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Small States' Trade with Developing Countries: Trends and Issues

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Background

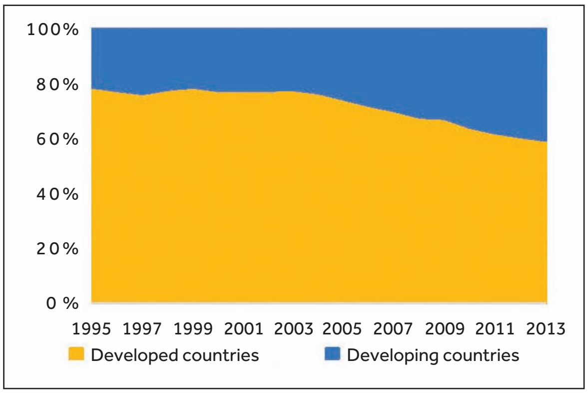
Since the late 1990s, one of the most striking features in the world economy has been the rising prominence of developing countries in terms of their economic growth and trade performance. This has also been reflected in the rapid expansion of trade between developing countries, known as South–South trade. Although the rise of the global South receives intense attention in global trade and development policy discourse, very little is known about small states' participation in South–South trade.

This issue of *Commonwealth Trade Hot Topics* analyses small states' trade with developing countries and discusses the way forward. Due to unavailability of data on bilateral trade in services, the analysis presented here focuses on merchandise goods.

Developing countries in the global economy

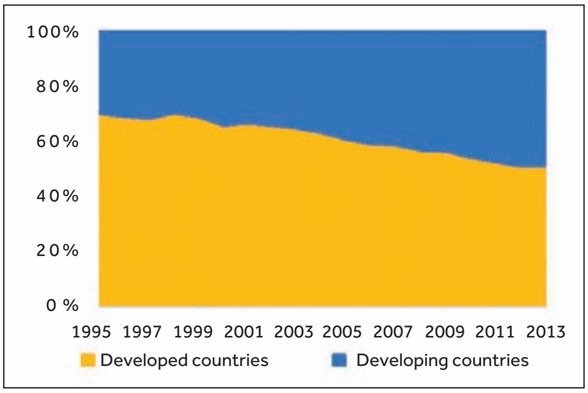
The world economy has seen an unprecedented growth of developing countries over the past 20 years or so, as evident in their rising shares in both global output and trade flows. Since 1995, the global South has almost doubled its share of world GDP from 21 per cent to 40 per cent (Figure 1). The combined GDP of all Southern economies has tripled in value since 2004: from US$10 trillion to more than US$30 trillion in 2013. At the same time, developing countries' share in total world merchandise exports has increased from 30 per cent to almost 50 per cent (Figure 2). In absolute terms, between 2002 and 2012, developing countries' exports have risen from just above US$2 trillion to over US$9 trillion.

Figure 1: Share in Global GDP



Source: Authors' estimates using UNCTADstat (2014)

Figure 2: Share in Global Merchandise Exports



Source: Authors' estimates using UNCTADstat (2014)

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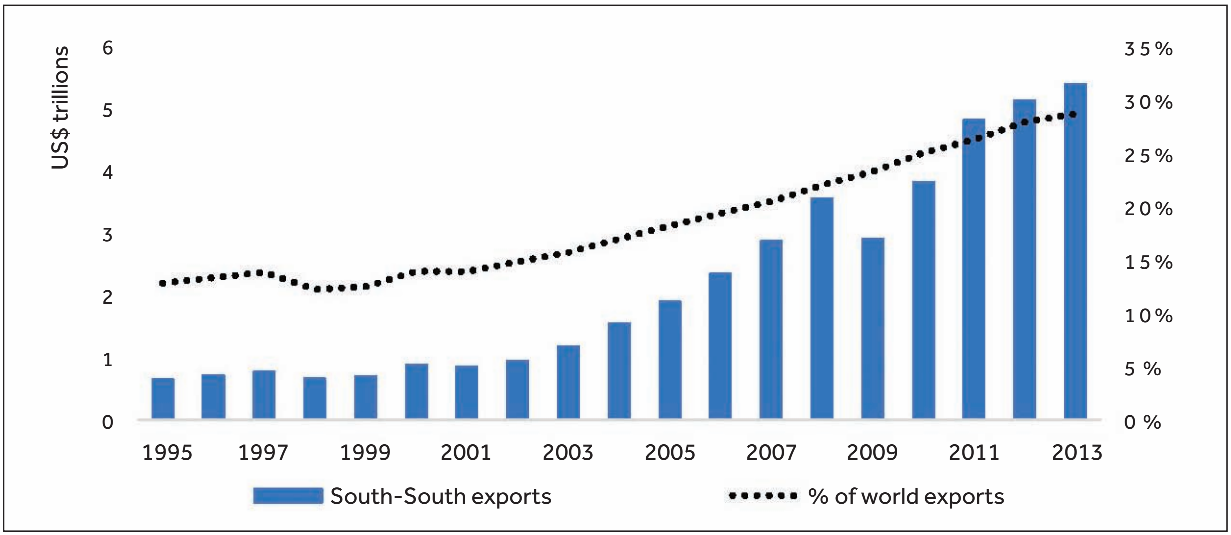
Figure 3: South-South Merchandise Exports (Volume and Share of World Exports)



Source: Authors' estimates using UNCTADstat (2014)

The recent growth in trade between developing countries has been at a much higher rate than overall global trade growth. South–South trade has expanded from less than US$1 trillion in 2002 to about US$5.5 trillion in 2013 (Figure 3), with its share in global exports doubling from 15 per cent to 30 per cent (Figure 3).

The growth in developing countries' output and trade is to a large extent attributable to the impressive economic performance of five large emerging economies, commonly known as BRICS: Brazil, Russia, India, China and South Africa. With their combined GDPs and exports estimated respectively at US$16 trillion and US$3.4 trillion, these countries together currently account for more than one-fifth of world GDP and 18 per cent of world merchandise exports.

Small states and the South

In this paper, we consider a group of 49 countries.[1] Due to their small populations, domestic markets are very limited in these countries, making it virtually impossible to reap the benefits of economies of scale in production, public sector projects, and investment in research and development. Small states' typical features of remoteness and isolation result in excessive trading costs, both due to small consignment size as well as shipping costs, which contribute to a lack of competition and efficiency in their domestic economies. All this leads to a relatively high cost of doing business. In addition, most small states suffer from general developmental challenges such as poor investment climate, weak institutions, and inadequate human capital resources. The interactions of these challenges are manifested in higher unit production costs, making their exports uncompetitive in global markets.

These trade challenges have had a noticeable impact on small states' growth performance in recent years. Developing countries as a group have experienced markedly higher growth since the 1970s compared with the growth of small state economies (Table 1). Furthermore, a significant portion of the growth in small states in the last decade or so appears to be concentrated in five countries that export primarily fuels such as oil. Since 2000, small states (excluding the five major fuel exporting countries)

Table 1: GDP per Capita Average Annual Compound Growth (Constant 2005 US$)

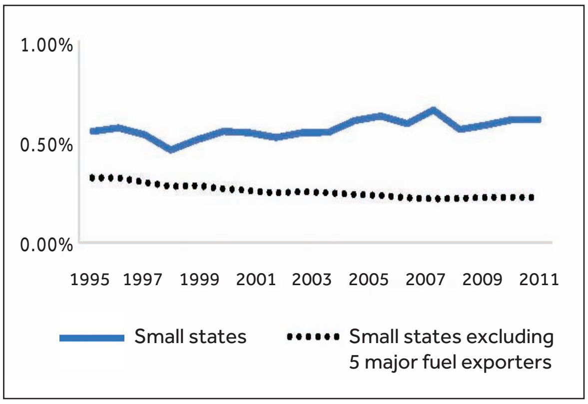
Country Group	1970-2013	2000-2013
World	1.43%	1.24%
Developing countries	2.74%	3.86%
LDCs	1.03%	3.60%
Landlocked developing countries	2.05%	3.85%
Small states	1.37%	1.46%
Small states (excluding fuel exporters)[2]	1.25%	0.98%
Sub-Saharan Africa	0.43%	2.21%

Source: Authors' estimates using UNCTADstat (2014)

1 This is based on the Commonwealth Secretariat definition of small states, comprising independent states with populations of up to 1.5 million with a few exceptions.

2 Excluding five major fuel exporters: Bahrain, Brunei Darussalam, Equatorial Guinea, Gabon, and Trinidad and Tobago.

Figure 4: Share of Small States in Global Merchandise Exports



Source: Authors' estimates using UNCTADstat (2014)

Table 2: Average Annual Export Growth Rates (2000-2012)

Country Group	Average Annual Growth Rate
Small states	13%
Small states (excluding fuel exporters)	8 %
BRICS	19%
South–South	17%
World	10%

Source: Authors' estimates using UNCTADstat (2014)

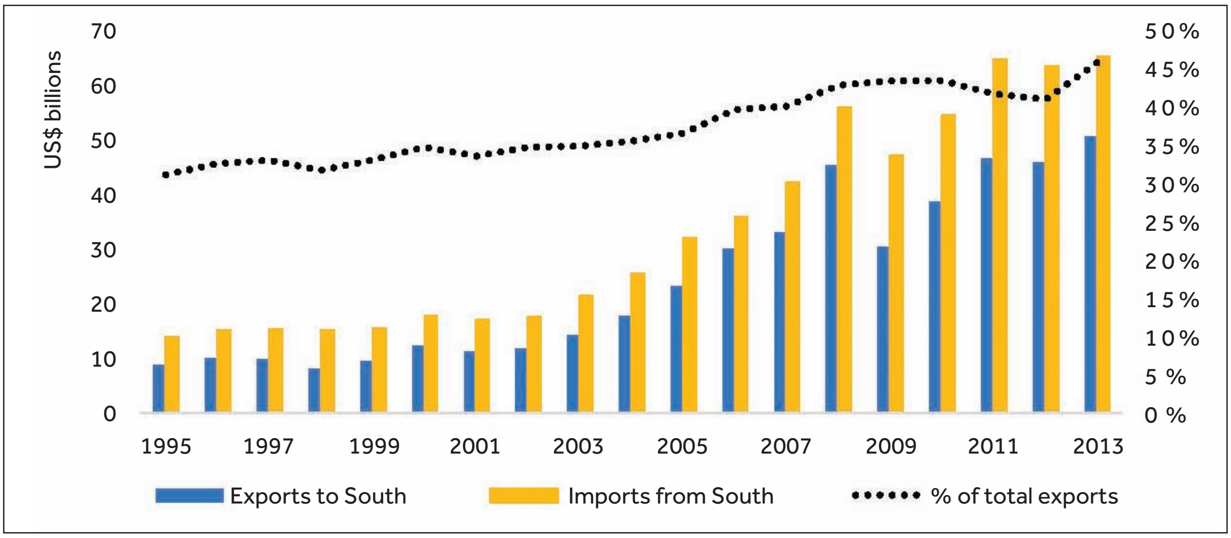
have experienced growth well below the world average, the global South average, and the average growth of other disadvantaged groups of countries such as least developed countries (LDCs) and Sub-Saharan Africa.

Small states' total merchandise exports have grown from US$35 billion in 2000 to almost US$112 billion in 2012 and their total exports of goods and services were valued at approximately US$149 billion in 2012. During the same period, their combined share of world exports has barely improved and is currently at 0.61 per cent (Figure 4).

Top exporters within the group of small states are the 'oil-rich' countries: Bahrain, Equatorial Guinea, Brunei Darussalam, Trinidad and Tobago, and Gabon. These countries' exports accounted for approximately 65 per cent of the total group merchandise exports in 2012. Excluding these five countries reveals that small states' relative significance in global exports has steadily declined from 0.32 per cent in the mid-1990s to 0.22 per cent at present.[3] Putting aside export volatility, which is quite a serious issue for small states, the average annual growth rate of their exports since 2000 has been 13 per cent, slightly higher than the overall world growth rate but lower than the South–South growth rate of 17 per cent (Table 2). Again, when the top fuel exporters are excluded, the average annual growth rate of small states' exports is only 8 per cent (Table 2).

Small states have seen a rise in trade with the global South. Since 2000, small states' exports to the South have grown faster than their exports going to developed countries. Of their total exports, the share going to Southern destinations has increased from 31 per cent in 1995 to 46 per cent in 2013 (Figure 5). Nevertheless, small states'

Figure 5: Merchandise Trade of Small States with Global South



Source: Authors' estimates using UNCTADstat (2014)

3 Without the top five fuel exporters, the total goods exports of small states were worth only US$41 billion in 2012.

share of all Southern merchandise exports has fallen from 1.8 per cent in 1995 to 1.2 per cent in 2013. Small states also have a declining share of South–South exports, currently representing less than 1 per cent of total South–South merchandise exports. That is to say, although the economies in the global South have become more important trade partners, small states are being marginalised in South–South trade.

Out of a total of US$112 billion in small states' merchandise exports in 2012, approximately US$47 billion (42 per cent) went to Southern partners, and US$65 billion to Northern partners (Figure 6). Within the exports to the South, exports to BRICS accounted for almost US$13 billion (28 per cent of all small states' exports to the South).

Figure 6 illustrates that while the majority of small states' merchandise exports go to Northern destinations, more imports originate from Southern partners. In 2012, imports originating from developing countries totalled US$64 billion against US$50 billion sourced from developed partners.

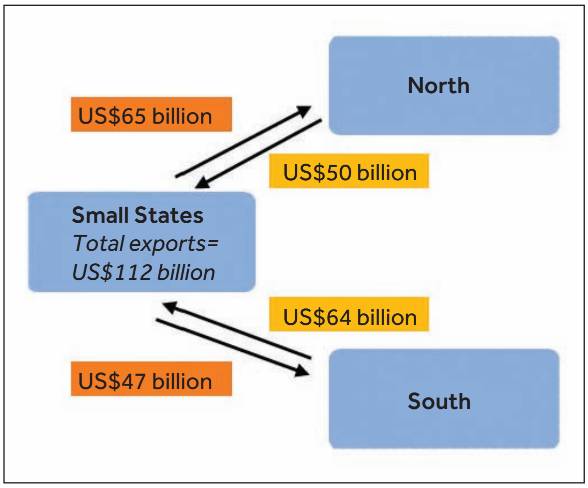
Trade composition

Small states as a group are predominantly exporting fuel and other primary goods, whereas they are importing mostly manufactured goods from both developing and developed countries. Small states' exports to developed and developing countries have very similar compositions: over 75 per cent primary commodities and fuel, and less than 25 per cent manufactured exports (Figure 7). More than half of small states' global imports (57 per cent) are manufactured products. Imports from BRICS countries alone have an even higher proportion of manufactured products, 63 per cent.

Trade partners

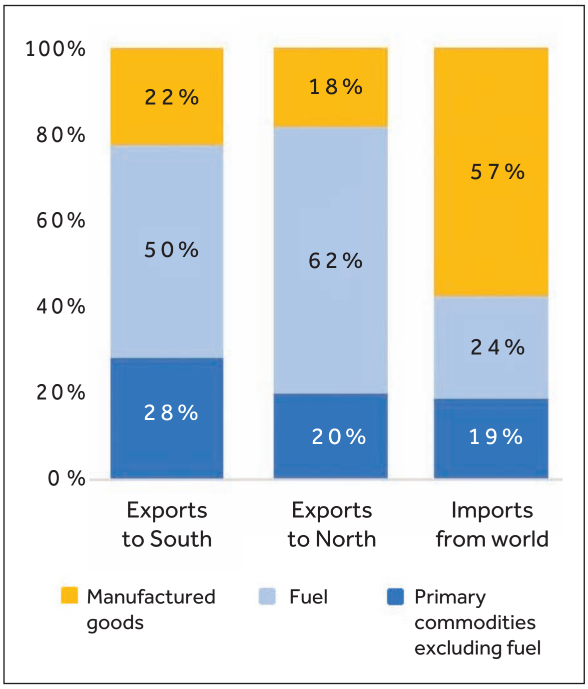
For small states, the biggest individual Southern trade partners appear to be China, Republic of Korea and India.[4] Between 2000 and 2012, the latest year for which information is available, China's share has increased from approximately 3 per cent to 6 per cent, and India's share has also doubled from 2 per cent to 4 per cent (Figure 8). The total value of small states' exports to China has increased dramatically: from US$1 billion in 2000 to US$6.2 billion in 2012.

Figure 6: Merchandise Trade Flow of Small States (Export and Imports, 2012)



Note: Authors' estimates using import and export data from UNCTADStat (2014)

Figure 7: Trade Composition of Small States (2012)

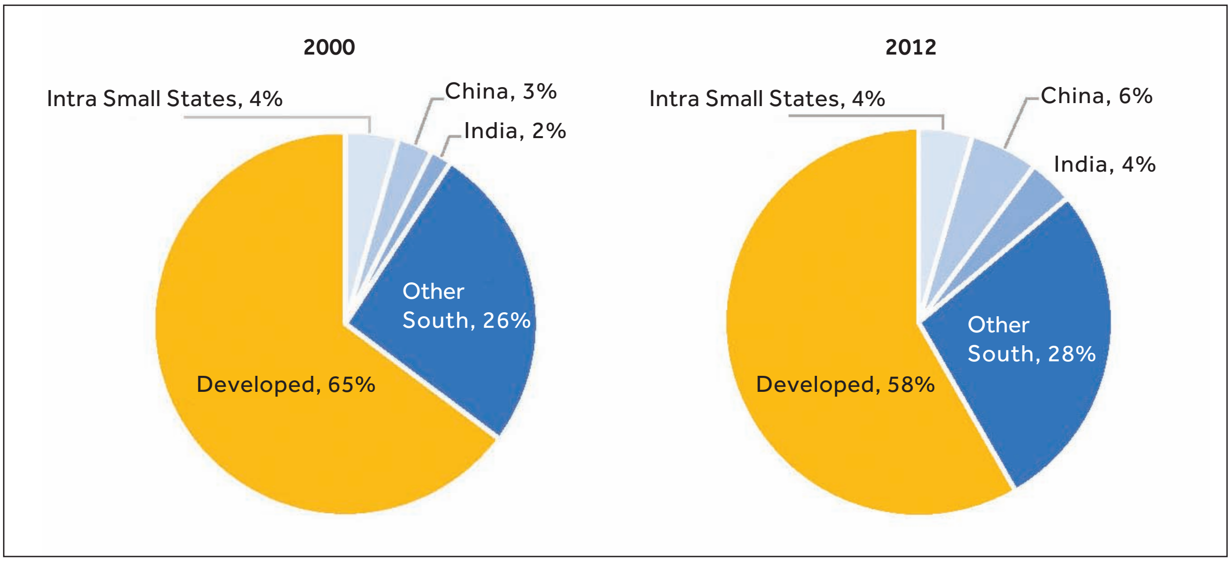


Note: Authors' estimates using import and export data from UNCTADStat (2014)

During the same reference period as above, small states' imports have seen a more drastic shift. China and India's import shares increased from approximately 2 per cent to 9 per cent and 2 per cent to 4 per cent respectively. The share of imports coming from Southern countries has increased from 45 per cent of total small states imports to 56 per cent. On the other hand, the share of small states' imports originating from developed countries has declined from 54 per cent to 44 per cent.

4 The relatively large share of the Republic of Korea is largely due to two countries: Bahrain and Brunei Darussalam.

Figure 8: Merchandise Exports of Small States by Destination, 2000 vs. 2012



Note: Authors' estimates using import and export data from UNCTADStat (2014)

Underlying factors in determining export trends

The above analysis seems to suggest that small states' trade trends have been greatly influenced by the rise of the global South. It is possible to use simple and formal methods to provide an indication of whether small states' comparative export performance reflects changing market shares or global trends in demand. One such method is the constant market share analysis (CMS), which provides insights into the reasons underlying a country's or country-group's comparative trade performance. Under this approach, total exports can be disaggregated into categories defined in terms of product-type and market-orientation in order to answer such questions as whether a country's exports have grown in line with its main competitors (i.e. a competitiveness effect), and whether a country's comparative performance reflects a strong presence in high-growth regions or products. Using CMS, small states' export growth has been examined both for the group and individually for each country.[5] The export growth was compared for two reference periods, 1995–1997 and 2010–2012, using the one-digit SITC Revision 3 classification level.

The results of this exercise, as summarised in Table 3, suggest that the general rise in world exports over time has been the biggest factor to influence small states' growth in exports as a group (i.e. 88 per cent of export growth can be accounted for by this alone). Approximately 33 per cent of this growth has been derived from the positive impact of their commodity composition. This can be attributed to the fact that small states continue to overwhelmingly rely on exports of primary commodities (and particularly fuel), whose price hikes along with increased demand have contributed to export performance. The competitiveness effects appear to be negative and quite large, indicating a declining share of small states' exports in various disaggregated product levels. In other words, small states have not been able to compete with other suppliers of their exports.

Table 3: Constant Market Share Analysis of Merchandise Exports, 1995-97 to 2010-12

Export Growth Effect	Value (US$ mln)	Share (%)
Due to increased world trade	65,884	88.3%
Due to commodity composition	24,364	32.6%
Due to market distribution	203	0.3%
Due to increased competitiveness	-15,827	-21.2%
Total change in exports	**74,624**	**100%**

5 This constant market share analysis followed the widely used methodology developed by Leamer and Stern (1970). See Chapter 7: Constant Market-Share Analysis of Export Growth in *Quantitative International Economics*.

The most striking result of the CMS analysis is the effect due to market distribution. It shows that changing market shares in favour of developing countries have apparently had a relatively small impact on small states' exports; the total change in export value due to this market-orientation shift has been US$203 million (just about 0.3 per cent of overall change in export gains).

When the analysis was undertaken for individual small states, it was reconfirmed that the general rise in world exports has been the most important driving force for the trade growth of 43 small states. For as many as 34 countries, a negative competitiveness impact was observed.

For such countries as Dominica, Kiribati, Nauru, Niue, and St Vincent and the Grenadines, the average value of exports between the late 1990s (1995–1997) and 2010–2012 declined in absolute terms. For these countries, world export growth had the biggest positive impact factor, while their lack of competitiveness also came out very clearly.

In terms of the market distribution effect, 19 countries (out of a total of 47 for which data was available, i.e. 40 per cent of the sample) experienced a positive impact from having their exports in fast growing markets, which is associated with the impact of increased trade with the South.

Participation in South–South trade: major issues for small states

The emergence of developing countries as a major driving force of global trade flows has important implications for small states as it does for other less advanced developing country groups such as LDCs and Sub-Saharan Africa. Trade with fast growing developing countries offers opportunities for specialisation, efficiency gains, export market diversification, and investment flows. In response to the rise of the BRICS nations, there has been a recent resurgence in interest on South–South trade and co-operation as a vehicle for promoting trade-led development in the weaker Southern economies. Large developing countries are now also providing improved market access to others.

However, the nature of small states' participation in South–South trade is cause for a number of concerns. Small states' exports to the South are predominantly primary commodities, 78 per cent of exports as shown above. This echoes the composition of Sub-Saharan African exports to Southern countries. The increased demand for fuels and industrial raw materials from rapidly growing large developing countries has resulted in export growth in a select few primary sectors and only resource-rich small states have been the major beneficiaries. This tendency towards international specialisation in trade greatly limits the participation of many. In contrast, large Southern countries are suppliers of predominantly manufactured goods, ranging from low-skilled labour intensive products to capital-intensive goods such as machinery, vehicles and pharmaceutical products.

While the South is now becoming an important source of trade, achieving fundamental development objectives in small states to ensure sustained productive economic activities may require strategic policy choices. While economic development would conventionally imply countries progressing from primary and traditional activities to more productive manufacturing and modern services sectors, small states are confronted with severe challenges with respect to their structural transformation. There has been some concern that competition from cheap manufactured imports sourced from the South will make it extremely difficult for domestic sectors to flourish given the already inherent disadvantages of small states in global trade.

Relatively recent empirical assessments demonstrate that what countries export and how they specialise matter for their future growth, and economic development requires diversification and not specialisation as such. It has also been shown that countries specialising in such areas as minerals and natural resource-based products will find it difficult to diversify, as these sectors have limited linkages in the economy and very few spill-over effects. Since countries move through the product space by developing goods similar to those they already produce, small states will find it harder to extend their product variety.

In the above context, the issue of integrating into global value chains (GVCs) to promote structural transformation attracts a lot of attention. Over the past few decades the fragmentation of tasks and production activities to yield many individual final products for international consumers has emerged as an important driving force shaping world trade. The geographic separation of production processes is increasingly regarded to represent an important opportunity for poor and small countries; given their limited productive capacity, integrating into GVCs may provide opportunities to gain access to new markets through concentrating their efforts in a specific area and a limited number of tasks. Through the exploration of these new market areas, effective participation in GVCs can help small states diversify their production and export structures.

However, international value chains, according to the most dominant school of thought, are regional in nature and, as such, production networks are concentrated in only a few regions.[8] Although the costs associated with the geographical distance are falling due to technological progress, not being part of a regional production network is unlikely to result in effective participation in value chains. This is clearly reflected in the existing patterns of GVCs: small states (and also Sub-Saharan Africa) are being largely bypassed. Therefore, while excessive trading costs undermine small states' trade competitiveness, the sheer absence of regional production networks will inhibit these countries from benefiting from GVCs.

Given the above, how small states can effectively take advantage of their engagement with Southern trading partners is an issue for serious consideration. Of course, trading with efficient and dynamic partners can generate welfare gains and positive spill-over effects. However, for securing gains, trade and economic co-operation with the South needs to be deeper.

Sourcing foreign direct investment (FDI) from emerging developing countries to build productive capacity is one option. Certain services sectors could be important areas for investment co-operation. Co-ordinated efforts by small states could also trigger regional production networks through the involvement of lead firms from emerging countries. Furthermore, as the relatively advanced developing countries become more important sources of technical and financial assistance, small states need to explore how to gather extended and effective support to deal with structural constraints or infrastructure bottlenecks and to improve their general competitiveness. In some cases, certain small states enjoy preferential market access in other countries. This could be a potential avenue through which FDI flows from the emerging South can be attracted.[9]

Conclusion

Small states' participation in South–South trade merits some serious attention. While they have witnessed increased trade with emerging countries, the general rise in world exports seems to be the most important factor behind small states' growth in exports to the South. Small states' export concentration in primary commodities has contributed to this trend. Indeed, putting aside the effects of commodities, the impact of changing market shares in favour of developing country exports or imports is very small. In addition, small states' competitiveness has been negatively impacted by changing market shares. Indeed, the shares of an overwhelming majority of small states in global South–South trade flows have seen a steady decline.

Despite the advantages of trading with large developing countries, the nature of international specialisation that makes small states suppliers of primary commodities and importers of manufactured goods causes some concern.

The scope of structural transformation and the role of trade in it for small states needs to be better assessed and supported through proactive engagement with the rising Southern partners. In this respect, investment flows and financial assistance from Southern countries can play a key role in developing productive capacity, unleashing services sector potential and triggering regional supply chains. In the absence of this comprehensive trade and development co-operation, small states are unlikely to gain much from South–South trade.

8 Richard Baldwin, one of the most prominent analysts of global value chains, has defined them as factory North America, factory Europe, and factory Asia.

9 There has already been a large increase in investment flows from China to small states. This has particularly been the case for small states rich in natural resources such as Belize, Botswana, Fiji, Papua New Guinea and Samoa. China has invested heavily in infrastructure projects. Further information can be found on the Heritage Foundation's website and in a Commonwealth Secretariat study entitled *Trade and Economic Relations with China: Perspectives from the Commonwealth* by P.Buckley, P.Enderwick, N.Forsans, M.Kafouros, H.Voss and S.Munjal (forthcoming).

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