

The impact of the EPAs of the Cotonou Agreement  
on trade, production and poverty alleviation in the  
Caribbean region

Final Report submitted by the Poverty Research Unit, Sussex  
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# Contents

- Part 1: Introduction and Executive Summary
- Part 2: The Caribbean Region and the OECS: an overview
- Part 3: Overview of 3 OECS Islands: Dominica, St. Kitts & Nevis, and St. Lucia
- Part 4: Analysing Caribbean and OECS trade with descriptive statistics
- Part 5: Regional integration in the Caribbean: A gravity modelling approach
- Part 6: Partial Equilibrium modelling of the EPA process
- Part 7: Measuring the impact of trade reform on poverty for Dominica, St.Lucia and St.Kitts and Nevis

## Part 1: Introduction and Executive Summary

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## 1. Introduction

The objective of this research project was to consider the potential impact of an Economic Partnership Agreement between the EU and the Caribbean region. More specifically the focus of the research was on the possible impact of an EPA on trade, welfare and poverty in the small island economies of the Organisation of Eastern Caribbean States (OECS). In the study therefore we consider both the Caribbean region as a whole, as well as looking at individual islands. In order to draw appropriate comparisons and conclusions this includes both the OECS and non-OECS economies. Within the OECS the study has largely focussed on three of the OECS islands – Dominica, St.Kitts and Nevis, and St. Lucia.

It important to emphasise that a principal motivating factor driving the EPA process is the WTO incompatibility of the existing arrangements. This means that a central determining feature of the EPAs is the need by the ACP countries to liberalise their import regimes with respect to trade in goods. The key objective of this study, therefore, was to focus on the implications of the preferential liberalisation of trade in goods for the Caribbean region and within this for selected OECS economies. It is important to recognise therefore that in three key senses this study does not purport to provide a comprehensive analysis of the overall impact of an EPA. First, we do not consider the issue of changes in access to the EU market, which may be important in certain sectors for certain economies. For example there are on-going changes to the banana and sugar regimes, which will impact substantially on certain economies. Secondly, we recognise that important to the Caribbean region is the role of the service sector both in terms of its' share in GDP and with respect to trade. Services are also part of the EPA negotiations. However, where agreement on trade in goods is necessary for the WTO compatibility of any EPA, this is not the case for services. It is not therefore necessary for there to be an agreement on services, and consequently the extent to which agreement on services will de facto be achieved remains unclear. While it is not within the scope of this study to provide a detailed analysis of the services sector, we recognise and discuss its' importance to the region. Thirdly, we do not formally address the issue of the impact of changes in policy on long run rates of growth for example arising from changes in productivity.

This report therefore primarily focuses on the preferential liberalisation of goods trade by the Caribbean region, and is divided into seven parts. These are:

1. **Introduction and Executive Summary:** Here we outline the main objectives, results and conclusions derived from the study.
2. **The Caribbean Region and the OECS: An overview:** This part of the report provides a detailed overview of the Caribbean region, and where relevant of the OECS economies. The aim is to provide an important backdrop to the EPA process. In the first section, we provide an outline discussion of the EPA process and discuss some of the key issues, which emerge in considering the importance of the EPAs for the Caribbean region. In the second section we examine key economic and social indicators for the region, and their evolution over time. In the final section we turn to a discussion of the institutional background to integration in the region. Here we discuss the background both to regional integration within the region, as well as to trading relations with third countries.
3. **Overview of 3 OECS Islands: Dominica, St. Kitts & Nevis, and St. Lucia:** This part of the report aims to provide background information on the economic structure, trade and poverty in the OECS. The countries chosen as case studies for the research project are Dominica, St Lucia and St Kitts and Nevis. We chose these particular countries because of their strong exposure to imports from the EU and other regions, the extent of poverty in each country, and their on-going reliance on agriculture for GDP and employment. These three countries had also completed Country Poverty Assessments (CPAs) within the last 10 years which gave us the opportunity to understand in some detail the nature of poverty in each and hence the likely impact of the EPAs on poverty in each country. This part of the report has three sections, one for each of Dominica, St Kitts and Nevis and St Lucia, which discuss the profile of poverty, the economic structure, and the patterns of trade in each.
4. **Analysing Caribbean and OECS trade with descriptive statistics:** In this part of the report we examine key features of Caribbean trade as well as their evolution over time. We do this by looking both at aggregate trade statistics by source, and by considering a number of descriptive statistical trade indicators. The aim is to provide an overview of the evolution of Caribbean trade flows, trade and production structure, as well as to provide an assessment of the possible impact on the Caribbean region, and on the OECS of possible changes in trade policy, and notably of an EPA. This part of the report is divided into three sections. The first focuses on the evolution of trade over time. The second section examines more closely the existing structure of trade where we examine patterns of revealed comparative advantage, look at changes in the composition of trade, as well as in the product concentration of trade. Finally in the third section of the report we focus on the concepts of trade creation, trade diversion and trade reorientation and use descriptive statistics to provide an assessment of the possible welfare impact of an EPA.
5. **Regional integration in the Caribbean: A gravity modelling approach:** The key objective of this chapter is to consider the evidence on the extent and success of regional integration in the Caribbean as well as its' evolution over the past decade. As part of this assessment, this chapter distinguishes between

the OECS countries and the other CARICOM countries. Methodologically we look at both descriptive trade statistics as well as employing the more formal gravity modelling approach. This part of the report is divided into two main sections. The first provides some relevant background information on the Caribbean economies, on the Caribbean regional integration process, as well as on the levels and evolution of regional trade flows in the region. In the discussion where relevant we distinguish between the OECS and the non-OECS economies. The second section focuses on the formal gravity model we use to assess regional integration in the Caribbean over the period 1990-2000 and then details and discusses the results from our formal estimation procedure.

6. **Partial Equilibrium modelling of the EPA process:** In this part of the report we explore more formally the possible impact on goods trade of an EPA on the Caribbean economies. The focus here is on the implications for the Caribbean of opening up their market to EU exports. The methodology we employ involves the partial equilibrium modelling of Caribbean trade at a very detailed level of product disaggregation, for each of the Cariforum countries for which data was available. We run different variants of the model in order to explore the sensitivity of the results to different assumptions. Hence, we allow for both perfect and imperfect competition, we allow for the use of different underlying elasticities, and different levels of aggregation, and finally we explore the implications of different preferential liberalisation scenarios. This part of the report is divided into five sections. The first provides background information on the Caribbean economies and their trade flows. The second section details the underlying modelling structure. In the third section we explore the consequence for trade and welfare of the preferential liberalisation of trade with the EU with the different variants of the model. The fourth section addresses the issue of substantially all trade where we use the model to explore the sensitivity of the results to allowing “substantially” all trade to be liberalised. In addition to this we use the results from our model to consider how difficult it might be for the Caribbean region to achieve agreement with respect to which industries should / could be included in substantially all trade. We do this by considering the degree of natural overlap between the Cariforum economies for different specifications of the notion of substantially all. Inevitably also, this leads on to a discussion of the possibility and merits and demerits of special and differential treatment in and for the region. Finally, in the fifth section we explore the impact of two alternative trade liberalisation scenarios – MFN liberalisation, and preferential liberalisation together with the imposition of a flat rate consumption tax levied on all imports. The consumption tax is set in order to offset the loss of tariff revenue implied by the liberalisation process.
7. **Measuring the impact of trade reform on poverty for Dominica, St.Lucia and St.Kitts and Nevis:** The aim of this part of the report is to consider the impact of the EPAs on poverty for Dominica, St Lucia, and St Kitts and Nevis. We focus on two principal possible reforms – the consequences for domestic prices of preferentially liberalising all trade with the EU, and secondly the consequences for domestic prices of the same liberalisation of tariffs, but coupled with the introduction of a revenue-neutral consumption tax levied on all imports. The methodology involves using household survey data on

household expenditures to estimate changes in the cost of living relative to a reference poverty bundle that arise in responses to simulated price changes of key consumption items. These simulated price changes are those predicted in Part 6 of this report, i.e. those price changes that result firstly from reduction/removal of trade tariffs and secondly those that result from a revenue-neutral sales tax. We examine changes in the cost of living for different deciles of the per capita expenditure distribution, and for the poor and non-poor, and identify which types of households are more likely to gain or lose from the simulated price changes. This part of the report is divided into five main sections. Section 2 discusses the data that is available on living standards in each country and highlights some limitations of the survey data available to us. Section 3 describes the methodology adopted in the study. Section 4 presents background descriptive statistics on poverty correlates and expenditure patterns in each island and section 5 presents the results. Section 6 concludes.

It is worth noting that each of the component parts of the project have been written as far as possible to enable them to be read in a self-contained manner. Hence, readers who are particularly interested in specific sections of the report should be able to read those sections without needing to read the report in its' entirety. In the remaining part of this section we turn first to our key conclusions and recommendations arising from the report, and secondly to the executive summary, which pulls together the key issues, results and conclusions from the component parts of the work undertaken.

## 2. Key conclusions and recommendations:

- EPA induced preferential trade liberalisation by the Caribbean economies is likely to engender trade diversion and only modest amounts of trade creation and trade reorientation. This emerges both from a consideration of descriptive statistical indicators and from more formal modelling. The direct overall welfare impact is likely to be extremely small, or could be negative depending on how governments respond to the concomitant fall in tariff revenue.
- For the OECS there is likely to be only a small decline in poverty from lower prices in domestic markets arising from any EPA induced preferential trade liberalisation. The corresponding increase in living standards should be felt by all sectors of society, though slightly more for those who are poorer. The impact is likely to be small largely because of the relatively low importance of the EU in total imports and consumption, and because of the importance of food items in the islands' consumption baskets.
- EPA induced preferential trade liberalisation is likely to result in substantial losses of tariff and hence government revenue, thus requiring some adjustment from national governments both in terms of establishing alternative sources of revenue, but also in terms of expenditure.
- Given that that the direct welfare gains arising from EPA induced liberalisation are likely to be extremely small, this inevitably raises the question as to the desirability of such an agreement. Its desirability is thus likely to depend then on key features of the agreement itself, and also on developments in trade policy with third countries.
- In particular, more substantial welfare gains are likely to arise in the presence of either multilateral trade liberalisation, and/or through furthering the process of deep integration in both goods and services. Ideally therefore, it is important that any EPA induced trade liberalisation is pursued within a broader based multilateral liberalisation perspective, and that moves towards deeper integration within the EPA process and the CSME are also encouraged.
- The successful integration of the Caribbean economies into the world economy is more likely to be achieved with the successful implementation of the CSME. This is likely to enhance the flexibility of the region to respond to the changing nature of global competition, to encourage the exploitation of economies of scale, as well as to facilitate productivity improvements.
- There is mixed evidence to suggest that there is a growing trend for intra-OECS and OECS-Caricom trade to be lower than intra-Caricom trade, and lower than trade between other comparable countries. While this could indicate the difficulties faced by the OECS in integrating both regionally and globally, there are also alternative plausible explanations. Prima facie then, this does not necessarily provide further support for the special and differential treatment (SDT) of the OECS.
- Where there may be a case for SDT for the OECS economies it is important that any such policy identifies clearly the grounds for SDT and distinguishes appropriately between countries and their evolving needs over time.



Introducing asymmetries in trade rules, or in tariff lists, is highly likely to increase distortions and inefficiencies, as well as having important implications for the political economy of trade policy for these countries, and hence in the long run make it more difficult for the region to integrate successfully into the world economy.

- However, given the diversity across the countries of the Caribbean, agreement on a common list in order to satisfy the criteria of substantially all trade may be hard to achieve. This suggests the need for detailed planning and negotiation.
- A more satisfactory way of addressing the problem of different countries' development needs is not to introduce diversity in trade rules (either within Caricom/CSME, or within an EPA) but in the implementation of development assistance, aid and via appropriate regional funding mechanisms.
- This links back to the potential gains from signing an EPA, and thus to the extent and nature of development assistance and aid which may be provided to the Caribbean as part of the preferential liberalisation process. That development assistance and aid is likely to be important in helping to ensure that there are real lasting benefits from any EPA process.

### 3. Executive summary

#### Some background statistics...

1. The Caribbean region is extremely diverse in terms of GDP, GDP per capita, population, and economic structure. For example in terms of GDP Dominica is 35 times smaller than the largest of the Caricom countries, Trinidad and Tobago. The poorest country is Haiti with a per capita income level in 2002, of \$418 (US), and the richest, Bahamas, is over 38 times richer with a per capita income level of, \$16083 (US). Similarly, whereas Bahamas is largely focussed on tourism, and financial services, Trinidad and Tobago is more concentrated on petroleum and petroleum products, St Lucia on bananas, and traditionally St.Kitts and Nevis on sugar.
2. The OECS comprises the smaller CARICOM member states of Antigua and Barbuda, Dominica, Grenada, St. Lucia, St. Kitts and Nevis, St. Vincent, and Montserrat. Anguilla and the British Virgin Islands are associate members. These islands are typically small in terms of their population with the largest being Antigua and Barbuda with just over 750,000 inhabitants, and the smallest St.Kitts and Nevis with a population of 46,000. In terms of their per capita GDP the OECS are typically middle-income countries, except Antigua and Barbuda where GDP per capita is higher at \$9426 (US). Three of the islands - Antigua and Barbuda, Dominica, and St. Kitts and Nevis - are among the ten most indebted emerging market economies in the world.
3. While there are important differences, there are also a number of similarities. Notably, important for most of the economies is the role of tourism, and services more generally. Manufacturing usually comprises a small proportion of GDP though a number of the islands have a small and in certain cases increasingly diversified manufacturing base. Typically the industries tend to be in food processing and hence related to the agricultural sector, or light manufacturing such as textiles, soap, or assembly operations. Some of the islands are also diversifying into financial services Finally, natural resources are important for several of the islands. This includes gold and/or bauxite and petroleum products.
4. In the mid 1990's, approximately 38% of the total population in the Caribbean or more than 7 million people were classified as poor, or 25% excluding Haiti, (World Bank 1997). Poverty levels in individual OECS countries appear to be among the highest in the Caribbean region. The percentage of the population below the poverty line for the OECS were: Dominica, 39%; Guyana, 35%; Grenada, 32.1%; Nevis, 32%; St.Kitts, 30.5%; and St. Vincent and the Grenadines, 37.5%. In contrast the figures for Barbados, and Trinidad and Tobago are 13.9% and 21.2% respectively.
5. Trade in goods and services is extremely important for the region. Exports of goods and services as a percentage of GDP is typically high which reflects the smallness of these economies and their consequent high reliance on international trade. For most of the Caribbean countries trade in goods as a percentage of GDP is above (in some cases substantially so) the average for upper-middle income countries.

6. Over the last 10 years, CARICOM's average unweighted tariff on imports from 3rd countries has dropped from around 20% to 10%. Typically the most protected sectors domestically are Food, Beverages and Tobacco, as well as consumer goods, and that these are also the sectors that have witnessed the most modest decreases in average tariffs. The least the protected sectors are in most cases fuels and lubricants, as well as capital goods with the latter being the sectors, which have seen the largest reductions in tariffs. There is some evidence then that the structure of CARICOM's Common External Tariff (CET) differs between competing and non – competing imports, as well as between input, intermediate and final goods, forming a hierarchy in which non-competing goods bear the lowest tariff, while competing final goods bear the highest tariff.
7. Over 1980-1990 the OECS countries benefited from a number of preferential trade agreements such as the EU-Lome process, the US-Caribbean Basin Initiative and CARIBCAN. This resulted in an expansion in the agricultural sector as trade preferences gave improved access for these produces to external markets. Growth in the 1980s was supported by public investment financed primarily through aid flows, and the strategies to support growth were determined by the special and differential treatment given to export commodities. Growth rates of the OECS were on average at 4.1% per year between 1980-2003. There was a decline in growth to 3.3% between 1994-1999, and to just 1.2% in 1999-2004. Changes to the international trade regime resulted in price declines for OECS agricultural exports such as sugar and bananas. In addition a worldwide recession in the early 1990s adversely affected tourism. At the same time there was an increase in the rate of population growth due to tighter emigration laws in North America and Europe. Population growth rates in the region between 1990-1996 averaged at 0.9% per year compared to 0.1% in the previous decade.
8. OECS countries share certain similarities, such as the traditional dominance of the agricultural. This can be seen in the share of agricultural exports, which ranges between 45%-60% of total exports. On average, the manufacturing sector accounts for 7% of GD. The larger manufacturing firms in the OECS islands are often foreign owned and produce primarily for the US market. Locally owned firms are dominated by agro-industrial products, led by fruit, vegetable and beverage processing, and household products derived from the oils and fats industry. The OECS islands are increasingly becoming more service oriented with the move to services taking various forms.
9. The largest source of imports into the Caribbean region is the United States though it's share declined over 1995-2002 from 54.6% of total imports (over a sample of 78 countries) to 38.4%. The EU is the second largest external supplier with its' share over the period moving from 13.4% to 14.3% . The biggest increase in the share of exports going to the Caribbean is from Venezuela, whose share rises from under 2% to nearly 6% of all imports. There are also modest rises for Trinidad and Tobago, Germany, Brazil and Mexico.
10. On average the share of CARICOM exports going to the EU has tended to be somewhat stable over the last 20 years, varying between 15%-20% of total exports. With regard to exports the EU is clearly an important destination for several countries. For example, for Barbados, Surinam, St. Lucia, St. Vincent and the Grenadines, the EU is the most important export market. What is also striking is the importance of the Caribbean region as a regional export destination. This is

most marked for Antigua and Barbuda where 77% of their exports go to the Caribbean region, but the region is also important for Barbados (48%), Dominica, Montserrat, and St Vincent and the Grenadines (in each case around 60%).

11. In examining the changing pattern of trade by country and by source over time, what is clear is that the picture is extremely varied and little common pattern emerges across the Caribbean islands. It is generally not the case that the non-OECS Caricom countries' experience differs substantially to that of the OECS. The distinction is perhaps more between Trinidad and Tobago and the remaining economies. Examination of aggregate trade statistics for the Caribbean region is likely then to be dominated by the experience of Trinidad and Tobago, and partly, in turn, by the role of the petroleum sector in this economy. In particular the declining intra-regional OECS share of trade can be attributed to the growth of the trade of Trinidad and Tobago more than to declining export and import performance of individual islands.
12. This is important for the discussion about the distribution of the benefits from regional integration across countries. It is clear that Trinidad and Tobago have been more successful than other Caribbean economies in increasing their imports and exports. However this is not simply an intra-regional phenomenon and it is hard to attribute this to the process of Caribbean regional integration. The increase in trade is also true with regard to their internal and external trading partners. There are two economies, which have experienced a relatively significant decline in the real value of their exports over the period in question and these are Jamaica, and St. Lucia. What is interesting is that this decline in overall exports is partly matched by a decline in intra-regional exports for Jamaica but not for St. Lucia.
13. In looking at the indices of revealed comparative advantage the data indicated that the number of industries for which the region has a revealed comparative advantage is typically comparatively small. This suggests a high degree of concentration of economic activity in certain sectors. The analysis also indicated for each country the extent to which revealed comparative advantage with respect to both the EU and the World has changed over time. Not surprisingly the evidence here was mixed with certain economies experiencing quite substantial changes (eg. Trinidad and Tobago, and St Kitts), but for quite different underlying reasons. A decile analysis of the changing composition of trade then provided information on the evolving structure of trade. This also indicated that in many cases there has been quite substantial change over time in particular in the more significant export sectors.
14. Evidence on the degree of export concentration indicates that it is typically very high across the Caribbean economies with the Herfindahl export concentration index across products ranging from 0.06 for Barbados, to 0.62 for Suriname. While exports are clearly highly concentrated the key sectors across countries differ. Hence, if one compares the top three export industries by country, there is little pattern to the industries, which emerge as being significant. In many cases the dominance of particular export sectors has been driven by the preferential access to export markets. The erosion of those preferences and the progressive liberalisation of trade barriers is thus having and will continue to have significant implications for a number of the islands.
15. The overall picture that emerges therefore is of considerable diversity across the Caribbean. Despite that diversity, changes in external trade relations are likely to

impact significantly on a number of countries in the region in terms of exports and production, and particularly for those economies heavily dependent on the existing preference structure. Preferential liberalisation with the EU, as is likely under an EPA, is unlikely to lead to significant welfare gains because of the consequences of trade diversion.

16. What does this suggest in terms of policy options for the region? What is clear is that in many cases existing export and production structures are based on historical preferences granted and are unlikely to reflect true comparative advantage. There are therefore long run welfare gains, and reductions in poverty to be attained via a process of trade liberalisation, structural adjustment and integration into the world economy. The more widespread and multilateral is the process of trade liberalisation the more likely it is that the economies production structures will move towards those areas and sectors where they have a comparative advantage. This could of course be either in manufacturing or in services. Given the size and location of many of the economies, it is also more likely that there will be gains in efficiency and flexibility arising from the furthering of the process of Caribbean regional integration.

## **Caribbean regional integration...**

17. In 1992 the Caricom members agreed in principle to implement the Caribbean Single Market Economy (CSME), with the OECS States being given longer adjustment periods in implementing the CSME measures. Progress in implementation has been somewhat slow with the CSME due to come into force from January 2006. As of the latest update, 12 of the CARICOM have signed and ratified the revised treaty. The Bahamas has still to decide if it wants to join the CSME, Haiti has been given considerable flexibility with implementing the Treaty given its economic circumstances and Montserrat, a British territory, is awaiting entrustment from the UK.
18. Via the CSME the Caribbean region is attempting to deepen the process of integration within the region, and hence to move from being a common market to being more of a single market. This is rightly seen as being important in terms of increasing the competitiveness and flexibility of the region as it engages increasingly with the world economy. The success of that process in terms of economic growth and prosperity, and in terms of enabling the integration of the Caribbean islands successfully into the globalised world economy, will thus depend crucially on the extent to which the CSME is de facto implemented.
19. It is likely that real movement on deep integration in the region via the CSME is likely to enhance the flexibility of the region to respond to the changing nature of global competition, and is more likely to encourage the exploitation of economies of scale in production, as well as to facilitate productivity improvements. All of this is likely to improve economic performance and growth and to improve the competitiveness of the region. To the extent then that there is scope for further Caribbean integration than this should be focussed on the removal of any remaining obstacles to shallow integration; and the furtherance of the process of deep integration

20. The importance of effective Caribbean regional integration for economic growth and prosperity has long been established in the region. However, there are two key caveats to this, which often emerge in discussions. The first is that there are concerns particularly within the region as to the intra-regional distributional consequences arising from the integration process. The second caveat, concerns the extent to which regional integration in the Caribbean has de facto and de jure been realised. For example, built into the relevant treaties is the explicit recognition of the special and differential treatment (SDT) of the LDCs. That special and differential treatment in particular with regard to tariff and non-tariff barriers serves to introduce intra-regional trade barriers, which limit the extent of integration in the region. There is also the issue of further barriers to trade, such as “other duties and charges” levied by certain member states.
21. Within the Caribbean region there is a long-standing distinction between, what are known as, the More Developed Countries (MDCs) and the Less Developed Countries (LDCs). It is important to note that classification between MDCs and LDCs does not depend on per capita income levels. The MDCs are: Barbados, Guyana, Jamaica, Suriname and Trinidad and Tobago. The remaining countries are considered as LDCs. Hence, the LDCs are those countries, which are seen as being particularly vulnerable *either* due to their size, *or* due to their levels of economic development. All the OECS economies are thus LDCs.
22. That distinction between LDCs and MDCs is then an important feature of the regional integration process, as the LDCs have a number of possible derogations and exceptions, which are formally part of the CARICOM and CSME processes. Not only are there differences within the Caribbean regional integration process itself, there are also differences in the treatments of LDCs and MDCs in agreements between CARICOM and other countries such as with the Dominican Republic. In these agreements, for example, the MDCs are required to liberalise their tariffs with the partner countries, while the LDCs are not.
23. Descriptive statistics indicate that intra-regional trade flows tend to be dominated by Trinidad and Tobago which has significantly increased its’ exports to the region in both petroleum products and in other manufactured goods. For most of the OECS economies the region is an extremely import destination for their exports, with the share of total exports typically between 50-70%. The value of real exports for St. Lucia, and St. Vincent and the Grenadines to the region has risen since the early 1990s, that of Dominica was steeply rising until 1997, but has subsequently fallen, while for Antigua and Barbuda, and St. Kitts and Nevis there has been little change over the period. For each of these economies there has also been a steady rise in the real value of regional imports.
24. Gravity modelling results suggest that the propensity to trade between the non-OECS Caricom members is significantly higher than the propensity to trade between countries not part of a regional integration grouping. This result is obtained across a range of alternative model specifications. There is also little evidence of any significant changes in this over the period in question (1990-2000). However, it is not possible to conclude that the high propensity for intra-Caricom trade is as a result of Caricom. It is equally possible that trade could have been high between these countries prior to the formation of Caricom, and that indeed the high levels of trade were instrumental in the forming of Caricom

25. Turning to the OECS countries, the gravity modelling produces a mixed picture. When looking at the entire sample of countries, three features emerge. First there is evidence that the propensity to trade between the OECS countries, and between these countries and the rest of Caricom is significantly higher than between countries not part of a regional integration grouping. Secondly, over 1900-1995 the coefficient on intra-OECS trade was highly comparable to that for intra-Caricom trade, however that from 1995-2000 there appears to be more of a divergence, with a clear decline in the intra-OECS coefficient. One possible explanation for this could be agreements with third countries which have served to switch sources of supply. Thirdly, throughout this period the propensity to trade between the OECS countries and the other Caricom countries is lower than that for intra-Caricom trade, and lower than that for intra-OECS trade with a fairly steady decline in this coefficient over the period.
26. Alternative specifications of the model, which for example, focus on the smaller countries in the sample, suggest that the propensity for intra-OECS trade may be lower than the other countries in the sample. Hence there is some ambiguity in the results as to whether the OECS economies do trade relatively more among themselves in comparison to other small economies. This also suggests that we should treat with some caution the results obtained from an aggregate gravity model, which includes countries of very diverse sizes. This is clearly part of the agenda then for future research – both to understand this phenomenon in the context of the Caribbean better, but also methodologically to consider improved ways of handling such size issues in the context of a gravity model.

### **The EPA process and its' impact on trade, welfare and poverty...**

27. The Caribbean region is in the process of redefining its trading relations with the EU, and possibly also with themselves. These changes are taking place as a result of two parallel process – negotiations with the EU on Economic Partnership Agreements, (EPAs), arising from the Cotonou Agreement and the on-going implementation with the region of the Caribbean Single Market and Economy (CSME). A key aim of the Cotonou agreement is that of “*reducing and eventually eradicating poverty consistent with the objectives of sustainable development and the gradual integration of the ACP countries into the world economy*” (Article 1).
28. In terms of trading relations with the EU, the options open to the ACP countries, and the Caribbean region are (i) negotiate and sign an EPA with the EU. Under this scenario the new negotiated arrangements would start to come into force on the 1<sup>st</sup> of January 2008. A key feature of any EPA is the *reciprocal* liberalisation of “substantially all trade”. (ii) Choose not to do the above, in which case the countries would then have access to the EU via its’ GSP preferences or via the preferences granted under the EU’s Everything but Arms initiative (EBA) which in the Caribbean context is only applicable to Haiti.
29. For the Caribbean, parallel to the above, are the trading relations with the Americas, and in particular the Free Trade Area of the Americas (FTAA). Currently the Caribbean countries have access to the US market via the Caribbean Basin Initiative (CBI) but this is due to expire in 2008. There is also on-going talk

about the FTAA process. As with an EPA this would imply *reciprocal* market access. Unlike the EPA, the CBI and the FTAA processes have little by way of development assistance provisions and finance.

30. The EPA negotiations and subsequent agreements are intended to cover six thematic areas, which are: market access; agriculture and fisheries, trade in services, other trade related issues such as non-tariff barriers, regulatory structure etc; development cooperation; and other/legal issues.
31. The focus on this report was largely on the implications of increased shallow integration for goods trade, via the removal of Caribbean tariffs on EU exports. Parallel to the process of shallow integration, it is important to also mention deep integration. Deep integration can covers many aspects such as regulatory harmonisation, common standards, harmonisation of institutional structures, creation of appropriate institutions to manage and facilitate integration. The likely benefits both in terms of spillover effects (externalities) and in the public good nature of many features of deep integration are likely to be extremely important for services and services trade. Given the importance of services to the region, and given the importance of deep integration for competitiveness and growth in services it is then important that these issues are addressed and furthered both in the CSME process and in the EPA negotiations. An EPA shallow integration process which resulted simply in the more symmetric liberalisation of goods trade is likely to much less beneficial to the region than one which also focusses on deep integration issues, and which incorporated services, and the particular needs of the region with regard to services liberalisation.
32. While recognising that there are important cross country differences the descriptive statistical indicators examined in this report suggest that there is a prima facie case for arguing that EPA induced trade preferential liberalisation with the EU has the potential for substantial amounts of trade diversion, and comparatively little trade creation or trade reorientation. From a welfare perspective this suggests that the direct gains from liberalising the Caribbean import regime may be quite low or negative.
33. This was corroborated by the formal simulation of EPA-induced Caribbean preferential trade liberalisation with the EU at a disaggregated country and product level. Based on mid-range elasticity values, the results suggest that on average imports from the EU as a percentage of total imports could rise in the order of 7.1% under perfectly competitive assumptions, and 5.7% in the presence of imperfect competition. Corresponding to this there is a decline in imports from the US (-3.2% under perfect competition, -0.4% under imperfect competition), the other Cariforum countries (-0.4%, -0.1%), and from the rest of the world (-0.8%, -0.3%). For the OECS countries the figures were similar though the absolute magnitudes a little higher. Increasing the underlying elasticities results in substantially larger changes in trade flows. These results suggest some possibility of trade creation, little indication of trade reorientation, and considerable scope for trade diversion.
34. This is then reflected in the impact of the preceding liberalisations on net welfare for the Cariforum countries. Welfare gains are typically very small. Under perfect competition the net welfare gain, depending on the underlying elasticities used, ranges from between 0.07% to 0.99% of base total total imports. Under imperfect competition the welfare gain ranges from 0.45% to 1.48% when the monopoly



profits accrue to the EU suppliers, and from 1.95% to 3.16% of base imports when the monopoly profits accrue to domestic distributors.

35. In contrast full MFN liberalisation, under perfect competition, leads to a smaller increase in imports from the EU (4%), and more substantial increases in imports from the US (18.4%), and the rest of the world (8.6%), and imports from Cariforum suppliers decreasing by -1.7%. Correspondingly the welfare gains are considerably higher, at 2.69% of base imports on average for all the Cariforum countries, and 2.26% for the OECs economies.
36. The changes in trade flows are also accompanied by substantial losses of tariff revenue, which on average range from 20% - 30% for the non-MFN preferential liberalisation scenarios. Given the importance of tariff revenue as a source of government revenue for many of these economies, this represents potentially a substantial fall in government revenue.
37. Where the EU preferential liberalisation is combined with a consumption tax levied on all imports in order to compensate for the loss in tariff revenue, there is a smaller increase in EU imports than in the base (6%), and more substantial decline in imports from the remaining suppliers – the US (-3.2%), the Rest of the World (-1.8%) and the other Cariforum countries (-0.9%). This simulation leads to a decline in welfare amounting to -1.55% of total imports for the Cariforum average, and -1.62 for the OECS countries. That decline in welfare occurs because of the imposition of the consumption tax on all imported goods.
38. We considered also the implications for the preferential liberalisation of “substantially” all trade. As a working assumption we assumed that there may be different criteria for defining substantially, but that on average the Cariforum countries would liberalise 80% of their trade. Using a criterion which excluded the 20% of industries which generate the most tariff revenue the impact on trade flows was diminished, and the welfare gain decreased to 0.13% of base imports for the Cariforum average, and 0.16% for the OECS economies. De facto this simulation was run on the basis of allowing for special and differential treatment, as the exclusion of industries was achieved on a country by country basis.
39. We also considered the impact of the EPAs on poverty in the small island economies of the Caribbean, with a particular focus on Dominica, St Lucia, and St Kitts and Nevis. We focus on two principal possible reforms - the consequences for domestic prices of liberalising all trade with the EU, and secondly the consequences for domestic prices of the same preferential liberalisation of tariffs, but coupled with the introduction of a revenue neutral consumption tax levied on all imports. The analysis focuses on the impact on poverty of changes in import prices and primarily of the prices of food items figuring in the islands’ consumption baskets. We do not consider the impact on poverty via changes in wages or employment. This is partly for reasons of data constraints, and partly because wages are likely largely determined by changes in sectors (export, government and services), which we do not model here.
40. The methodology involves using household survey data on household expenditures to estimate changes in the cost of living relative to a reference poverty bundle that arise in responses to simulated price changes of key consumption items. We examine changes in the cost of living for different deciles of the per capita expenditure distribution, and for the poor and non-poor, and

identify which types of households are more likely to gain or lose from the simulated price changes.

41. The evidence suggests that there are strong relationships between certain household characteristics and the probability of being poor. In Dominica, households with better educated heads are less likely to be poor, as are female headed households. Households with higher dependency ratios are much more likely to be poor, as are households with larger proportions of unemployed members. There is no statistical evidence of a link between poverty and employment in agriculture in general or in the banana sector in particular. However some sectors are associated with reductions in the probability of being poor: households with more workers in transport and the government sector are less likely to be poor. The results for St Kitts and Nevis, and for St Lucia are similar, although we do not have access to detailed employment data to fully explore the importance of sector of employment. Households with better educated are less likely to be poor; rural households are more likely to be poor and households with more dependants and fewer workers are generally more likely to be poor. It should be stressed that not all of these results are statistically significant so need to be treated with caution. However they do provide some qualitative information about the nature of poverty in the Caribbean.
42. On the basis of the two experiments (the change in prices arising from the reduction in tariffs on EU imports, and change in prices of the same liberalisation of tariffs, but coupled with the introduction of a revenue neutral consumption tax) we show that this results in falls in the average cost of living in almost all cases. The exception is for St Lucia where there is a very slight increase, 0.14%, in total annual expenditure in the presence of the revenue neutral sales tax.
43. In order to assess the *real* reductions in the cost of living, the reduction in household specific cost of living need to be compared to a reference standard. In the absence of data on income we estimate the cost of the consumption bundle used for setting the poverty line in each country. This analysis indicates that for St. Kitts and Nevis, and for St. Lucia, there are real income gains across the whole distribution, whereas for Dominica, it tends to be the poorer deciles which experience the real increase in living standards.
44. Looking at poverty headcounts although the households in the lower deciles gain on average by proportionately more than the reduction in the poverty line, poverty headcounts may rise. This is because either the gain is not sufficient to lift a poor household over the poverty line, or the loss of a non-poor household pushes it below the poverty line. In Dominica, headcounts rise by as much as 2.31 percentage points. St Kitts experiences smaller increases, Nevis relatively little change under each simulation, while St Lucia sees poverty headcounts falling under most scenarios.
45. Finally we explore the characteristics of the winners and losers in each country under each simulation. For Dominica generally, households with better educated heads of household do less well than those with no education. Female headed households and older heads also appear to do less well than male headed households and younger heads, Households outside of the main urban areas are predicted to experience greater reductions in the real cost of living. With the revenue neutral sales tax the households with large number of dependants are likely to experience smaller reductions in the real cost of living. Finally,

households with more workers and with smaller proportions of unemployed members are predicted to experience smaller real improvements in the cost of living. For St. Kitts, and Nevis, and for St. Lucia, the results are qualitatively similar. As earlier it should be stressed that not all of these results are statistically significant so need to be treated with caution.

46. Our results show that generalising about the potential impacts of preferential trade liberalisation should be done with caution and further underline the need for country specific studies. The pattern of relative gains and losses is likely to vary across countries. One generalisation is possible however: the potential impact of the EPAs on poverty in the Caribbean via the price changes included here is likely to be small.

### **Special and differential treatment, and substantially all trade...**

47. For the OECS major changes to their economies' are taking place and will continue to take place as a result of the changes in the regional and international trading environment. Their economic development strategy to date has been based around special and differential treatment that guaranteed access to external markets for key products and at prices which supported inefficient production, that maintained non-reciprocity in preferential trading arrangements both regionally and with non-regional trading partners; and which provided them with longer adjustment periods to implement CARICOM regional integration measures. The combination of all these measure has been a major factor in contributing to the level of economic development in the region and thus their simultaneous dismantling will undoubtedly have major consequences.
48. Justification for SDT typically derives from a perceived lack of resources / structure to engage fully and successfully in the integrated economy. That perceived lack of resources or structure can refer to either a lack of human or physical infrastructure, or because of weaknesses in the underlying institutions be they legal, regulatory or fiscal for example, difficulties in accessing appropriate forms of credit, and/or due to the size or location of a given economy and hence its' potential vulnerability. It is undoubtedly the case that for certain, often very small economies, there are indeed difficulties associated with one or more of the above which make it more difficult for them to engage more successfully in the global economy.
49. We recognise that there may indeed be a case for special and differential treatment for particular economies under certain circumstances. In order to be successful SDT needs to be able to distinguish between countries and thus to be able to recognise their different needs, and the evolution of those needs over time. Other wise SDT is likely to be a blunt instrument that arbitrarily includes / excludes countries, and is less likely to be successful in addressing the needs of specific countries. It is also important to recognise the political economy implications of SDT which can result in sectors and countries effectively indefinitely maintaining protection of inefficient industries.

50. It is thus important to consider whether the form of proposed SDT is more likely to help or to hinder the successful integration of a given country into the global economy. In terms of trade negotiations the forms of SDT typically discussed include: (i) differential and improved access to the markets of trading partners, (ii) differential restrictions with regard to access of the trading partners to the domestic market; (iii) flexibility in the implementation of given agreements, for example with respect to timing or coverage of goods, and (iv) differential rules being applied to different partners. There is also an issue of whether any differential treatment, which is granted should be done so on a permanent or temporary basis.
51. SDT in the Caribbean region is firmly grounded and in part justified in the region by the issue of the uneven distribution of the gains from the regional integration process, and in part by the perceived vulnerability and geographical isolation of the LDCs such as the OECS, as well as the perceived lack of resources for engaging in the regional or global economy. Vulnerability includes proclivity to natural disasters, as well as economic vulnerability which in turn is closely related to issues of economic size and economic diversification.
52. In this report we provide mixed support to the argument that the experience of the OECS economies may be qualitatively and quantitatively different to that of the remaining Caricom economies. That different experience is often used to argue for special and differential treatment for the OECS, and the LDCs. However, we would argue that one has to be extremely careful in both justifying any special and differential treatment as well as in its implementation. It is important to understand the underlying causes of any differences and then to design policies which minimise distortions and which facilitate integration into both the regional economy as well, as the wider international trading community. SDT may not be the best route for this.
53. Hence, to the extent that OECS regional trade is lower/different it is important to understand the causes. For example it may be that for reasons of size and vulnerability the OECS economies have more difficulty in engaging in the process of regional integration. which could then be offered as a argument justifying SDT. Alternatively lower levels of intra-OECS trade could be due to the existing nature of SDT, which has enabled these economies to protect key industries but at the expense of long run competitiveness. Or, that intra-regional trade in goods is lower for the OECS economies because they are structurally different from the larger economies because of the greater importance in services. The decline in the intra-OECS coefficient identified in the base regression could well be a reflection of the increased specialisation in services which is taking place. Hence rather than indicating a problem, the lower levels of manufactured goods trade may be a positive indication of structural adjustment taking place in the economy.
54. Discussions of SDT in the Caribbean and in the context of the EPA negotiations are also complicated by three factors. First, the existing presence of SDT within the region itself given by the distinction between LDCs and MDCs. Secondly, the inclusion of the Dominican Republic in the Cariforum grouping, and hence in the EPA negotiations. Thirdly, because of the relationship between the EPA process, and the process of regional integration in the region and in particular the CSME with its' inbuilt SDT.

55. It is therefore extremely important to be very clear about the grounds for any special and differential treatments (infrastructure, institutions, size/location) in the region, and given those grounds to consider carefully optimal policy responses. Our view in this report is that introducing asymmetries in trade rules, asymmetries in tariff lists etc. is highly likely to increase distortions and increase inefficiencies and in the long run to make it more difficult for the Caribbean economies to successfully integrate into the world economy, and that therefore such form of SDT should be avoided.
56. If differential treatment with regard to tariff liberalisation is to be sought a preferable option, though far from ideal would be to have a common list, but possibly with different time scales for specific countries. Clearly introducing different time scales also introduces distortions and adds to bureaucratic complexity, but less so than with differential lists. In addition as the sole difference is over time scale in principle the SDT is time delimited which should introduce more appropriate incentives in the long run.
57. If there is to be agreement on a common list to cover substantially all trade, than this will require detailed negotiations over the composition of that list. On the basis of various possible criteria (high tariff revenue, high tariff, largest welfare gain....) we have explored the degree of overlap across Cariforum countries over the industries they would wish to exclude. Using these criteria we show that there is very little overlap criteria, which of course derives from the high degree of heterogeneity across the Caribbean economies. This, in turn, suggests that reaching agreement on a common list of industries to be excluded under substantially all trade may be fairly difficult to achieve and that therefore the process of detailed negotiation may be complex and protracted.
58. A more satisfactory way of addressing the problem of different countries' development needs is not to introduce diversity in (trade) rules, but in the implementation of development assistance and aid. We would therefore argue that there is a need for addressing the concerns of specific countries via this route as opposed to via introducing distortions in the underlying trade rules. That development assistance could be channelled within the region itself, both through the creation of a regional development fund, and via development assistance and aid through the Cotonou agreement.