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Development challenges facing island developing countries: basic issues and prospects in the context of trade liberalization and globalization

Report by the UNCTAD secretariat

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Contents[1]

[1] The statistical data used in the preparation of this report will be available in a separate annex document.

Introduction

1. The General Assembly, in its resolution 49/100 of 19 December 1994, invited the Commission on Sustainable Development to convene a high-level panel to discuss the challenges faced by island developing countries (IDCs), particularly in the area of external trade. It also invited the Secretary-General of UNCTAD to organize this panel. To that end, UNCTAD prepared this report which will be the main input to the panel's discussions. The report first provides an overview of the performance and problems of IDCs, particularly in the external trade sector. It then analyzes the main features of trade liberalization and globalization and their relevance for IDCs. The paper then focuses on the implications of these developments on the trade specialization prospects of IDCs. Finally, the paper draws up key policy recommendations for future action.

2. Furthermore, UNCTAD, in cooperation with the Department for Policy Coordination and Sustainable Development, undertook two studies covering the Caribbean and Pacific regions. These studies, which examine regional specific trade and development issues, will be submitted to the panel to assist it in its deliberations. The panel will also have a background document on trade issues and sustainable economic development which provides a broad spectrum of issues related to the development constraints and prospects of IDCs.

3. The focus on external trade issues, which permeates through the documentation before the panel, underscores the paramount importance of trading opportunities for sustainable economic development, considering the smallness of most IDCs domestic markets and the heavy dependence of these countries on foreign markets. These aspects are fully recognized by the Programme of Action for the Sustainable Development of Small Island Developing States (SIDS), which was adopted by the Global Conference on the Sustainable Development of SIDS in Barbados in May 1994. The Programme of Action stresses, *inter alia*, the importance of seeking expansion and more stability in export earnings through diversification in goods and services, and points to the need for a "non-discriminatory trading system" (Para. 96) if SIDS are to achieve sustained economic growth.

4. This issue paper responds to the request of the Programme of Action for a study of "the effects of trade liberalization and globalization on the sustainable development of small island developing States, including relevant recommendations" (Para. 99). Although the issues analyzed are mainly those of small island economies, the paper refers to island developing countries in general, in accordance with resolution 49/100.

I. OVERVIEW OF THE PERFORMANCE AND PROBLEMS OF ISLAND DEVELOPING COUNTRIES, PARTICULARLY IN THE EXTERNAL TRADE SECTOR

5. IDCs are a very diverse group of countries with a wide range of geographical situations, natural resource endowments and economic capacities. These disparities are reflected in the diversity of national income levels within the group: half of the 37 island developing countries and territories with a population under one million belong to the two highest-income countries groups according to the World Bank, while nine IDCs within the same size limit are in the category of Least Developed Countries[2].

6. In spite of their diversity, most IDCs share common characteristics such as smallness (which implies a limited domestic market), remoteness (distances from large market centres), geographical dispersion, proneness to natural disasters,

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[2] Cape Verde, Comoros, Kiribati, Maldives, Samoa, Sao Tome and Principe, Solomon Islands, Tuvalu, Vanuatu

scarcity of natural resources and the risk of depletion of non-renewable resources, fragility of eco-systems, shortages of fresh water supplies, export concentration, heavy dependence on imports, transport and communications constraints, emigration of skilled nationals, shortages of skilled manpower, and a weak indigenous technological capacity. Most of these characteristics are particularly acute in small IDCs. Among all these factors, smallness and external dependence can be described as the main characteristics of island-specific vulnerability. Smallness regards either the global size of a country or the existence of small peripheral islands in an archipelagic country. External dependence is a context that refers to physical factors, such as natural disasters or global environmental trends, as well as economic factors, such as foreign market conditions (e.g., instability in prices, demand, etc.). Many implications of smallness cause the external trade structure of most IDCs to be little diversified and highly dependent on external forces, which explains the situation of economic vulnerability of these countries. This overview first highlights recent developments in the external trade sector of IDCs.

1. Trade performance of island developing countries[3]

7. During the 1985-1992 period, the average annual growth of IDCs agricultural production was slower than that of manufacturing production (2.6% and 4.1%, respectively). A higher growth performance was recorded in the field of services: wholesale and retail trade services grew by 4.7% during the 1985-1991 period, while transport and communications services recorded an annual growth rate of 6.0%. The export ratio (X/GDP) of IDCs was estimated at 31% in 1992, and the import ratio (M/GDP) at 51%. The latter figure indicates the extent of external dependence of IDCs, where a high import propensity is often observed. Yet, the average annual growth of imports of IDCs was significantly lower in the 1980-1993 period (7%) than in the 1970-1980 period (16%). The average export growth performance of IDCs was also significantly lower during the 1980s decade (4.4% in 1980-1993) than during the previous decade (16% in 1970-1980). These estimates indicate that the global trade performance of IDCs has been much less strong in recent years. This is corroborated by the indication of a decline in the terms of trade of IDCs between 1980 (index 100) and 1993 (88.5). Export instability increased during the 1980s decade, as the magnitude of fluctuations in merchandise export values augmented by 24% during that period in comparison with the 1970s decade.

8. The average dependence on the first commodity in percentage of total exports decreased significantly between 1980 (50%) and 1992 (36%). This means that the export concentration of IDCs has diminished, while the instability of export earnings remained a sign of economic vulnerability. Manufactured exports have been playing an increased role in the structure of exports of IDCs (24% in 1992 instead of 20% in 1980). Food imports account for a much smaller proportion of total imports than manufactured imports (20% and 63%, respectively). IDCs exported 73% of their merchandise to developed countries and 24% to other developing countries in 1993. Similar ratios for imports confirm the importance of North-South trade for IDCs: 70% of total imports are from developed countries, and 29% from developing countries.

9. The value of services exports was in 1992 three times larger than the value of merchandise exports, and the total inflow of export receipts from services and private transfers from abroad was nearly four times as large as the total value of merchandise exports. The importance of tourism in island economies is reflected in the average ratio of tourism earnings to total earnings from goods and services exports in 1992: 34%. While the average trade deficit of IDCs, in

[3] Some 47 island developing countries and territories with a population under 5 million make up the sample hereby used.

percentage of GDP, was high in 1993 (-52%), the average current account deficit (-8%) reflected the mitigating impact of service receipts and private transfers. IDCs recorded a low average number of months of imports covered by international reserves in 1993 (2.8 months).

10. A comparative glance at the economic performance of IDCs and non-island developing countries (non-IDCs) reveals that IDCs demonstrated, in the last decade, a better performance than non-IDCs in terms of growth of agricultural, manufacturing and services production[4]. IDCs also recorded, in the 1980-1993 period, slightly higher trade growth than non-IDCs. However, a sharp contrast between the two categories is observed in the degree of export instability: the magnitude of fluctuations in merchandise export values increased by 24% in IDCs from the 1970s decade to the 1980s decade, while it diminished by 14% in non-IDCs. This reflects a much greater export concentration in IDCs. The instability of export receipts during the 1980s decade was greater in IDCs than in non-IDCs by 75%, whereas the gap between the two categories of countries was only 21% during the previous decade. Of significance too is the contrast between the trade deficits of IDCs and non-IDCs in percentage of GDP (-52% in IDCs; -15% in non-IDCs). In short, the external fragility of IDCs is greater than that of other developing countries within the same range of sizes, as also illustrated by the difference in the average number of months of imports covered by international reserves (2.8 in IDCs; 4.0 in non-IDCs).

11. These observations reflect a variety of island-specific characteristics that are at the root of the trade performance, external dependence and economic vulnerability of IDCs. One can classify the factors affecting the external trade performance of IDCs into factors of comparative disadvantage on the one hand, and factors of comparative advantage on the other hand.

2. Factors of comparative disadvantage of IDCs

12. The two main categories of factors of comparative disadvantage of IDCs are the handicaps of smallness and remoteness, which are usually analyzed as the intrinsic factors of trade concentration, external dependence and economic vulnerability. However, the relationship between smallness or remoteness and economic performance is not static. It has changed in recent times. In particular, the inverse causality between the lack of opportunities to find economies of scale (the overriding consequence of smallness) and the economic viability of projects has decreased as a result of success, in some IDCs, in adopting more appropriate technology and realizing small-scale investment.

2.1 *The issue of smallness*

13. As pointed above, many IDCs have a narrow natural and human resource base and a small domestic market. As a result, their economic structure is often little diversified and lacks resilience *vis-à-vis* adverse external factors (physical or economic). Concentration in the trade structure is a source of external dependence. As the external context is prone to instability (international prices/demand fluctuations), trade concentration can be a serious cause of vulnerability[5].

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[4] Some 28 non-island developing countries with a population under 5 million make up the sample considered in this comparison.

[5] In the Windward Islands of the Caribbean, the strong concentration on banana production (over 50% of merchandise exports in St. Lucia, Dominica and St. Vincent and the Grenadines) is a source of economic vulnerability, considering the uncertainty in the future of preferential market access to the European Single Market, and the risk of physical destruction due to inclement weather.

14. As smallness and the lack of diversification are common to several IDCs within a given region, intra-regional trade is unlikely to develop insofar as small island countries tend to produce the same commodities (e.g., sugar, copra, banana) and offer limited scope for intra-regional complementarity.

15. Diseconomies of scale result from the absence of a critical size, either in investment or in the production process, at the level of domestic consumption or in terms of access to an external market. Even though there is a large variety of situations in which the problem of scale and economic viability can be observed, these situations generally have in common a context of lack of competitiveness and insufficient profitability. These are often determining factors in deciding against a production project when the investment is foreseen as being uneconomical because the local market is insignificant while exporting competitively remains out of reach.

16. There are of course areas of decision-making in which scale-related handicaps have to be ignored, i.e., in which decision makers will have to accept the costs of smallness. Such areas are generally confined to the domain of public policy-making. They involve the physical or social infrastructure that is required if very small communities, particularly in peripheral islands of archipelagic countries, are to receive equitable attention. For example, the construction of a jetty or a health centre, or the renovation of school premises in an outer island with a population of a few hundreds will be envisaged regardless of their unit cost if such decisions are deemed to be vital for this population. Often, financial aid will be sought for such vital, though uneconomical projects. Smallness can therefore entail external dependence, not only in the area of trade but also in terms of the level of access to external financing.

2.2 *The issue of remoteness*

17. The issue of island remoteness is closely related to that of smallness in the case of archipelagic countries. In most situations of geographical remoteness within a given country, trade development in the peripheral islands (other than local trade resulting from subsistence activities) is even more constrained than in the main islands because of the difficulties in importing production inputs and transporting outputs either to the capital or abroad.

18. For some IDCs, remoteness within the island region adds further to the problem of the lack of inter-island complementarity in production. Even if a given product could be "complementary" enough to find a regional market, inter-island distances within the region may imply transport costs that would be disproportionate to the market value of the products. In cases of longer distances, relatively high shipping costs applied to small-scale transactions, and often in goods of limited value, can be a major obstacle to the participation of an IDC in international trade. Distance and low levels of demand for cargo loads often make island ports of call unattractive for long-haul shipping lines. Developments in containerization and bulk transport, which have changed the nature of sea transport, have led to the marginalization of small island operators.

19. The impact of the cost of island remoteness with regard to international tourism may be less negative. To many tourists, the inconvenience caused by a longer flying distance with a reasonable cost difference will often be deemed acceptable in comparison with the interest in the island destination. In most other areas of international services, the disadvantage of remoteness may also be considerably reduced as a result of the increasing use of modern telecommunications.

3. Factors of comparative advantage of IDCs

20. Like all countries, IDCs enjoy comparative advantages, although the latter are often not completely perceived and exploited. Factors of comparative advantage of IDCs include: (a) qualities based on natural resources, with environmental beauty as a determining factor of tourism development; (b) socio-political stability, which is observed in a majority of IDCs; and (c) the privileged links of IDCs with developed market countries through trade preferences for the benefit of various sectors of activity.

3.1 *Qualities based on natural resources*

21. Comparative advantages based on non-renewable resources have limitations that need to be taken into account in long-term, sustainable development planning. In the area of renewable resources, the most significant comparative advantage is often found in the size of marine resources, particularly in IDCs of the Pacific that have large exclusive economic zones.

22. Another valuable natural advantage of many IDCs is the quality of the environment, an asset which is conducive to tourism activities. Environmental diversity and beauty become particularly beneficial when they allow specialized forms of tourism, including tourism products that are based on ecological, health-related or cultural values.

23. While few large-scale natural advantages other than vast marine resources and, for some IDCs, oil or mineral resources can be identified, there are other types of advantages that are associated with smallness and remoteness. In the Caribbean, many of the highly rated luxury resorts are found on small peripheral islands of archipelagic countries or territories. In some cases, remoteness is regarded as a related attribute that enhances the quality of the product. Such comparative advantages may have significant economic implications in IDCs where environment-based industries, in particular tourism, exist or could be developed.

3.2 *Socio-political stability*

24. Over three quarters of IDCs with a population under 5 million enjoy a relatively stable political situation. With a few exceptions, the social situation has also been stable in IDCs in general. While such stability is generally desirable to allow an open economy to progress, it becomes indispensable if the specialization pattern is largely based on international services. Often, smallness and isolation contribute to a fair social and political cohesion in island societies. In the absence of major social inequalities, entrepreneurship tends to be widely accepted and economic motivation takes place. Tourism and offshore finance services would not have developed if socio-political stability was not a dominant feature in many IDCs.

3.3 *North-South relationships*

25. Factors of good governance partly explain the privileged relationship that most IDCs maintain *vis-à-vis* developed market countries in general, and former or remaining colonial powers in particular. A large part of the trade opportunities enjoyed by IDCs of the Caribbean, the Indian Ocean and the Pacific is due to the continuation of significant trade preferences for these countries (Lomé Convention, Caribbean Basin Initiative, various generalized systems of preferences from OECD countries, etc.). Availability of aid has in recent years become more closely related to the quality of governance in developing countries in general. While this trend does not exclude IDCs in principle, a paradox can be found in the lessening of eligibility to concessional aid levels that several

Caribbean countries and territories are now faced with, not because they are not well governed, but as a result of their apparent prosperity as measured by GDP-based indicators[6].

4. External dependence and economic vulnerability of IDCs

26. As a result of their specific handicaps, IDCs are intrinsically vulnerable. Vulnerability, however, connotes a degree of exposure to various risks, but does not imply that the threats underlying these risks are necessarily verified. In the absence of realization of risks, an island country might demonstrate a good economic performance. However, very few IDCs have remained undisturbed by external shocks or negative influences. External shocks, particularly those relating to international trade, represent a general threat from which virtually no IDC is likely to escape. Certain implications of trade liberalization and globalization are of critical importance in this regard.

II. RECENT DEVELOPMENTS TOWARD TRADE LIBERALIZATION AND GLOBALIZATION: IMPLICATIONS FOR IDCS

27. The outcome of the Uruguay Round of multilateral trade negotiations (UR) as well as certain regional trading arrangements have implications for IDCs.

28. **In the long run**, IDCs, like other developing countries, are expected to benefit from the global context of trade liberalization, which will bring about new trading opportunities, and from the new multilateral trade framework, which improves rules and disciplines. However, the extent to which IDCs will be able to benefit from these developments depends on the capacity of these countries to manage their transition to a situation of greater integration in the global economy.

29. **In the short run**, most IDCs are faced with a major challenge because of their structural disadvantages and their generally limited capacity to meet new trading opportunities in terms of competitiveness and reliability of supply. The tariff reductions that result from the UR and are based on the Most Favoured Nation (MFN) principle imply that the preferential margins which have been accruing to many IDCs will be eroded. This erosion factor is particularly relevant to textiles, clothing and other manufactured products. It challenges with particular acuity the IDCs which have been able to diversify and develop manufacturing activities. The challenge stems from the difficulty, for such countries, to maintain market shares in preference-giving countries as the latter are increasing competition to IDCs from third countries, including some highly competitive developing countries, by reducing the MFN tariffs facing these countries. For some IDCs, therefore, little or no benefit is likely to be gained in the short run. A few IDCs may be "net losers" as a result of losses in

[6] This growing concern, which is mainly heard in the Caribbean region, has raised the question of constructing an indicator of economic vulnerability to complement the imperfect information provided by GDP-based measurements. The Barbados Programme of Action recommends that such indicator be developed (Para. 113 and 114).

competitiveness and slow progress in seizing trading opportunities[7]. These issues will be discussed below.

30. As of 22 February 1996, 14 IDCs with a population under 10 million were members of the World Trade Organization (WTO), out of a total membership of 119 countries[8]. As of 31 January 1996, three other IDCs had requested to join the WTO, and their applications were being considered by accession working parties[9]. Two more IDCs had the observer status[10].

31. Among island States which were neither members nor observers of the WTO or currently being considered by accession working parties as of 31 January 1996 were six Least Developed Countries[11] as well as the Federated States of Micronesia, the Marshall Islands and Nauru.

32. There are four general areas of implications for IDCs of the new multilateral trade framework: market access; non-tariff measures; the "new issues"; and systemic issues.

1. The Uruguay Round and IDCs prospects for export market access

33. Market access obligations of WTO members are based on national schedules of commitments. The outcome of the UR implies a wider geographical coverage of commitments encompassing a large number of developing countries, more open markets for goods (with a broader coverage which includes agriculture), and a higher degree of market access security as a result of the central role of tariff binding, which is estimated to cover 87% of total merchandise trade. As a result of the conclusion of the UR, tariffs will be reduced; tariff escalation, which affects processed goods, will be eliminated or reduced in various sectors; and a variety of non-tariff barriers to trade will be phased out. Overall, international trade, particularly of industrial goods, is being liberalized, even though tariff reductions in developed countries for industrial goods from developing countries will be less significant than for goods from other developed countries. While average tariff reductions may be less than satisfactory for some product groups of particular export interest to IDCs (e.g., fish products,

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[7] A thorough analysis of the impact of the Uruguay Round can be found in: UNCTAD, **The outcome of the Uruguay Round: an initial assessment**, Supporting Papers to the Trade and Development Report, 1994. The impact of the Uruguay Round on different island regions has also been analyzed in detail in various studies. See in particular: Davenport (M.), *Impact of Uruguay Round and NAFTA on Commonwealth Caribbean Countries, with special reference to Jamaica*, Commonwealth Secretariat, May 1995; G.S.R Associates, *Implications of Uruguay Round Agreements for CARICOM countries*, August 1995; REDMA Group, *The Uruguay Round Agreements: Implications for the CARICOM region*, Report to the CARICOM Secretariat, 1995; ESCAP, *Uruguay Round: some implications for Pacific island countries*, 7-9 November 1994; Greenaway (D.) and C. Milner, *The Uruguay Round and Commonwealth Developing Countries: An Assessment*, A Report to the Commonwealth Secretariat, February 1995.

This section does not attempt to report all findings from these studies, but focuses on the most important aspects of cross-regional interest.

[8] These countries were: Antigua and Barbuda, Barbados, Dominica, the Dominican Republic, Fiji, Grenada, Haiti, Jamaica, Maldives, Mauritius, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Trinidad and Tobago.

[9] Seychelles, Tonga, Vanuatu.

[10] Papua New Guinea’s protocol of acceptance of WTO obligations was approved by the General Council of WTO on 15 November 1995. The General Council has approved the schedules of the Solomon Islands, thereby agreeing that the country has fulfilled the requirements of membership and can accede to the WTO 30 days after it accepts the WTO Agreement, which it can do not later than by 31 December 1996.

[11] Cape Verde, Comoros, Kiribati, Samoa, Sao Tome and Principe and Tuvalu.

leather goods), there are product groups also of export interest that have recorded more than average tariff cuts[12].

34. To a large extent, products made in IDCs and exported to developed market countries are covered by preferential trading arrangements which imply low-rate or zero-rate tariffs. The main preferential trade schemes benefitting IDCs are found in the trade provisions of: the Lomé Convention between the European Union (EU) and ACP countries[13]; the Caribbean Basin Economic Recovery Act involving preferential access to the United States market for Caribbean countries, CARIBCAN between Canada and Caribbean countries, the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA) between Australia and New Zealand and Pacific island developing countries, and individual generalized systems of preferences granted by other OECD countries.

35. Many **tropical products** are of significant export interest to IDCs. It is estimated that the erosion of preferences will be small because MFN tariffs were not high for most of these products. However, the elimination of preferential access to the EU market for coffee and cocoa beans producers is likely to affect the EU market share of some IDCs[14]. EU preferences for these products as well as palm oil had helped IDCs that incur high transport costs to reduce the comparative disadvantage entailed by these costs.

36. A number of IDCs are highly dependent on exports of **bananas**[15]**.** In the light of the revised GATT (1994), the EU's import regime of preferences/tariff quotas for bananas from ACP countries is regarded as an unfair trade practice by non-ACP, competing producers. This import regime, which is being challenged and on which a GATT panel made an adverse decision in 1993, is due to last until 2002. The uncertainty concerning its extension beyond this date makes the remaining period particularly critical for the concerned banana-producing IDCs, which are urged by circumstances to engage into long-term economic diversification.

37. **Sugar** is of particular importance to several IDCs[16], while it competes with sugar beet, a temperate agriculture product. Under the Sugar Protocol of the Lomé Convention, the EU buys country-specific quantities from ACP countries at a fixed price which is negotiated annually. As a result of the decrease in domestic support to European beet producers, prices of beet sugar are expected to diminish in the EU, and there is a risk that the intervention price of cane sugar which is offered to ACP countries by the EU will eventually decrease, even if quotas remain.

38. The **Agreement on Agriculture** provides for wide tariffication of existing non-tariff barriers, binding of resultant tariffs, and tariff reductions, as well as gradual phasing out of domestic support measures and export subsidies. Least

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[12] Details of tariff reduction for selected primary and processed commodities in the European Union, Japan and the United States before and after the UR can be found in: UNCTAD, *Analysis of the evolution of prices and trade of commodities to be expected in the light of the results of the Uruguay Round, with particular emphasis on their implications for developing countries, including their diversification prospects*, The Uruguay Round and international commodity trade and prices, Addendum, Statistical annex, Table 16, TD/B/CN.1/30/Add.1, 31 August 1995, pp. 23-28.

[13] 26 of the 70 ACP countries are island developing countries.

[14] examples: Sao Tome and Principe, Papua New Guinea, Solomon Islands

[15] The proportion of bananas in the structure of merchandise exports of the Windward Islands in the Caribbean was as follows in 1992: St. Lucia 61%, Dominica 58%, St. Vincent and the Grenadines 57%.

[16] particularly, Mauritius, Fiji, Barbados, Jamaica, Trinidad and Tobago

Developed Countries are exempted from these requirements[17]. Some IDCs, such as Cape Verde, Comoros and several small Pacific island countries, are **net food-importing countries.** They may suffer from increases in import prices of temperate products (cereals, meat) for which protection and subsidies will decrease. It is difficult to evaluate this effect with precision, because different factors such as agricultural supply responses in the importing countries and changes in consumption patterns or importing policies should be taken into consideration. A Ministerial decision was adopted at the end of the UR in favour of these countries[18]. Compensatory measures are expected to bring responses to this issue.

39. The **Agreement on Textiles and Clothing** provides for a gradual elimination of quantitative restraints under the Multifibre Arrangements (MFAs). Few IDCs have been bound by MFAs, as most textile-producing IDCs enjoy preferential market access for textiles and clothing. The gradual loss of preferences for IDCs that export to developed countries which are called to integrate MFA quotas into the general MFN framework represents a major challenge for these exporting countries, considering the competition brought by third countries that will be able to export without MFA restrictions.

40. In the textile sector, the question of comparative advantage is of particular importance. Because of the labour-intensive nature of the sector, few small IDCs have begun or successfully pursued textile production. Textile industries are mainly found in Mauritius, Fiji and Jamaica, where manpower has not been scarce and labour costs have remained within competitive ranges given the preferential access that these countries have benefitted from[19]. Textile products from ACP countries, subject to their compliance with rules of origin, are admitted duty-free on the EU market. Caribbean products have been enjoying preferential access to the United States market under regulations whereby products manufactured from United States-made inputs can be admitted on the United States market with a customs duty based only on the value added in the exporting country.

41. Textile-producing IDCs are affected by the 10-year phasing-out period during which third countries with significant competitive advantages will gradually receive MFN treatment from importing countries. It is important, for the concerned IDCs, to take advantage of this period to adjust or reconsider their specialization in the textile sector. Adjustments should imply either significant efforts to increase competitiveness in existing textile activities, or a certain extent of re-specialization, either within the sector through diversification into higher value-added products, or away from the sector by terminating least competitive productions[20].

42. Several Caribbean countries as well as Mauritius and Fiji have a **manufacturing** capacity with regard to such products as chemicals, consumer electronics, toys, footwear and sport equipment. Market access improvements resulting from the UR are beneficial to these countries. For IDCs that cannot

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[17] cf. UNCTAD, **The Least Developed Countries 1995 Report**, pp. 119-126.

[18] cf. Ministerial Decision on Measures Concerning the Possible Negative Effects of the Reform Programme on Least Developed and Net Food-Importing Developing Countries, 1994.

[19] Preferences have been given in the following markets: Mauritius from the EU; Fiji from Australia and New Zealand; Jamaica from the EU and the United States.

[20] For Caribbean countries, existing preferences vis-à-vis the United States market may be enhanced through tariff-free entry into the United States, i.e., NAFTA-parity treatment; on the EU market, ACP countries will continue to benefit from tariff-free access so long as the Lomé Convention will last.

specialize into products for which tariffs have diminished, the benefits are limited at present. However, export capacities may expand over time with existing enterprises improving their export potential and new enterprises being created to seize new trading opportunities. For such enterprises, the UR Agreements on non-tariff measures provide a global framework which protects them against unfair trade practices.

2. The Uruguay Round Agreements on non-tariff measures and "new issues" and their implications for IDCs

43. Multilateral disciplines on non-tariff measures have been significantly improved so that such measures will no longer be used as disguised forms of protection. IDCs exports have not been spared by non-tariff measures[21]. The Agreements on Safeguards and on Subsidies and Countervailing Measures are among the new instruments that regulate the use of non-tariff measures. Other areas in which the UR has enhanced the framework of international trade for developing countries in general and IDCs in particular include the "new issues" of services, trade-related investment measures and trade-related aspects of intellectual property rights.

44. The **Agreement on Safeguards** prohibits the use of voluntary export restraints, orderly marketing arrangements and similar measures that can affect the external trade of developing countries. It brings transparency in the procedure to be followed when safeguard measures are invoked, specifies the criteria to determine serious injury, regulates notification and consultation procedures and imposes disciplines and accountability in the use of safeguard measures. IDCs may find an advantage in the *de minimis* clause whereby a safeguard measure cannot be applied against a product from a developing country if this country’s share of the total imports of the relevant product in the importing country does not exceed 3%, and when developing countries with individual import shares of less than 3% account collectively for not more than 9% of the total imports. Considering that most individual IDCs will be unlikely to often account for more than 3% in the import structure of any importing country, the risk of facing safeguard measures will be limited.

45. The **Agreement on Subsidies and Countervailing Measures** imposes disciplines in the use of subsidies and countervailing measures. Special and differential treatment is accorded to developing countries and Least Developed Countries, considering the importance of certain subsidies in the public policies of developing countries. The use of subsidies by IDCs, within authorized limits, should be guided by the consideration of trading opportunities and island-specific supply constraints. Considering the complex nature of obligations and legal and administrative implications for national implementation of the Agreement, many member IDCs are likely to need technical assistance in this regard.

46. The **General Agreement on Trade in Services** (GATS) offers a sound framework for this sector of great interest to IDCs. The GATS liberalizes cross-border movements of persons only at senior technical or managerial levels. This, to a large extent, meets the interests of IDCs that have a prominent service sector (tourism, information processing, offshore finance, etc.) and need expatriate expertise to raise these activities to international standards. On the other hand, IDCs that would have a comparative advantage in exporting labour services and would count on remittances from nationals working abroad could find obstacles in other member countries, as the latter are not committed by the GATS to authorize free entry of labourers.

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[21] The World Bank estimated at 21% and 24% the proportions of Caribbean exports to the EU and the United States, respectively, that have been affected by non-tariff measures devised to restrict or control trade.

47. Most IDCs have significant comparative advantages in certain areas of services. It is in their interest to liberalize the entry of quality services as inputs to foreign exchange-earning sectors of services. Considering the importance, for service economies, of having access to advanced technology, some IDCs have put as a condition accompanying their schedule of commitments to the GATS the possibility of benefiting from the assistance of developed countries in improving their access to technological facilities. An example relevant to the tourism sector is the access to computerized reservation systems, an area which is affected by Article IV of GATS[22].

48. The **Agreement on Trade-related Investment Measures** (TRIMs) removes a certain degree of freedom in policy-making by prohibiting measures that are sometimes used by developing countries, including IDCs, *vis-à-vis* foreign investors: local content requirements, trade balancing requirements, minimum export requirements, etc. Usually, developing countries that apply TRIMs are desirous of redistributing the benefits of hosting multinational enterprises, and countering the use of restrictive trade practices by these enterprises. In most IDCs, however, local supplies are insufficient, non-existent or unsteady. Many IDCs, particularly in the Caribbean, are already widely open to foreign investors and not inclined to impose restrictive conditions. What matters more to these countries is the prospects that foreign direct investment brings with regard to indigenous employment. In larger IDCs, however, there may be a need to protect local suppliers of goods or services, and certain TRIMs may have been designed to that end. The Agreement on TRIMs, in this regard, may impose a constraint on policy options and limit the bargaining position of host countries *vis-à-vis* foreign investors.

49. The **Agreement on Trade-related Aspects of Intellectual Property Rights** (TRIPs) sets out a national-treatment commitment and a most-favoured-nation clause with regard to the protection of individual property. It concerns all intellectual property rights and sets out the obligations of member governments to ensure that intellectual property rights can be effectively enforced by foreign right holders as well as by nationals.

50. For many IDCs, the Agreement on TRIPs implies legislative revisions but has little immediate impact on trade and development strategies. Such impact could be significant if these countries were encouraging exports of technology-intensive goods, because of the increased cost of acquiring and using technology if the protection of this technology is effectively implemented. Such costs could erode the export competitiveness of certain imitation products, particularly in the textile field where a number of IDCs have been successful. In IDCs like in other developing countries, effective implementation of intellectual property rights obligations in technology transfers could be a factor adverse to industrial development by introducing a fair pricing of technology. But a positive effect could be the encouragement, for IDCs, to adopt appropriate technology in productive investment, and pay more attention to the question of the optimum size and type of equipment, a concern which may be conducive to greater efficiency and profitability and enhanced respect for the environment. Another special interest of IDCs will be the protection of their own intellectual property rights. An example can be found in the area of information processing activities, where computer software products are locally designed and need appropriate protection.

3. Systemic issue: the dispute settlement mechanism

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[22] cf. Article IV.1b of GATS: *Increasing participation of developing countries*, where "distribution channels and information networks" are cited.

51. Improvements in the dispute settlement mechanism and the scope for a greater participation of IDCs in the multilateral trade framework constitute an important area in which IDCs should benefit from the outcome of the UR.

52. The **Understanding on Rules and Procedures Governing the Settlement of Disputes** sets out the procedure to settle disputes that have not been settled through consultations. The new dispute settlement apparatus in the WTO comprises a Dispute Settlement Body (DSB) as well as an Appellate Body to consider issues of law covered in regular panel reports and legal interpretations developed by panels. An Appellate Body report will be adopted by the Dispute Settlement Body and unconditionally accepted by the parties within 30 days following its issuance to members, unless the DSB decides by consensus against its adoption.

53. IDCs will generally benefit from the improvement brought to the new dispute settlement system, particularly because the latter is more equitable between members with unequal bargaining powers. In the past, large countries could block the dispute settlement process more easily than any small contracting party could. However, the main problem that IDCs are facing with the new dispute settlement mechanism is their relative incapacity to cope with procedural requirements such as the various investigations and consultations implied in situations of dispute. IDCs that will be involved in dispute settlement matters will therefore need technical assistance to meet these requirements.

54. One of the major changes introduced by the WTO dispute settlement mechanism is the *negative consensus* approach. Under this approach, a consensus will no longer be needed in order to <u>advance</u> proceedings as was the case under the old GATT system. Instead, it will be needed in order to <u>halt</u> the proceedings from advancing at any stage of the formal dispute settlement procedure. This change can be regarded as an enhancement insofar as it removes the potential for blocking dispute settlement procedures. However, the effectiveness of the negative consensus principle can also be interpreted as having significant implications for developing countries, for example in the context of the challenging of trade preferences. In a situation of dispute settlement where the final decision would be favourable to the members which challenge the preferences enjoyed by IDCs, the probability of the DSB deciding *by consensus* against the adoption of the adverse report would be near to zero. In this framework, small IDCs with a highly concentrated export structure and an export performance dependent on preferences could lose their last chance of attracting an exceptional or differential treatment[23].

4. <u>Competition policy in the context of trade liberalization</u>

55. Enterprises, in island developing countries (IDCs), are often faced with a lack of opportunities to benefit from economies of scale. Many small enterprises would not have been able to remain profitable without the protection of tariffs or quantitative restrictions. Moreover, in small island societies, the temptation to protect may stem from links of kinship between policy makers and entrepreneurs. However, protecting small producers to allow competition to be confined to domestic suppliers would defeat the objective of liberalizing international trade.

56. It may then be in the interest of IDCs to facilitate the development of less fragmented, open economies with small numbers of efficient, larger

[23] Windward Island countries of the Caribbean have expressed this concern with regard to the challenging of the European Union’s banana import regime and preferences in favour of ACP countries.

enterprises. The question is how to maintain a sufficient degree of competition between such entities without sacrificing the gains from economies of scale and efficiency. Given the influence of globalization factors, it may be advisable to encourage competition to a domestic island market. Competing viably on such a market will not depend on scale factors only. Other factors that can enhance the chances of incoming enterprises include the possible superiority of a new type of competing product; the inherent value of a well recognized brand that is new to the country; an improved technology; or improved distribution methods, which can also be enhanced by increased competition. Such factors can put a positive pressure on incumbent firms in an island country and increase the efficiency of these firms and their capacity to become competitive exporters as well.

57. IDCs governments should facilitate the emergence of competitive enterprises, which are likely to raise quality standards while at the same time trimming price levels. This implies providing appropriate information on investment opportunities and appropriate local facilities for prospective foreign investors. Foreign direct investment as well as mergers or takeovers by foreign firms can bring about desirable results. Such developments, however, should be subject to competition policy if governments want to ensure that no individual actor on the market will enjoy excessive market power that would distort competition. Appropriate competition policy should therefore be devised, including the adoption of competition legislation and the establishment under such law of a Competition Authority responsible for monitoring the implementation of the law and advising the government on competition policy matters. The competition law should also include provisions for preventing anti-competitive mergers and acquisitions.

58. Exclusive dealers and sole importers are also commonplace in IDCs for many categories of goods such as vehicles, electronics and intermediate inputs that are used in the local production of goods or services. A lack of competition at the importing level may entail higher prices and restricted choices, and will not necessarily guarantee a better quality of the output. In a closed economy, collusion among producers or traders may stifle competition and result into higher prices for customers. Here again, the role of the Competition Authority in ensuring that competition is promoted throughout the domestic economy will have beneficial results.

59. There may be situations in which small enterprises, in IDCs, would temporarily need some protection in order to remain competitive, considering their importance for employment, regional development or other socio-economic factors. Competition policies, while reflecting the above concerns, should provide for sufficient flexibility with respect to industries that cannot withstand foreign competition in the context of globalization. Trade policies should therefore integrate developmental aspects.

5. Regional trading arrangements

60. The context of trade liberalization, for IDCs, does not only stem from the conclusion of the Uruguay Round. Trade liberalization requirements have been part of individual countries structural adjustment programmes since the 1980 decade, particularly in the Caribbean. At the regional level, the evolution of the CARICOM institution has also taken place in a liberalizing environment. The CARICOM presently aims at the creation of a Single Market and Economy, involving free (or unrestricted) movements of goods, services, capital and labour with a view to encouraging competitive production of goods and services. The context of regional trade liberalization, in the Caribbean, is also affected in the longer run by the recent creation of the Association of Caribbean States (although the latter does not provide a formal framework for trade integration),

as well as the project to form a Free Trade Agreement of the Americas (FTAA) by 2005. The existence of NAFTA may affect Caribbean trade in another way, through the threat of trade and investment diversion away from the Caribbean and for the benefit of Mexico, which is in a situation of free trade and free movement of capital and persons *vis-à-vis* Canada and the United States[24].

61. In the South Pacific, there are significant constraints on regional trade integration because of the lack of complementarities between partner countries, while development policies aim at stimulating trade and investment at a broader level, particularly through closer economic links with the wider Asia-Pacific region. Such links are expected, in turn, to increase trade within the South Pacific region[25].

62. In the context of trade liberalization, preferential arrangements under the Lomé Convention that are of export interest to ACP island countries should be continued, particularly for bananas, sugar and rum.

III. IMPACT OF TRADE LIBERALIZATION AND GLOBALIZATION ON THE SPECIALIZATION PROSPECTS OF IDCS

63. The globalization trend in the world economy can be defined as a movement of greater integration of national economies in the spheres of trade, investment and finance[26]. Trade liberalization, which involves movements of goods, capital and persons, is closely linked to the globalization trend as the latter implies reduced barriers to trade and wider competition, lesser obstacles to foreign investment and movements of persons, and a more transparent framework of rules and disciplines. These conditions, which are to a large extent created by the outcome of the UR, are essential to allow transactions in the global economy to be effective.

64. However, globalization is not likely to be achieved through the integration of all national economies or all regions. Certain categories of countries do not have a sufficient resource base or infrastructure to find a sizeable slot in the globalizing economy. Generally speaking, poor countries and small developing countries face the risk of remaining relatively marginalized from global trends.

1. Globalization and IDCs trade in goods and services

65. IDCs present a fairly wide range of degrees of integration in the globalizing economy, from total marginalization in the case of the most remote Pacific States, to new forms of involvement in the global sphere through advanced service sectors in certain territories of the Caribbean, the Pacific and the Indian Ocean. While IDCs have generally no impact on the world economy because of their small size, some IDCs could derive "spin-off" benefits from certain effects of globalization.

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[24] For details on the current situation of Caribbean trade integration, see: *Trade issues and development prospects of island developing countries of the Caribbean*, Report to UNCTAD, by D. Pantin, February 1996.

[25] For details on regional cooperation in the South Pacific, see: *Trade issues and development prospects of island developing countries of the Pacific*, Report to UNCTAD, by P. Osborne, February 1996.

[26] cf. UNCTAD, *Report of the Secretary-General of UNCTAD to the Ninth Session of the Conference*, TD/366, 2 January 1996, p. 10.

66. In the global economy, IDCs generally aim at developing a production capacity and a variety of inputs to meet the expectations of foreign partners. However, considering the difficulty to develop a "carrying" capacity, in an island environment, it is not surprising that many IDCs do not necessarily expect to become really integrated in the global economy. These countries are often more tempted to pursue the opposite "niche" market approach, as they expect the latter to offer economic opportunities of a more accessible nature.

67. Three driving forces in the globalization process are relevant to IDCs and can be examined accordingly: foreign direct investment; global communications facilities; and the new multilateral framework of trade liberalization.

1.1 *Foreign direct investment*

68. Successful sectoral developments, in IDCs, have often resulted from well absorbed foreign direct investment. The absorption capacity of a host country is carefully considered by any investor who pertains to the global economy. A "global" investor is an economic actor whose investment decision is made in accordance with a global strategy which presumably involves his simultaneous presence and intervention in several countries or regions. His production, marketing and finance functions are likely to be coordinated at a multi-national (or "global") level. Deciding to invest in a small island country will probably take place only if a situation of competitive advantage has been identified in the islands. Such advantage, given the characteristics of IDCs, will be judged on the following main criteria: the geographical situation of the country (its proximity to large markets or major shipping or air routes), the natural environment (for investment in tourism), socio-political stability (an essential condition to attract any foreign investor), the presence of a qualified labour force oriented toward service activities (for offshore finance, information processing, etc.), the presence of a minimum diversity and quality of domestic producer services, and the existence of a reliable communications infrastructure (a cross-sectoral condition to attract foreign investment). Another determining factor of the decision to invest will be the participation of the host country in global trade and investment liberalization, particularly its commitments under the Agreement on TRIMS (unconstrained openness to investors), the Agreement on TRIPs (protection of the investor’s industrial/intellectual rights) and the General Agreement on Trade in Services (cross-border transactions, commercial presence, movements of persons).

69. Foreign investors, in theory, are sensitive to the competitive position of a host country in terms of labour costs. Comparative studies of labour costs have shown that, while a few of the larger IDCs (such as Haiti, the Dominican Republic, Mauritius) have demonstrated cost competitiveness, a growing number of IDCs of smaller size may not have this advantage. However, the labour cost factor, in foreign investment cases that involve IDCs, has become less determinant than other factors of competitive advantage relating to skills, stability, reliability of supplies, etc. Patterns of investment incentives are also an important factor of investment decisions[27].

1.2 *Global communications facilities*

70. The efficiency of operations and transactions in the global economy is largely facilitated by the growing integration of communications facilities, which constitutes an important facet of the globalization trend and can contribute to reduce the marginalization of developing countries. Countries such as IDCs that suffer from problems of remoteness and high transport costs could expand their export opportunities if they were able to have access to major

[27] However, a decrease in the relative importance of this factor will be noted in Section 3 (Para. 76).

international maritime and air routes. Not all IDCs, however, are likely to deal, currently and in the future, with sufficiently large volumes of merchandise trade to be able to justify large investment in transport infrastructure for an enhanced integration in global transport networks.

71. A sector for which access to global communications facilities and information networks is very important is that of services. State-of-the-art telecommunications facilities are essential for IDCs that are involved in international tourism, information processing or offshore finance services. Enterprises of small or medium size in these countries can broaden their markets by using information networks that will allow them to disseminate information on their goods and services[28]. In particular, remote, low-income IDCs may find in "electronic commerce" facilities such as those offered by UNCTAD's Global Trade Point Network cost-effective instruments for rationalizing their product specialization and enhancing their marketing possibilities[29]. The globalization of communications facilities, with the possibility of extending them to the smallest and most remote IDCs, therefore serves a double purpose: (a) it can enhance the business environment of IDCs, thereby making these countries, *ceteris paribus*, more attractive to foreign investors in "global" industries such as tourism or offshore finance; and (b) it can also, under an opposite angle, increase the chances of IDCs to succeed in micro-initiatives such as "niche" export projects, which do not generally pertain to the "global" sphere, but often provide small IDCs with valuable economic opportunities. The reasons for IDCs preferences for either "global" or "niche" economic activities will be discussed below.

1.3 *The new multilateral trade framework*

72. Trade liberalization is now organized under the WTO framework, which aims at reducing the obstacles to trade in goods and services in an equitably regulated and disciplined manner. The increased international competition which will result from this framework will facilitate the globalization trend[30]. IDCs should benefit from the comprehensive scope of the UR, as the latter has addressed, beside tariff and non-tariff obstacles to trade, issues that are critical to island economies, namely, trade in services, trade-related investment measures and trade-related aspects of intellectual property rights. As a large majority of IDCs will eventually be members of WTO, trade liberalization should in the long run facilitate a better integration of these countries in the global economy. However, the transition to this integration is anticipated to be difficult for some countries, and will necessitate for all IDCs an appropriate economic development strategy.

2. Globalization and micro-initiatives in the specialization of IDCs

73. In the context of trade liberalization and globalization, trading opportunities are expected to arise for the benefit of all national economies. Yet, it is anticipated that the most disadvantaged countries will face difficulties in identifying these opportunities, and in taking advantage of them. The risk of marginalization exists for developing countries that have little or no capacity to create an enabling environment for new or enhanced specialization. In their geographical and economic diversity, IDCs are confronted by this

[28] cf. UNCTAD (1996), op. cit., p. 10.

[29] Cape Verde and Sao Tome and Principe are among developing countries engaged in developing a Trade Point.

[30] "Globalization is the product of liberalization": UNCTAD (1996), op. cit., p. 11.

problem. Some among the most disadvantaged IDCs demonstrate little ability to diversify or only maintain their specialization in tradeable goods or services. On the other hand, there are IDCs that have already developed viable trading activities and are equipped to diversify their economy in the light of new trading opportunities. By and large, the issue of specialization, for IDCs, rests in the choice between two apparently opposite approaches: (a) on the one hand, activities implying a direct relationship with foreign economic actors who partake of the "global" economy; (b) on the other hand, micro-initiatives involving island-specific goods or services with a unique nature, and generally a trade relationship with very few partners. The latter approach, which does not involve wide competition on foreign markets, is commonly referred to as the "niche" market approach, and its characteristics are somewhat opposite to those of "globally" induced activities.

74. It is generally assumed that most IDCs have little scope for viable specialization in "global" competitive activities. Moreover, many "globally" generated activities based on productive investment in merchandise trade may have undesirable environmental implications and may conflict with the objective of sustainable development. Meanwhile, "niche" export opportunities may be difficult to identify and have a limited impact in terms of domestic employment and foreign exchange earnings. The issue is to establish, in spite of these limitations, which approach is the most desirable for IDCs, and whether some progress can be made on both sides. Evidence from the experience of IDCs shows that: (a) there are merits in the two approaches; (b) the respective merits closely relate to the size, development level and degree of external openness of the countries; and (c) the two approaches are not incompatible and can reinforce each other and create a pattern of sustainable economic development.

2.1 *Globally induced specialization*

75. The legitimate interest that many IDCs have in globally related specialization can be generated by their perception of relevant comparative advantages and fostered by their desire to avoid marginalization from the global economy. Sometimes, the perception of a comparative advantage may be an illusion if the required business environment, which should be part of the country's advantage, does not actually exist to attract outside partners. The thrust toward free-zone industrialization in countries such as the Dominican Republic and Mauritius took place at times when the debate on "global" factors was less prominent, but a "global intuition" was already present among policy makers. These countries provide examples of situations in which attracting foreign investors to compete in global markets such as textiles and clothing has been regarded as the avenue to diversification away from dominant crops[31].

76. The conditions for successful specialization in "globally" related activities can be summarized as follows: an adequate physical infrastructure, including for international transport; the existence of a sufficient base of producer and professional services; a climate of socio-political stability; and sufficient openness to foreign investors in the trade-related investment regime. It has often been pointed out that the two factors that could in theory be regarded as *sine qua non* conditions for attracting foreign direct investment, namely, labour cost competitiveness and investment incentives, are often outweighed by the previously cited conditions. Labour costs, while remaining an important component of profitability for investors in IDCs, are less critically important for service sectors, where the largest proportion of investment now takes place. Investment incentives, including the rationalization of authorization and incorporation procedures, remain essential in IDCs like in other developing countries, but their generalization among competing countries

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[31] The Meade Report on *The economic and social structure of Mauritius,* in 1960, paved the road for successful economic development, as has been observed in that country in recent years.

has diminished their relative significance: if an IDC, in a given region, offers the same incentives as its neighbours do, its determining competitive advantage over the latter will have to be found among other factors (particularly, among qualitative factors) if that country is seeking a competitive edge in attracting foreign investors.

2.2 *"Niche"-type specialization*

77. Many of the intrinsic characteristics of IDCs impose severe constraints on the range of possibilities for viable economic specialization. In a situation of "small islandness", where advantages from economies of scale are difficult to find in production, marketing or transport, the context of globalization may remain a foreign phenomenon, and island regions could become pockets of marginalization. Many IDCs, however, retain chances to succeed through other development patterns that better match their intrinsic disadvantages.

78. There is a scope for micro-development experiences based on small-scale projects involving small inputs, small outputs and generally small market outlets, all of these remaining within sustainable development standards. Such projects, which can apply to merchandise trade as well as trade in services, are often referred to as pertaining to the "niche" market approach, which essentially involves a certain degree of uniqueness in the product and an exclusive or narrowly distributed marketing arrangement. Under the latter, a single producer or a small number of producers in the island country will export to a narrow market in which the importer will carry out the marketing and distribution functions, as such functions could not be efficiently fulfilled by the island producer considering the latter's small size. Often, the chances of success of a "niche" market venture rest on the ability of the island's foreign partner to transfer to the island-based producer his technology and know-how. Equally important to the success of the operation will be the importer's intimate knowledge of his "captive" market, in which he will be able to promote and distribute the goods or services efficiently.

79. The interest of IDCs in the "niche" market approach essentially stems from the awareness, among island entrepreneurs, of the "unique" nature of many island-specific goods and services. In particular, this approach can provide viable trading opportunities for nature-based ("green") products or environment-based services, to which island features of unspoiled nature and environmental beauty are generally conducive. As this definition reveals, the "niche" market approach is apparently opposite to the "globally" induced approach to specialization. That is mainly because of differences in the numbers of economic actors involved and in the size of markets ("global", as opposed to "captive"). In spite of such differences, it must be recognized that both approaches, if applied to an IDC, commonly involve a degree of external dependence, either on foreign direct investors, or at least on foreign partners that are likely to control the market.

80. These clear-cut concepts depict a duality of situations in which not all IDCs can be recognized. It is therefore important to point out the inter-relations and complementarities that can take place between the two approaches.

2.3 *Globalization and "niche" markets: a two-pronged approach to specialization*

81. Few IDCs provide pure examples of either "globally" induced specialization or "niche" trade activities. On the other hand, there are many cases of island economic activities that stand close to one of the two models while actually drawing on both in a viable manner.

82. Certain activities may demonstrate a high degree of specialization and display features of product and/or market "uniqueness" that delineate a situation

of the "niche" type. Among such activities, one finds specialized forms of tourism involving --always on a small scale-- water sports, medical or cultural features, or eco-tourism activities offered by service suppliers that have neither the capacity nor the desire of accommodating a wide foreign demand, and concentrate their promotional efforts on small market segments. One often finds, in these sectors, that the context in which the specialization has developed, and sometimes the way in which it is operated relate to "global" factors, and in particular, have been induced by a "global" demand. In an Eastern Caribbean tourism destination more richly endowed with an exotic flora and fauna than with traditional beach attractions, unique ecological features have been developed as part of "tourist packages" twinned with neighbouring islands which respond to a more traditional tourist demand. The nature island thus benefits at the same time from its own eco-tourism activities, which involve product uniqueness, and from a neighbouring market which is representative of the global tourist demand. The "green" island therefore receives indirect benefits from a segment of the global demand, as the primary destination of these tourists is the neighbouring island, not the nature island. In other types of activities, a common scenario will be that of a "niche" sector which has developed as a result of micro-initiatives following business ideas that originally arose from successful, "globally" competitive activities.

83. Conversely, certain economic activities may pertain to widely competitive sectors and be apparent participants in "global" trade while the products demonstrate a measure of uniqueness in relation to an island feature. The latter can be incorporated in indigenous material or goods or services of a cultural nature. By giving an exotic dimension to a product that should otherwise be normally competitive by "global" standards, an IDC can enhance its chances of diversification. This approach would provide, for example, a model for enhancing a clothing industry in an exotic IDC that has been benefiting from trade preferences and is now faced with the problem of adjusting to the global liberalization of the textiles and clothing sector and consequent erosion of preferences.

84. In many IDCs, the two opposite approaches could be reconciled, as they can reinforce each other. Success *vis-à-vis* global competition may take place in island economies that have been able to create, despite handicaps, an enabling domestic environment (infrastructure, skilled human resources, producer services, etc.). Such conditions can in turn enhance the chances of success of "niche" market activities, which often derive, as explained above, from initiatives that draw on competitive experience. Circumstances could also be met whereby a viable "niche" trade relationship involving a pioneer IDC and a narrow export market could develop successfully through a widening of this market base and the emergence of some inter-country competition. The broadening demand could in turn encourage an expansion of the production base, both in the pioneer IDC and elsewhere, particularly in neighbouring island countries as the latter would easily lend themselves to an imitation effect. The initial "niche" relationship, in this scenario, would be taken over by "global" producers and traders. Although few examples of this type of evolution have been observed among IDCs, one foresees a field of opportunities in the area of "green" products in the context of the widening trend of "green consumerism", in view of the ecological qualities of many IDCs.

3. General remarks related to sectoral specialization

85. Overall, the following general remarks can be made about the question of the potential of IDCs to achieve successful specialization or re-specialization in the context of globalization.

86. Considering the high degree of trade concentration in several IDCs that are still dominated by agriculture, viable re-specialization implies diversification within the commodity sector first, and secondarily toward other activities. Particular attention should be given to vertical diversification

involving higher value-added products based on existing commodities, and to products that meet the "green" demand.

87. IDCs which have developed an industrial base and have benefited from preferential market access are facing a major challenge which urges them to strengthen their competitiveness in current activities --a difficult objective for the most disadvantaged among these countries-- and organize their product diversification in the light of new trading opportunities and comparative advantages.

88. The widest scope for viable specialization or re-specialization in IDCs rests on the development of international services, a field of activities which is being encouraged by the new WTO framework and in which there is space for initiatives under which island economies can find a path to economic sustainability. A large proportion of the scope for services lies in specialized tourism, offshore finance, information processing, and a variety of micro-activities based on island-specific features and advantages.

89. For all IDCs, however, successful specialization or re-specialization implies the adoption of a development strategy that will adequately address the specific problems of "islandness", recognize and exploit all possible comparative advantages, and take into consideration the constraint of environmentally sustainable development in the efforts to raise the economic structures to higher levels of prosperity.

IV. CONCLUSIONS AND RECOMMENDATIONS

90. IDCs which are or will become members of the World Trade Organization should **in the long run** benefit from increased trading opportunities and the improvement of rules and disciplines in the new multilateral trade framework. The latter is expected to provide these countries with greater and more predictable market access for many export products. In this sense, the new environment which results from the context of trade liberalization and globalization affects island developing economies in the same way as it affects other open developing economies.

91. As a consequence of their specific disadvantages and intrinsic vulnerability, IDCs face particular challenges **in the short run**. There are limitations to these countries capacity to fully benefit from new trading opportunities because of the structural handicaps inherent in the economies of these countries. Many IDCs have a limited capacity to diversify their production and export base into activities with a higher value-added. The "phenomenon of marginalization" is analyzed by the Report of the Secretary-General of UNCTAD to UNCTAD IX as arising from a variety of structural factors among which many problems of IDCs can be recognized[32].

92. Among the factors of marginalization that are observed in IDCs are supply-side constraints such as the weakness of the technological capacity; the lack of entrepreneurial skills; and the lack of finance availability for small farmers and small-scale enterprises. The Report of the Secretary-General of UNCTAD also stresses the negative impact of commodity dependence, "a major constraint on the ability of many developing countries to take advantage of trading opportunities...", and points to structural impediments to attracting foreign direct investment: the scarcity of domestic savings, which reduces the scope for joint ventures, and the low level of productivity, which is partly due to the lack of adequate infrastructure.

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[32] cf. UNCTAD (1996), op. cit., p. 25.

93. IDCs are faced with many of the challenges that liberalization and globalization impose on the process of sustainable economic development. It is in the interest of these countries to endorse the global strategy proposed by the Secretary-General of UNCTAD for promoting international trade and enterprise development as related factors of economic development. Like many developing countries, IDCs are faced with the double challenge of alleviating the costs of their transition to the global economy, and seizing new trading opportunities. This "cost/benefit" challenge, however, can only be coped with in the light of the particular implications of islandness for trade development. As demonstrated earlier, IDCs could reconcile prospects for specialization in close connection with the global economy (the "global" approach) with prospects for specialization in small-scale, "niche" activities. The latter can even be enhanced by a proximity to the "global" sphere.

94. Following are some elements of a strategy for the sustainable economic development of IDCs in general, considering the risk of marginalization faced by many of these countries in the context of liberalization and globalization. As the main problem of island vulnerability relates to the situation of external dependence, which is common to all IDCs, the immediate objective is to strengthen the trade structure of these economies: sustainable economic development implies viable diversification to increase the resilience of the economy to physical and economic shocks, considering that, in a situation of narrow specialization and export concentration, such shocks can have severe effects. In order to achieve the objective of sustainable economic development, IDCs should give priority consideration to the following areas of action, in cooperation with their development partners.

. Alleviate the handicaps of islandness

95. IDCs should pursue their efforts to realize the investment necessary to overcome the physical handicaps which hinder competitiveness in production, marketing and transport and can be determinant factors of marginalization from the global economy. In this respect, particular attention should be given to the facilitation of transfers of appropriate technology with a view to enabling recipient countries to adapt to changing market conditions (including environment-related standards imposed from outside) and compete effectively. This

involves, *inter alia*, (a) allowing IDCs to have access to optimal-size equipment in a flexible manner and thereby reduce the problem of the lack of opportunities to benefit from economies of scale; and (b) make investment compatible with the domestic goal of environmentally sustainable development. The areas of investment considered here include international and domestic transport infrastructure and equipment and appropriate telecommunications equipment, and involve the development of a capacity to identify cost-effective, "optimum" size in public sector investment as well as productive investment. This objective implies strengthening the institutional and technical capacity to monitor technological developments and assess their relevance to island situations. Of equal importance, in this connection, will be the development of a variety of specialized domestic services (engineering, maintenance, repair, etc.), which may partly require the presence of expatriate personnel.

96. Particular attention should be given to the interest in promoting cooperative transport and communications arrangements, for example, through regional initiatives such as regional ports with facilities for transshipment of containers and other cargoes from trunk shipping routes to smaller islands, and regional ship repair arrangements.

. Promote appropriate macroeconomic and trade policies

97. Sound macroeconomic management is essential for creating or maintaining an environment of competitiveness, stability, predictability and business confidence. Competitiveness should be facilitated by realistic exchange rate

policies. Economic policies should also encourage an efficient allocation of production factors in the light of trading opportunities. The latter would be enhanced by the application of appropriate competition policies, including the implementation of national competition laws.

98. The larger IDCs should seek to promote integrated production structures based on strengthened backward and forward linkages in order to reduce external dependence in certain areas such as food imports. The scope for deriving trading opportunities from the new multilateral trade framework, however limited it may be for many IDCs, should be fully exploited. In this connection, technical assistance should be provided to the IDCs which have not moved to accede to the World Trade Organization or are only in the process of accession. Assistance should also facilitate implementation by member IDCs of their legislative and regulatory obligations at the national level.

. <u>Develop human resources in all areas relating to external trade and enterprise development</u>

99. Considering the scarcity of skilled human resources in many IDCs, training opportunities directly or indirectly relating to trade development and entrepreneurship should be sought in order to enhance the capacity of the countries to manage their transition to a situation of greater integration in the global economy, and to take advantage of the new trading opportunities. In IDCs where entrepreneurship is limited, human resource development and sensitization to enterprise development is of critical importance. For many IDCs where skilled occupations cannot adequately be held by local manpower, the GATS provisions liberalizing movements of persons at technical and managerial levels are beneficial.

. <u>Enhance the use of current trading opportunities</u>

100. The capacity of IDCs to better exploit existing trade preferences should be strengthened. In spite of the erosion of preferential margins, the generalized system of preferences (GSP) is expected to continue to play a significant role in facilitating the participation of IDCs in international trade. Awareness of GSP schemes, which are major determinants of trading opportunities, is essential if IDCs want to build export strategies. At the international level, rules of origin criteria should be flexibly defined for the most poorly endowed IDCs; accept relatively higher proportions of third-country inputs in the manufacturing of export goods; and provide for simple administration of documentary and shipment requirements. Other measures to enhance the effectiveness of GSP schemes should include the extension of product coverage to more goods of export interest to IDCs (e.g., tropical products, leather goods, textiles and clothing) and the harmonization of GSP rules of origin among preference-giving countries.

. <u>Take advantage of new trading opportunities</u>

101. An essential area of action, for IDCs, is to develop their capacity to identify new trading opportunities through systematic analysis, at the national level, of the implications of changes in market access for their exports, considering the existing patterns of trade and the potential for diversification. The development of trade information capacities through global communications facilities should be actively pursued. In order to stimulate responses from producers, sensitization and training efforts should be intensified and highlight the changes that have taken place with respect to tariff and non-tariff measures, quality standards and systemic procedures. Awareness programmes on new trading opportunities should be organized at national and regional levels. Particular attention should be given to the implications of "green consumerism" and related trading opportunities, non-tariff obstacles to "green" trade, and the scope for diversification into environment-based activities. Generally, more technical assistance will need to be devoted to the identification of new trading opportunities and dissemination of findings.

102. Awareness of the new rights and obligations of IDC members of WTO is also essential, and will imply continued technical assistance to facilitate the implementation of market access commitments and enable IDCs to implement legislative and regulatory changes with regard to non-tariff policies and new issues (TRIMs and TRIPs, in particular).

. Create an enabling environment for trade-related foreign investment

103. Taking advantage of new trading opportunities, in most IDCs, will often imply either foreign direct investment or operational links with foreign partners under marketing, technology transfers or franchising arrangements. Many IDCs should envisage a strategic review of their business climate, assess the important factors of attractiveness from the viewpoint of foreign investors, and integrate in their development strategy the thrust to create an "enabling environment": infrastructure, competitiveness of production factors, investment incentives, producer services, etc.

. Strengthen regional cooperation for trade development

104. While all IDC regions would not support with the same strength the idea of seeking a complete regional trade integration or the creation of free trade zones, it is broadly recognized that functional cooperation at the regional level is necessary in areas where most countries would be too small to achieve efficiency. Intensification of the tasks undertaken for the benefit of IDCs traders by organizations such as the CARICOM Export Development Agency, the Eastern Caribbean States Export Development Agency or the South Pacific Forum Secretariat should be envisaged or pursued with a view to enhancing the capacity of the relevant countries to maximise the realization of trading opportunities and minimize transition costs in the context of trade liberalization.