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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,

[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