3

Possible Trade Implications for Small States

In order to see how these trade channels may affect small states, let us briefly describe the characteristics of their international trade. Their small market size and remote location tend to put small states, and small island states in particular, at a disadvantage in international trade. Due to the small domestic market, most of the firms are small and medium-sized enterprises (SMEs) with limited opportunities for economies of scale and investment in research and development.[5] Most small states lack skilled labour or adequate human capital, which limits access to external capital and constrains industrial development. In several cases, limited market size and collusion between business and government imply a lack of competition. This leads to misallocation of resources, production inefficiencies and lack of incentives for innovation. All these factors contribute to high unit production costs. These are compounded by high transportation costs due to the remoteness and insularity of many small states (and of all of those included in the sample used in the data analysis). Small states therefore need to charge higher prices or to accept lower returns on some part of their costs, as compared to larger economies. Winters and Martins (2004) calculate the income penalties suffered by micro states (up to 12,000 inhabitants) and very small states (up to 200,000 inhabitants) to be so large that exports in a free trade regime are virtually impossible for them in a large variety of sectors.

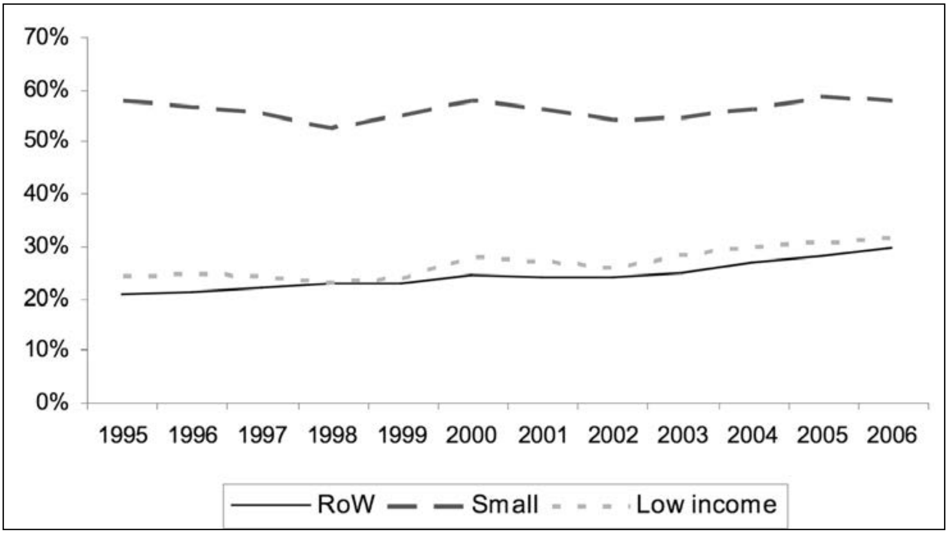
Such high (average) penalties have two important implications. First, small states tend to have a lowly diversified production structure, with most exports concentrated in a few sectors, and a large number of products and services acquired from abroad. For most economies in the Pacific and Caribbean regions, the combined share of the first and second commodity or service exported is over 50 per cent of total exports of goods and services. Second, they rely more than other countries on external assistance, including trade preferences, aid and remittances.

As far as the lack of diversification is concerned, the reliance on imports for a large part of the tradable sector makes small states particularly open to trade. While openness facilitates specialisation and increases the productivity of domestic industry, it also makes these countries more vulnerable to sudden shifts in international demand. Figure 1 shows the higher dependence of small states on foreign markets relative to the rest of the world. Although such dependence (measured as share of GDP) has been declining relative to that of other countries, it is still twice as great as that of the rest of the world and that of low-income countries.

3.1 Trade in goods

The majority (around two-thirds) of small states' trade is in goods, of which small states are net importers (Figure 2). This is consistent with the fact that small size is

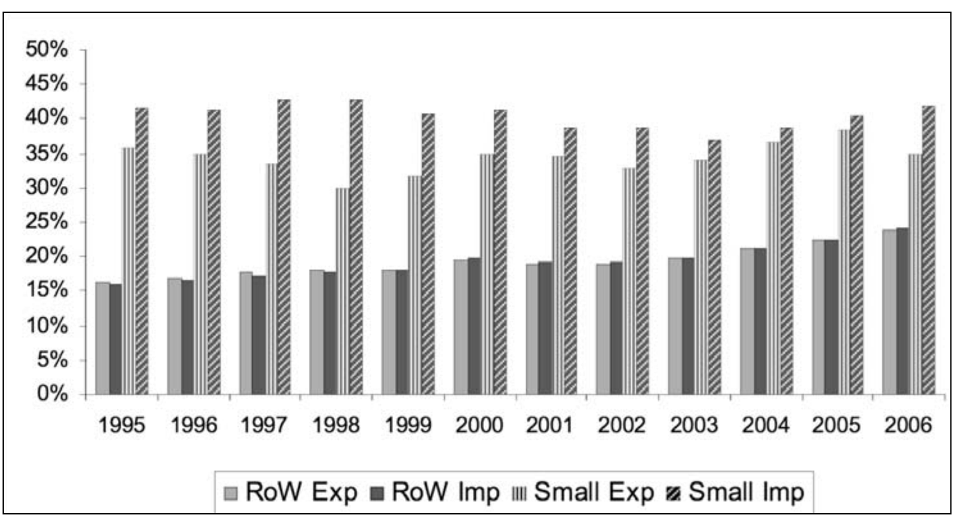
Figure 1. Exports of goods and services (percentage of GDP)



Source: *World Development Indicators* (2008)

associated both with scarce economies of scale (important for capital-intensive manufactures production) and often with a lack of significant natural resource endowment. Trade in goods in small states has remained stable over the past decade relative to the size of their economies, while it has increased in the rest of the world.

Figure 2. Exports and imports of goods (percentage of GDP)

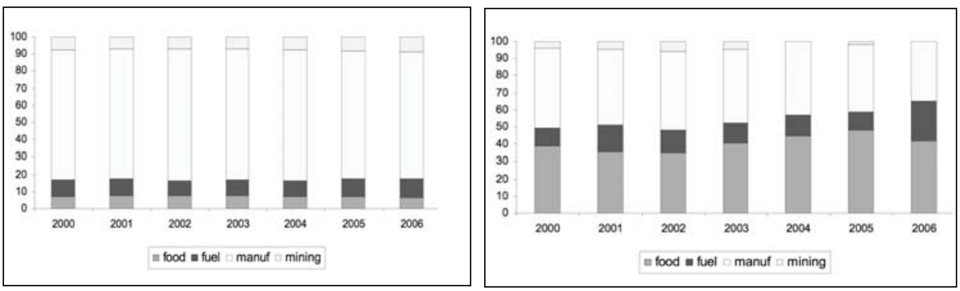


Source: *World Development Indicators* (2008)

Unlike for the world as a whole, manufactures are not the major goods exports from small states (Figure 3).[6] This is probably due to the lack of meaningful economies of scale in small states, as well as to the trade preferences received by these countries. These mainly cover agricultural products, e.g. tropical products, beef and rice, which have become their largest export category. For certain small countries (e.g. Swaziland and the Caribbean basin countries), these represent important niches of specialisation, accounting for a large part of their merchandise exports.

Figure 3. Distribution of exports of goods across major categories

World | Small countries



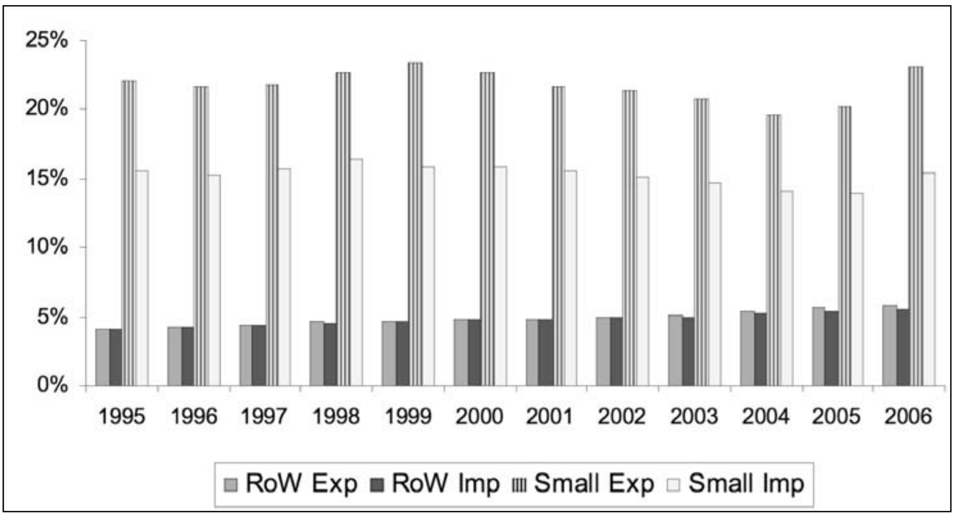
Note: the figures are averages weighted by countries' export values.
Source: *World Development Indicators* (2008)

While these preferences have been instrumental in developing important export industries in some of these countries, questions remain concerning the extent to which these industries will be able to compete once preferences start to be eroded. In the face of the global financial crisis, such preferences, especially when they are in the form of quotas, should provide an insurance for their recipients against slumps in demand. However, a substantial part of the preferences is supposedly in the process of expiring (e.g. preferences for bananas and rice). Whether the crisis will influence the modalities of the phasing-out process remains to be seen. In any case, to the extent that demand for agricultural products is less income elastic than that for manufactured and intermediate goods, this pattern of specialisation may help trade in small states to weather the crisis.

3.2 Trade in services

The sector where small states have been most successful in finding niche export markets has been services. This is not surprising given the high transport costs incurred by small states, and SIDS in particular, in trading goods internationally and the lower level of economies of scale of most services industries.[7] Small states are net exporters of services and the surplus roughly offsets the deficit in the balance of trade in goods (Figure 4). Although trade in services forms a smaller proportion of total trade than trade in goods in small states, the degree of services specialisation in trade – and in exports in particular – is more pronounced. The ratio of services exports to GDP in the Caribbean small island community is five time larger than in the rest of the world (as compared with a factor of two for goods).

Figure 4. Imports and exports of services (percentage of GDP)

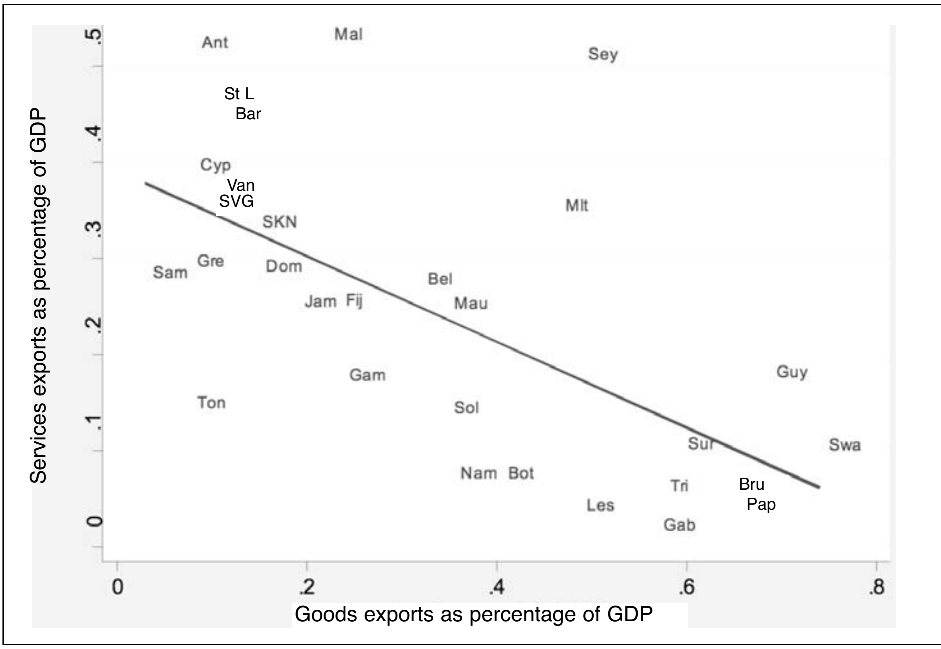


Source: *World Development Indicators* (2008)

Interestingly, there seems to be a trade-off between dependence on exports of services and on exports of goods. Figure 5 elucidates this: the share of exports of services in GDP is negatively correlated to that of exports of goods, except in three countries, Malta, Seychelles and Tonga. This suggests that small states tend to specialise in one macro tradable sector, and the specialisation probably diverts scarce resources away from the other sector. For example, economies such as those of Swaziland and Brunei Darussalam have developed large commodities exports (sugar and oil), which dominate the allocation of resources in the tradable sectors. This need not be the case in a large economy, which can be internationally competitive in both goods and services. This pattern of relative specialisation does not seem to be explained to any significant extent by geographical region: islands in the same area can have a very different specialisation pattern. For example, Guyana and Trinidad and Tobago mainly export goods, while Grenada and Antigua and Barbuda mainly export services.

Tourism represents the most important constituent of trade in services in the majority of small states. The share of tourism in total exports in small states is well above that in the rest of the world (Figure 6). If the latter is computed using the average of shares weighted by the export values of countries, then the difference is magnified. This is because large countries tend to have a highly diversified export portfolio and tourism therefore represents a relatively small share of total exports (as does any other sector). Small states' dependence on tourism has remained stable over the last decade, while it has declined somewhat for the world as a whole, thus widening the gap further. However, there is a large variation among small states in the degree of their export dependence on tourism. As shown in Table 1, tourism represents significantly more than half of total exports for several small states (with St Lucia and The Bahamas being the most dependent), while for others the tourism industry is negligible, representing less than 5 per cent of total exports.

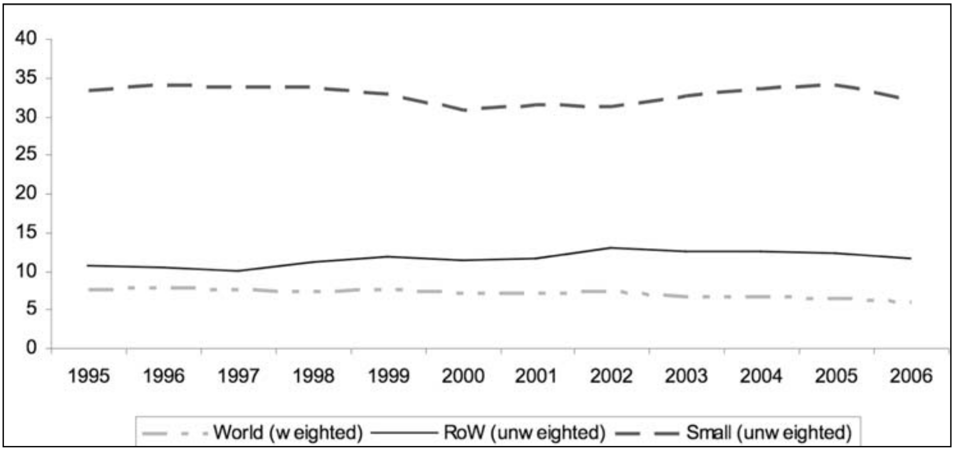
Figure 5. A trade-off between exports of services and exports of goods?



Source: Authors' elaboration on *World Development Indicators* (2008)

The importance of tourism for small states' exports is confirmed by Figure 7. Countries with a high share of services in their exports tend to have a relatively large tourism sector, except for a few exceptions, mainly concentrated in sub-Saharan Africa. These exceptions are essentially small landlocked economies, such as Namibia, Botswana and Swaziland, which are exporters of goods and have tourism as a major service export. Trinidad and Tobago is different in that its energy-related exports dwarf its tourism activity, but the latter is still important in absolute terms. The strength of the tourism sector has helped sustain economic growth in a number of small states which are among the richest in their respective regions (e.g. Barbados, The Bahamas, Seychelles and Maldives). On the other hand, this dependence may be a concern in the light of the current crisis, given the potentially high income elasticity of tourism demand.

Figure 6. Tourism receipts as a percentage of total exports



Source: Authors' elaboration on *World Development Indicators* (2008)

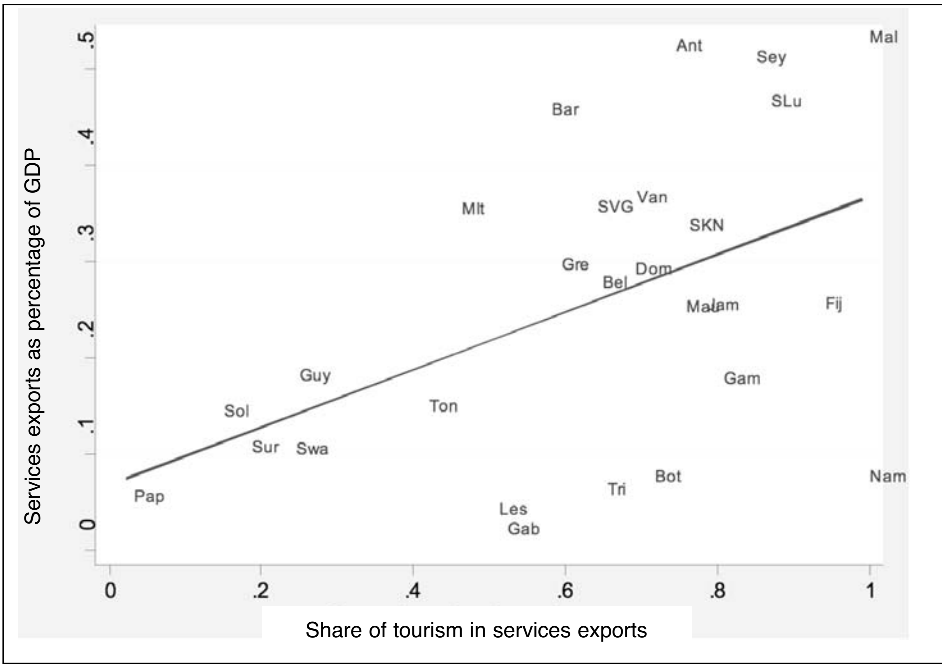
Table 1. Most and least tourism-dependent small states

Country	**Tourism (as % of exports)**
St Lucia	71.3
Bahamas, The	68.2
Maldives	64.1
Samoa	63.9
Antigua and Barbuda	62.6
Vanuatu	55.4
Solomon Islands	4.2
Lesotho	4.1
Swaziland	3.5
Gabon	1.8
Papua New Guinea	0.2

Source: *World Development Indicators*

The discussion suggests that small states are potentially vulnerable to trade shocks, as their dependence on trade is high relative to that of other countries and their economic base, and hence their exports, are undiversified. Let us turn to the evidence on the actual and likely effects of the crisis in more detail.

Figure 7. Are exporters of services also exporters of tourism?



Source: Authors' elaboration on *World Development Indicators* (2008)