how this enhanced preferential arrangement can actually help strengthen the region's export performance in the U.S. market. Furthermore, there is a real uncertainty as to the future of such preferential arrangements, with both CBI and Cotonou Agreement expected to expire in 2008.

The relationship of CARICOM with third party countries, and the insertion process of the region into the hemispheric economic integration are undergoing some changes in recent years. The CARICOM region initially presented a monolithic face to the world in terms of its trading relations, ever since a customs union was negotiated in 1973. However, in recent years, the trading system is making allowance for not only regionally negotiated agreements with third parties, but also for individual CARICOM members to negotiate arrangements with other third parties. In order to allow for a greater degree of flexibility in the trade liberalization process, countries that have achieved a greater degree of competitive readiness can now seek the approval to go ahead and form trading agreements with certain third parties even before the other member countries are ready to do so. In this context, Trinidad and Tobago has independently initiated trade negotiations with Mexico and Costa Rica.

Trade with the European Union has always remained significant for CARICOM countries ever since their independence. The EU ranks the second after the US as a source of imports as well as the destination of exports. The imports from the EU are diversified into many intermediate or final goods, reflecting the dependence of CARICOM countries on external sources for many of the machinery, equipment and other industrial and consumer products. On the other hand, a high level of concentration is observed for

CARICOM exports to the EU market. In spite of the effort for export diversification, the concentration ratio for the largest four export items to the EU increased from 0.682 in 1991 to 0.829 in 1997.<sup>14</sup> These figures clearly demonstrate the limitation for the small island economies to diversify exports.

It has been sometimes argued that the price concession and guaranteed access to the EU market has encouraged many ACP countries to remain heavily dependent on a few traditional primary products that are hardly competitive in the global market. Assessment of the trade performance indicates that CARICOM members took advantage of the preferential tariff margin provided under the commodity protocol of Lomé convention. However, outside of the items traded under the commodity protocol, very little increase in exports from the Caribbean countries to the EU has been observed during 1988-97. We may conclude, therefore, that preferential treatment provided under Lomé conventions were not sufficient incentive to develop new production capacity or to diversify exports in CARICOM. And now, these countries are facing the threat of losing even these preferential treatments. Whether these preferences have actually done disservice to the small countries by discouraging tough decisions on their part to develop new productive capacity, or that these preferences were simply not enough in magnitude, what seems clear is that continuation of the same arrangement would not work for the future of these small states.

While CARICOM common market seems to have provided important export market for less developed members, there is no clear evidence that the CARICOM as a whole gained any net benefit from the common market arrangement. As more developed members start to have independent bilateral trade agreements with third party countries, the significance of CARICOM as a trading block may even further be weakened.

## **V. Future of Small Island States**

Small states' openness to trade and more concentrated production and export structure tend to make their GDP highly volatile. Although smallness of the country, as defined by its population size, does not necessarily mean smaller GDP or GDP per capita, the high GDP volatility renders these small economies highly vulnerable.

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<sup>14</sup> These four export items are: aluminum ores and concentrates, sugar, bananas and methanol.

Small island economies of the Caribbean have joined force to form a customs union and a common and single market to address their vulnerability as individual countries. However, the success of CARICOM as a regional trading block has been limited. Preferential treatment provided under North-South regional integration agreements such as CBI or Lomé and Cotonou Agreement has only produced mixed results. While Lomé convention helped CARICOM countries maintain some steady level of commodity export to the European markets, exports have been limited to a small number of commodities and no export diversification has occurred. CBI seems to have generated limited benefit to island economies in the Caribbean, particularly with the competition from Mexico after the establishment of NAFTA.

ACP countries, including CARICOM members, are expected to lose the preferential treatment under Cotonou Agreement in 2008, and face the challenge of complete reciprocity and WTO conformity. If the existing preferential treatment has not provided any significant benefit to small vulnerable states, then can we expect that suspension of these preferences would not cause much damage to them? If, as argued by some, the existence of special access to the EU market has discouraged ACP countries from developing more competitive productive sector, then would the termination of such preferences bring more serious, albeit painful, efforts on the part of the ACP countries? That is a possible scenario.

We started this note with three questions: (1) does the small states' claim for a special preferential treatment have any merit? (2) What makes small states different? (3) What can be the strategy for survival and development for small vulnerable states in a rapidly integrating and global world economy?

We summarized the differentiating characteristics of small states as their income volatility due to their openness to trade, high dependence on trade, and susceptibility to natural disasters. Limited diversification opportunities also characterize small economies. Then, in consideration of these characteristics, special preferential treatment has been given to many of the small states with ambiguous outcomes. Is there theoretical or empirical evidence that support continued needs for these preferential arrangements?

Joint Task Force (2000) advocates the adoption of special treatment for small states in the WTO: "... the special characteristics and vulnerability of many small states should be recognized as justifying special consideration by the international system to

*deal with those issues that are crucial to the transformation of their economies, such as the length of transition periods*". The report also argues for enhanced financial and technical assistance for small states.

The extent to which small countries themselves can realize trade diversification and expansion through regional integration is limited. Almost by definition, the limited resource base in these countries restricts such possibility. Openness of these small states is in itself welfare-enhancing in theory. However, this openness and greater dependence on trade makes their economy highly volatile and vulnerable. If the main problem is that of volatility, theoretically, some insurance mechanism could be designed to insure these small vulnerable economies against negative shocks. However, as long as such insurance mechanism is not available in reality, there may be sufficient and justifiable reason for the world trading system to provide a special and preferential arrangement for small vulnerable states. The performance of the past and existing system of preferences will have to be analyzed carefully to understand the causes of their limited success. Based on such analyses, a new scheme of special assistance for small states may focus on responding to their GDP volatility through establishment of a permanent, special scheme of insurance for small economies, rather than a simple unilateral provision of preferential market access.

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