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Background and Motivation

Lack of supply response following significant unilateral liberalisation of trade regimes and market opening in developed and relatively advanced developing countries has prevented many low-income economies from taking advantage of the growth in worldwide trade and investment flows. Most of these countries lack basic infrastructures, skilled human resources and managerial capacity, and this inhibits trade-led growth and development. The absence of effective supply response in these economies has also meant their weak integration into the global economy. Trade capacity building has therefore become a major national and international concern in attempts to ensure beneficial participation by poor and vulnerable economies in world trade.

Financial and technical assistance from multilateral and bilateral donors aimed at facilitating the integration of developing countries into the global economy through initiatives that expand trade has been in operation since foreign aid was considered to be a means for supporting growth and development in developing countries. Under the World Trade Organization's (WTO) Doha Round of multilateral trade talks, technical assistance for trade capacity building became a prominent issue. In 2005 the Hong Kong Ministerial Declaration called for aid for trade (AfT) to help developing countries build the supply-side capacity and trade-related infrastructure that they needed to help them implement and benefit from WTO agreements and more broadly expand trade. AfT emerged during a period of increased aid commitments with the clear purpose of providing additional funding (i.e. on top of existing aid commitments) for developing countries' trade-related needs. A WTO task force identified six categories of AfT, building on the definitions used in the WTO/OECD trade-related and capacity building database: trade policy and regulations; trade development; trade-related infrastructure; building productive capacity (including private sector development); trade-related adjustment (including support for adjustment associated with changes in international trade regimes); and other trade-related needs.

While AfT has become part of the established terminology in trade policy discourse involving the WTO, the categories of aid falling under the task force definition have existed for decades, making it possible to examine the impact of this type of assistance in order to identify the most effective interventions. Calì and te Velde (2008) analysed the effects of past AfT on trade-related performance for a large set of developing countries. Although they found that AfT had a generally favourable impact on exports and the costs of trading, they concluded that these effects were likely to depend on specific circumstances (e.g. the type, focus and sector of aid programmes, and whether AfT removes binding constraints).

This paper extends the assessment of AfT to a specific group of countries, known as small and vulnerable economies (SVEs). SVEs are a group of developing countries facing unique challenges related to their integration into the global economy.[1] The group is mainly made up of Caribbean and Pacific small and island states, whose exports tend to be concentrated in a few sectors and are extremely vulnerable to volatile international markets.

Due to their small populations, the domestic market is small in these countries. As a result, most of the firms are small and medium-sized enterprises with limited opportunities for reaping the benefits of economies of scale and investing in research and development.[2] In addition, most SVEs have a poor investment climate, weak institutions, remoteness and lack of skilled labour or adequate human capital, which limits access to external capital and constrains industrial development. Small states are also characterised by lack of competition in product markets. This leads to a misallocation of resources, inefficiencies in production and lack of incentives for innovation. Moreover, the small size of the domestic market often implies that in most sectors production cannot enjoy economies of scale. All these factors contribute to high unit production costs for firms in these countries. The high production costs are compounded by high transportation costs due to the remoteness and insularity of many small states. This implies that SVEs need to charge higher prices to stay in business or else accept lower returns on some part of their costs as compared with larger economies.

The vulnerability of small states to fluctuations in input and output prices is aggravated by their undiversified economic bases, which itself is in many cases an outcome of their limited size and the scarcity of human capital. For most economies in the Pacific and Caribbean regions, the combined share of the first and second commodity/service in total exports of goods and services is over 50 per cent. Many other small states in different regions exhibit a similar pattern, which indicates the higher vulnerability of these states to internal and external shocks.

In addition, in the context of wider integration, Mattoo and Subramanian (2004) argue that small states face systematic problems within the multilateral trading system despite acquiring significant influence in the system since the Uruguay Round. This is because of their limited bargaining power in trade negotiations and misalignment of their interests with those of the broader trade liberalisation agenda. Importantly, the cost of doing business in small states seems to be generally higher than in other countries. In a Commonwealth Secretariat study, Winters and Martins (2005) find that business costs, particularly transport and labour, are significantly higher in small states.[3] On average, micro (and very small) states face cost penalties ranging from 22 to 222 per cent relative to the median country. The authors argue that small consignment size, poor infrastructure, lack of competition and weak institutions inflate the costs of trade and create strong economic disadvantages for these countries.

In this context, well-designed trade-related assistance may help SVEs face the challenges posed by their characteristics. This is particularly the case during a time when the prospects for small states have deteriorated further due to (future) preference erosion and the emergence of new and large competitors (Briguglio *et al.*, 2006). Many small economies are critically dependent on trade preferences that they have enjoyed for a considerable period, but are now being eroded because of changing trade regimes in developed countries. There is evidence that some of these countries are likely to face severe consequences from further multilateral trade liberalisation. Given all this, a review of the small states agenda proposed in the Commonwealth/World Bank *Joint Task Force Report* (2000) suggests the need for small states to reposition themselves in the global economy and move further into knowledge-based and service industries. Qureshi and te Velde (2008) suggest how this can be done and how AfT can play a role. The report also calls for a renewed effort by the donor community to help small states address the challenges of adjusting their economies. It is worthwhile pointing out that the WTO's AfT agenda includes helping countries to adjust to trade shocks and that mitigating the loss of trade preferences through most favoured nation (MFN) tariff reductions by developed countries constitutes an interest of small states.

This paper takes the issue of aid for trade in small states seriously. It sheds light on the extent to which SVEs have been able to access AfT funds and on whether and to what extent this assistance has helped SVEs improve their trade performance. It is divided into seven sections. Section 2 examines the rationale for AfT to SVEs by looking at the evolution of their significance in global trade and the expected costs of adjustment from trade integration. Section 3 describes the programmes and institutions offering AfT and in particular programmes for countries such as SVEs. Section 4 takes stock of the volumes and types of trade-related assistance that SVEs have received so far and compares them with other developing countries. Section 5 analyses how AfT could help developing countries integrate in the global economy through an export demand model with particular reference to SVEs; it also reviews some suggestive evidence on the effectiveness of AfT on trade-related performance. Section 6 provides empirical results associated with the impact of AfT on export performance in SVEs and other developing countries. Section 7 concludes the paper by drawing some policy implications for SVEs.