

# Financing Diversification in ACP Sugar-Exporting Countries

*Edwin Laurent*

## Introduction

The export of cane sugar to the European Union by several ACP countries has been facilitated by special guaranteed arrangements enshrined in the Sugar Protocol. The secure earnings from this trade contribute to the stability of rural incomes, and in several of the countries sugar exports are the foundation for national economic growth and development. However, threats to the regulatory basis on which this trade operates are emerging that could jeopardise the income and employment provided by the industry. In order to safeguard living standards as well as growth and development prospects, in the event of a decline in the industry, economic adjustment entailing the introduction of replacement income and employment-generating activities will be essential.

This chapter examines the likely threats in the EU to the current marketing system for ACP sugar and their impact, and makes recommendations based on the lessons of the recent experience of EU financial assistance to ACP banana exporters, notably the Windward Islands,<sup>1</sup> for providing external support for economic diversification.

## The Sugar Protocol

The Sugar Protocol, originally signed on 28 February, 1975, committed the European Community (EC) 'for an indefinite period to purchase and import, at guaranteed prices, specific quantities of cane sugar, raw and white which originate in the ACP States and which these States undertake to deliver to it'.<sup>2</sup> This arrangement has boosted the development of the sugar industry in ACP states and provided the beneficiary countries with guaranteed market access at predictable and stable prices, which for several years have been significantly in excess of world market prices. The latter have, in general, been too low to cover costs of production and offer a remunerative return to ACP producers. Between

1990–2001, average EU prices were 61.14 US cents/kg as opposed to 22.20 US cents/kg on the world market.<sup>3</sup>

The key elements of the Sugar Protocol are the guaranteed purchases of a fixed quantity of sugar (1.3 million tonnes from ACP and India) at the annually 'negotiated' price, whose level is to be '*within the price range obtaining in the community taking into account all relevant economic factors*'. The preferential arrangements for the ACP and India are part of a broader structure, the Common Market Organisation (CMO) for sugar in the EU. This system also encompasses a production quota scheme, guaranteed price and intervention mechanism, export refund programme, and production levies operating within a unified and interlinked structure. If for whatever reason changes in the character or operation of the Sugar Protocol result in significant price declines, exporting countries will be obliged to reduce costs of production, find new sources of replacement income or both.

## Threats to the Protocol

Whilst the legal integrity of the Protocol has not been challenged, its ability to continue to provide prices that are sufficiently remunerative is under threat since it is part of the EU's CMO, whose reform is being forced by both internal and external pressures, the latter coming principally from the mandate set out in paragraph 13 of the WTO Doha Ministerial Declaration of 14 November, 2001.

Negotiations had already been launched in the WTO since 2000 under Article 20 of the Agreement on Agriculture,<sup>4</sup> but were given new impetus when, in the following year, ministers launched the Doha Development Agenda with its ambitious plan for agriculture to '*establish a fair and market-orientated trading system through a programme of fundamental reform encompassing strengthened rules and specific commitments on support and protection in order to correct*

and prevent restrictions and distortions in world agricultural markets'. Based on that objective ministers, in their Declaration, committed to 'Comprehensive negotiations aimed at: substantial improvements in market access; reductions of, with a view to phasing out all forms of export subsidies; and substantial reductions in trade distorting domestic support'.<sup>5</sup>

Even as these negotiations were proceeding, Australia and Brazil on 27 September, 2002 filed a complaint in the WTO alleging that export subsidies in excess of the EC's approved ceilings were being granted and that the provision of the guaranteed intervention price, since it is available only to domestic producers, violates the national treatment provisions of GATT Article III. The complaints were followed by fruitless consultations and eventually a Panel, the 'European Communities – Export subsidies on sugar' was established on 29 August, 2003 by the WTO's Dispute Settlement Body and composed on the 23 December of the same year with Thailand joining in as a complainant. The report of the Panel, which ruled in favour of the complainants, was presented to the Parties in the first week of August 2004. The ruling was appealed, but the Appellate Body found that certain EU sugar exports benefited from cross-subsidisation and that the EU had been exceeding its export subsidy commitments. Reform of the CMO for sugar became even more pressing and was being forced on the EC not only by existing WTO liberalisation obligations and envisaged future commitments to emerge from WTO Agriculture negotiations, but more urgently by the necessity to comply with the mandatory Panel ruling.

### **Reforming the EU Common Market Organisation for Sugar**

Anticipating pressures and obligations to 'liberalise', the EU Commission, in July 2004, announced plans for reform of the CMO. In a communication to the European Parliament on the 14th of the same month, the Commission proposed: 'A significant reduction in two steps of the institutional support price for EU sugar with the abolition of intervention and the introduction of a reference price. This reference price will serve in the establishment of the minimum price of sugar beet producers, the trigger level for private storage, the

level of border protection and the guaranteed price under the preferential import mechanism'. It also noted that: 'In addition, the proposal will provide the basis for initiating a structured dialogue with EU partners in the developing world on the sugar sector, in order to consider the manner in which the EU can best contribute to necessary and inevitable adjustment in sugar production in African, Caribbean and Pacific countries (ACP) and India'.

As the EU Agriculture and Rural Development Commissioner, Mrs Fischer Boel said to the EU Parliament in June of 2005, 'The need for change is born of forces working both at home and abroad'. That month her Directorate put out a public document summarising the imperative for reform as being driven by:

- the unacceptability of artificially high prices currently three times those on the world market. The reform would promote 'more market orientation' while restructuring of the sugar sector takes place. Ultimately market prices will revert to their intended role of being the (undistorted) factor in the allocation of resources and investment decisions;
- the ruling of the WTO's Appellate Body against certain of the practices of the EU's sugar regime; and
- the need to replace the existing sugar regime that is set to expire on the 30 June, 2006. Given EBA commitments and the WTO ruling, continuation of the existing system was rejected as an option.

The Plan will start from 2006. As outlined in the European Commission's June 2005 statement, 'The European Sugar sector – Its importance and future', it will 'Substantially cut back sugar exports and export refunds, abolish intervention, reduce EU production and the informal sugar price and grant a de-coupled payment to sugar beet farmers'. According to the impact projections of the Commission, support prices will drop by 36% over three years.

The negative economic consequences of such a major fall in prices and hence revenue will be considerable. (There will be no increase in overall volume since the country allocations under the Protocol are fixed.) The Commission has confirmed that it will assist the Protocol countries and India to adapt

to the new market conditions with programmes for improving the competitiveness of the sugar sector, where it is economically viable, and provide support for diversification, when improvements in competitiveness in the sugar sector are not sustainable.

### **Consequences for the ACP Sugar Protocol members**

Table 1 summarises the contribution of the sugar industry to foreign earnings and employment, and

illustrates its domination of the economies of most of the ACP supplying states.

The beneficiaries of the Sugar Protocol are all small economies and their heavy dependence on the income from their sugar exports to Europe makes them particularly vulnerable since changes to the system that result in income loss or contraction of the industry can have severe consequences for the entire economy. The Technical Centre for Agricultural and Rural Cooperation based in the Netherlands computed the likely impact on national

**Table 1. Contribution of sugar to employment and foreign exchange**

| Country           | Year | Contribution to foreign earnings |                    | Share of employment            |                       |
|-------------------|------|----------------------------------|--------------------|--------------------------------|-----------------------|
|                   |      | % of agricultural exports        | % of total exports | % of employment in agriculture | % of total employment |
| Barbados          | 2001 | 100.0%                           | 12.5%              | 52.6%                          | 1.8%                  |
| Belize            | 2001 | 22.0%                            | 19.6%              | 51.2%                          | 14.1%                 |
| Fiji              | 2001 | 67.4%                            | 23%                | 12.8%                          | 7.3%                  |
| Guyana            | 2000 | 65.2%                            | 22.6%              | 32.2%                          | 9.7%                  |
| Jamaica           | 1999 | 48.7%                            | 8.0%               | 16.4%                          | 2.9%                  |
| Malawi            | 2001 | 11.2%                            | 9.0%               | 5.5%                           | 1.3%                  |
| Mauritius         | 2001 | 89.6%                            | 19.5%              | 80.2%                          | 6.4%                  |
| St. Kitts & Nevis | 1999 | 92.3%                            | 21.8%              | 58.27%                         | 8.45%                 |
| Swaziland         | 2001 | 34.4%                            | 9.4%               | 80.9%                          | 8.6%                  |
| Trinidad & Tobago | 2001 | 18.2%                            | 0.6%               | 61.7%                          | 4.8%                  |
| Zimbabwe          | 2000 | 7.6%                             | 3.3%               | 7.8%                           | 2.1%                  |

Source: Compiled from *Third Party Submission by the ACP Sugar Industries*, to the WTO Panel, 18 March 2004.

**Table 2. Projected loss of earnings**

| Country           | Sugar Protocol quota (tonnes) | Current earnings (€) (€523.70/t) | Earnings after Stage 1 reform (€329.0/t) | Income losses from reform (€) |
|-------------------|-------------------------------|----------------------------------|--|-------------------------------|
| Belize            | 40,349                        | 21,130,771                       | 13,274,821                               | -7,855,950                    |
| Congo             | 10,186                        | 5,334,408                        | 3,351,194                                | -1,983,214                    |
| Ivory Coast       | 10,186                        | 5,334,408                        | 3,351,194                                | -1,983,214                    |
| Fiji              | 165,348                       | 86,592,747                       | 54,399,492                               | -32,193,255                   |
| Guyana            | 159,410                       | 83,483,017                       | 52,445,890                               | -31,037,127                   |
| Jamaica           | 118,696                       | 62,161,095                       | 39,050,984                               | -23,110,111                   |
| Barbados          | 50,312                        | 26,348,394                       | 16,552,648                               | -9,795,746                    |
| Madagascar        | 10,760                        | 5,635,012                        | 3,540,040                                | -2,094,972                    |
| Malawi            | 20,824                        | 10,905,528                       | 6,851,096                                | -4,054,432                    |
| Mauritius         | 491,031                       | 257,152,935                      | 161,549,199                              | -95,603,736                   |
| St Kitts & Nevis  | 15,591                        | 8,165,007                        | 5,129,439                                | -4,313,432                    |
| Swaziland         | 117,845                       | 61,715,426                       | 38,771,005                               | -22,944,421                   |
| Tanzania          | 10,186                        | 5,334,408                        | 3,351,194                                | -1,983,214                    |
| Trinidad & Tobago | 43,751                        | 22,912,398                       | 14,394,079                               | -8,518,319                    |
| Zimbabwe          | 30,225                        | 15,828,832                       | 9,944,025                                | -5,884,807                    |

Source: *AgriTrade*, a publication of the Technical Centre for Agricultural and Rural Cooperation (CTA)

earnings for ACP states of the reforms currently envisaged by the Commission. Table 2 summarises the projected loss of earnings.

The economic impact of such massive loss of income will be considerable and will force ACP countries to adapt. Already St Kitts-Nevis has found that it is unable to continue in the circumstances and has abandoned the industry altogether.

### **Experience of the Banana Protocol**

Sugar is not the first ACP export commodity to come under threat, placing at risk external income flows and rendering imperative the need to restructure and diversify in order to safeguard earnings and employment. The first such ACP commodity was bananas. Here the creation of the 1993 European Single Market and the subsequent GATT/WTO disputes prompted a still ongoing process of liberalisation of the banana market. The reforms and changes resulted in lower prices for ACP suppliers and, in some cases, exports have consequently fallen sharply or even disappeared.<sup>6</sup> Consequently, with the creation of the Common Organisation of the Market in Bananas (COM), the EU introduced the Special System of Assistance (SSA) in 1994 through Regulation 2686/94 that provided technical and financial assistance measures and income support for banana producers. The measures were aimed at increasing productivity (including through irrigation and drainage and renewal of plantations), product quality, and marketing and at encouraging diversification. The amount provided under the SSA was €78 million during the entire four-year life of the programme. The Special Framework of Assistance (SFA) established by EC Regulation 856/99 replaced this system in 1999. Under the SFA the income-support component was abandoned. Funds averaging in the region of €45 million per annum have been used for a variety of projects covering field productivity improvements, institutional development and reform of the banana sector, diversification projects, and the provision of social safety nets. In addition to the SSA and SFA, the ACP were, in certain circumstances, also eligible for compensation for loss of earnings under the Scheme for the Stabilisation of Export Earnings (STABEX) and more recently through the replacement mechanism for Financing

Short-term Fluctuations in Export Earnings (FLEX).

A study by external consultants<sup>7</sup> to evaluate the efficiency, effectiveness, impact and viability of the arrangements concluded that the assistance had covered a broad range of initiatives and that its greatest impact on competitiveness had been where it involved improving productivity in the field. The study recommended that priority in future should, however, be given to diversification. The Commission clearly took steps to implement this recommendation. Whilst diversification projects had accounted for 12% of SFA funds in 1999, by 2002 they were using up to 64% of the total. During the four years 1999 to 2002, out of a total of €176.18 million, the bulk of the funds, €118.33 million, nonetheless went into projects aimed at boosting productivity. Diversification projects were principally in the Windward Islands, with Dominica accounting for €14.84 million, Saint Lucia €24.9 million, and Saint Vincent €6.10 million. Elsewhere, the only other major allocations to diversification projects were in Somalia (€3.4 million) and Jamaica (€3.3 million). Actions to promote diversification were, however, usually confined to the agricultural and rural development sectors.<sup>8</sup>

### ***Was the support effective?***

The Windward Islands,<sup>9</sup> which received a substantial portion of the total assistance, are the least-diversified of the ACP suppliers, and despite the assistance provided have not made considerable progress in diversification.<sup>10</sup> In a 2003 Evaluation of the SFA, the UK-based consultancy firm, Landell Mills Ltd, highlighted various shortcomings, including unclear objectives. This permitted considerable influence of individual decision-makers who were sometimes hampered by unrealistic expectations and an ill-defined approach to diversification.

The banana-dependent Windward Islands have several ongoing diversification projects in place supported by external funding since the early 1990s. By the end of the decade there was much greater enthusiasm and commitment but nonetheless the pace of actually getting the projects operational has been slow. This would have been due to a number of factors but it should be appreciated that it is only a few years since the serious acceptance of diversification

as a policy imperative. Given that diversification in single-commodity exporting countries is a long-term process, it is probably too soon to expect dramatic results in the Windward Islands. However there might have been scope for more result-oriented management of the process particularly assisting and encouraging investment in new areas of productive activity and ensuring the transmission of clearer market signals to entrepreneurs.

### ***Applying the lessons***

The experience of banana suppliers, particularly in the Windward Islands, in mobilising and applying EU funding for diversification provides a useful foundation, not for replicating but for learning from the experience so as to avoid pitfalls and errors and building on those lessons. Maybe the most important lesson is the need for a genuine commitment in the country to economic diversification. This might seem superfluous but unless such commitment is present there will not be the consistency and adequacy of institutional support and facilitation needed for what will invariably be a particularly challenging enterprise. It must be appreciated that fundamental economic restructuring is required, not simply the selection and introduction of a replacement crop or single productive activity. The search has to be for multiple new areas of productive activity in which the country has or can realistically expect to develop a comparative advantage. Such identification and development of new industries does not readily lend itself to management within an annual project cycle. Rather long-term vision and programming are essential, which must be realised within a consistent policy framework. Indeed the Commission itself recognised this as essential and in its report to the European Parliament on the 23 December, 2002 undertook to explore the possibility of devising multi-year action plans. This is a step in the right direction but the plan period needs to be long enough so as to be consistent with the requirements of the diversification process.

It was only recently that the focus of EU financial support for banana suppliers has been moving towards diversification, and even so this has been principally in the Windward Islands. Elsewhere projects to boost banana production and productivity

have dominated. In the case of sugar, diversification needs to be clearly identified from the outset as a priority for funding with the encouragement of private sector investment in new industries in which market signals indicate the existence of long-term international competitive advantage.

The diversification process is an essential component of the economic adjustment that must take place as a result of the envisaged declines in earnings from and employment offered by the sugar industry. To be successful it requires both a conducive institutional and policy framework as well as actual investment in new areas of productive activity.

### ***Impediments***

The ACP sugar suppliers are all small developing economies sharing certain economic disadvantages that can have adverse consequences for their ability to rapidly and successfully adapt to market changes. The development of appropriate policies must therefore be informed by familiarity with the economic constraints that these countries face that preclude the successful application of conventional economic remedies.

The impediments that they face include:

- Labour market rigidities. Although there is surplus labour in all of the Protocol states there is inadequate flexibility in the labour force due to a lack of new and appropriate skills.
- Undeveloped capital markets that are not only ineffective in mobilising funds for investment but in general do not make risk capital available for new ventures on reasonable terms, particularly to entrepreneurs who are not yet established.
- Foreign direct investment (FDI) has been a major source of financing investment, particularly in manufacturing and the export service sector of developing countries. However with only two exceptions the ACP sugar exporters have not had notable success in attracting FDI despite a generalised improvement in their investment climate.
- The small size of the domestic market that obliges reliance on exports even in the current context of the decline of trade preferences and the intensification of international competition.

## ***The role of the public sector***

The following contributions must be made by the government:

- Provide a predictable, stable and supportive environment for business (both local and foreign).
- Provide institutional support and investment incentives, marketing and support for export, and technology and quality improvement in support of new enterprises.
- Promote the upgrading and adaptation of the labour force and of managers through adequate investment in appropriate technical education and skills training.

At the national level there needs to be clear commitment to diversification and the support of the government for investment in new areas of productive activity to replace or compliment declining income and employment from cane sugar production and exports. A range of programmes will be required which will have to be administered by the public sector, including the training of managers and technicians and the provision of required infrastructure. A key role for governments will be to devise and administer investment incentives and inducements that are coherent with its policy of diversification into new areas in which the countries have already existing or potential advantage. The signals sent to investors in existing and new industries, through incentives, etc., must be rational and clear with no masking of market realities pertaining to international competitiveness. Incentives that promote investment will be essential but where the beneficiaries are in activities with no economic future, they will invariably prove counterproductive. For certain of these activities governments will invariably require donor assistance.

## ***Assisting the investor***

The reality in the ACP countries in question is that the private rather than the public sector in general principally undertakes actual investment in new productive activities. Even if the right signals and institutional and other support facilities are available, entrepreneurs, particularly in new or non-traditional

activities, often face severe obstacles, the most widespread of which is inadequate access to financing. This manifests itself in three ways:

1. exorbitant cost of capital in terms of interest rates;
2. repayment periods that are too short in relation to the project's income-generation patterns; and
3. excessively stringent collateral requirements.

External grant and concessionary funding can be used in such a manner as to overcome these impediments. The following proposal can provide a means of addressing these difficulties.

## **A proposal for financing of private sector diversification projects**

In view of the following:

- the substantial loss of earnings and employment envisaged due to the changes to the EU's CMO for sugar;
- the high degree of national dependence on the industry in the ACP Protocol Members; and
- the inability of these countries on their own, to generate or mobilise the financing required for the adjustment and diversification process;

substantial external funding will be required to finance the needed investment. The Commission announced that it will provide €40 million to assist ACP Protocol members and has since indicated that there will be a substantial increase to that figure.

In order to ensure that such financial support actually contributes substantially to diversification, the EU and ACP sugar producers should apply the lessons learned from the experience of ACP banana producers in managing SFA and SSA resources. From the outset a strong focus on investment in new productive areas in which market signals indicate an international comparative advantage would be essential. It is proposed that a substantial portion of the financing be made available as risk capital to the private sector for use in new and approved areas of productive activity via a rolling fund to be administered by the banking sector. Investors in new or

expanding manufacturing or agricultural or qualifying service enterprises would be eligible for access to financing.

The following conditions should apply:

- Investment projects and business plans are to undergo and pass rigorous appraisals for viability and sound management according to previously set and approved criteria.
- Reasonable collateral requirements for loans are to be set at a level that provides adequate but fair banking safeguards, but are not so high as to deny suitable investors the opportunity to obtain a loan. The aim here is to ensure that the investor has a genuine stake in the business and is not shielded from risk. In practice, bank personnel are likely to require special training in risk assessment for such 'non-traditional' business enterprises.

In order for actual investment to take place, it will be essential that funds are available to entrepreneurs on reasonable terms that do not preclude access by projects with normal anticipated profitability. Hence:

- the loan repayment periods are to be appropriate for private investment projects, even if this necessitates longer durations than currently available; and
- the rates of interest to apply on qualifying loans should be reasonable and appropriate for such projects even if this could necessitate their being substantially lower than those otherwise prevailing.

It will be necessary for the donors and the governmental authorities to ensure that this facility actually generates the required new investments. They should also ensure that the share (interest and charges) retained by the banking sector is limited to actual costs plus a reasonable margin and that the facility is operated in keeping with applicable WTO rules.

On first sight the provision of access to credit and risk capital on more favourable terms than currently available might conceivably be criticised as interfering with the working of the financial market. However, it should be recalled that a major impediment faced by current and potential investors in productive enterprises in the Windward Islands is that risk

capital and credit are in general not available on suitable terms. If, as this paper assumes, the banking policies, terms and conditions in the ACP sugar-exporting states are not substantially more favourable than those in the Windward Islands, then on their own the banking sectors in those countries will not provide the required and adequate financing on acceptable terms for investments in new areas. Therefore, despite institutional and other support, adequate private sector investment in new productive enterprises essential for diversification will not take place. The proposed facility corrects rather than creates distortions in the domestic capital market.

The existence of dual interest rates and lending policies is justifiable since the funds would be provided to the local banks at lower rates and on more favourable terms than those they themselves would otherwise raise commercially. The on-lending at the often excessively high domestically prevailing rates of donor funds, provided on a concessionary basis, would constitute a perverse subsidisation of the financial intermediaries rather than the actual provision of support to investors.

The use of loans rather than grants is recommended since the latter, by shielding entrepreneurs from risk, would weaken the pressures for sound and responsible investment and managerial decisions as well as blurring market signals. These pressures on the investor and clarity of market signals are essential if choices as to areas for investment are in fact to be limited to those in which there is genuine anticipation of comparative advantage.

In the context of the severe economic impediments faced by the small economies dependent on sugar, the achievement of concrete results in diversification requires a pragmatic rather than an ideological approach.

## Conclusion

The ACP sugar exporters will need considerable and multi-faceted external financial and other support for the adjustment of their economies as income and employment in the sugar industry declines. An essential component of the adjustment process will be diversification of their economies, but a most serious obstacle is the inadequacy of access to risk capital on affordable terms for entrepreneurs in productive

enterprises. Unless this impediment is overcome, diversification programmes will either fail or make unacceptably slow progress. In addition to the range of public sector and institutional support, priority attention needs to be paid to tackling this deficiency. The proposed risk capital facility is intended to do this. Once it is properly devised and efficiently managed it can address in a practical way one of the principal obstacles to investment in new productive enterprises, the inadequate access to credit and risk capital on affordable terms. With the above-mentioned criteria satisfied, this facility can be self-sustaining with minimal subsequent bureaucratic involvement.

Whilst various donor agencies should be approached for support in the adjustment process, the offer made by the Commission to initiate dialogue with the ACP sugar suppliers and to draw up tailor-made programmes needs to be seized upon so as to ensure that the programmes are consistent with national economic policies and that the scope and terms of support are adequate. Also it is for them to ensure that the funding and support programmes are devised and administered in such a manner that they

can have real impact as intended. There is already experience with external support for adaptation and diversification of the banana sector. It would be in the interests of ACP sugar suppliers to learn from that record.

## Endnotes

1. Commonwealth of Dominica, Grenada, Saint Lucia and St Vincent & the Grenadines.
2. Protocol 3 of the ACP–EU Partnership Agreement, Cotonou, Benin, 2000
3. C.R. Milner and L.W. Morgan 'The impact of the ACP of the reduction by the EU of import export subsidies on Sugar'.
4. 'Continuation of the Reform Process' Article 20; WTO Agreement on Agriculture; Marrakesh, 15 April, 1994.
5. Doha Ministerial Declaration, 2001.
6. Major losers have included Cape Verde and Madagascar, which no longer export, and the Windward Islands, Surinam and Jamaica, whose exports declined tremendously.
7. M. Hubbard, A. Herbert and Roumain de la Touche, 'Evaluation of EU assistance to ACP banana producers'.
8. Communication of the Commission and the European Parliament (2002) 763.
9. Expect for Grenada that has an historical trade in spices and cocoa.
10. Gary Melville, 'Situational analysis of the Agricultural Sector of the OECS Member Countries', Dec. 2002.