

trade hot topics

The Impact of EU Bilateral Trade Agreements with Third Countries on the Caribbean Rum Sector

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Background

The African, Caribbean and Pacific (ACP) states are among those economies that have traditionally enjoyed tariff preferences in the European Union. However, progressive erosion of preferences due to multilateral liberalisation and other regional trade arrangements involving the EU and third countries threaten to erode such preferences. In the event of third countries' securing duty-free market access, EU importers will face an effective increase in the relative prices of products originating in traditional preference-dependent ACP suppliers affecting their export competitiveness.

This issue of *Commonwealth Trade Hot Topics* provides the empirical evidence of the effects of preference erosion for the Caribbean rum sector. It shows that if the EU agrees a free trade agreement (FTA) with Central America, Peru, Colombia and the Mercosur trading bloc, Caribbean rum exports would decline by 3 per cent (i.e. equivalent to three-quarters of a million euros), affecting individual Caribbean countries, and particularly Guyana very badly. A complete EU liberalisation of rum trade would lead to annual losses for the Caribbean of 5.5 per cent or €1.3 million each year. Annual losses

would accumulate to nearly €10 million over the period 2014—2020.

The Aid for Trade (AfT) initiative is intended precisely to address such instances of trade preference erosion. And thus how it can help the Caribbean to adjust, by making its producers more productive and/or by encouraging diversification should comprise an important policy issue.

Rum exports and trade preferences in the EU

In the past, Caribbean countries benefited from preferences for the bulk of their commodity exports to Europe — including bananas, rice, rum and sugar — as part of the Commodity Protocols contained in the preferential trade agreements between the EU and the ACP countries. Under the Rum Protocol contained in all the Lomé Conventions since Lomé I was signed in 1975, Caribbean bulk rum exporters received duty-free access under quota to the European market.

In 1996, imports of ACP light rum into Europe were fully liberalised with the removal of all quotas on ACP rum. At the end of the 1990s, the EU and the USA concluded an agreement on tariffs on distilled spirits: the 'zero-for-zero' agreement. The agreement

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Table 1: EU non-preferential rum tariffs

Tariff heading (CN category)	Duty applied
22084039 (Bottled rum under €7.9)	€0.60 /%vol/hl +€3.20/hl (equivalent to €0.632 per litre of pure alcohol)
22084099 (Bulk rum under €2)	€0.60 /%vol/hl (equivalent to €0.6 per litre of pure alcohol)
22084011 (Bottled heavy rum)	€0.60 /%vol/hl +€3.20/hl (equivalent to €0.632 per litre of pure alcohol)
22084051 (Bulk heavy rum)	€0.60 /%vol/hl (equivalent to €0.6 per litre of pure alcohol)
22084031 (Bottled rum over €7.9)	Duty free
22084091 (Bulk rum over €2)	Duty free

Note: CN stands for Combined Nomenclature of the EU trade classification.

contained a special annex with respect to rum. This annex provided for the progressive liberalisation of MFN (most favoured nation) duties and quotas on most bulk and bottled rums entering the EU and the USA. It put in place specific new tariff headings which were designed to gradually erode preferences, allowing the ACP industries some time to adjust.

Currently, rum entering the EU is categorised under one of six different tariff headings. These relate to the size of the container (bulk — over 2 litres; or bottled — 2 litres or less), and the value of the rum in those containers. There are also two separate tariff headings for ‘heavy rums’. Countries benefiting from preferences (including CARIFORUM) face zero tariffs in all of these categories, but countries that do not have preferences face the duties shown in Table 1.

Two of the preferential tariffs are controlled by a ‘price point’ which is designed to ensure that only the lower-value products are given a measure of preferential treatment. For example, bottled rums from non-preferred suppliers valued at €7.9 or less (cost, insurance and freight — CIF), are subject to a tariff, as are bulk rums valued at €2 or less. CARIFORUM producers knew when the ‘zero-for-zero’ agreement on white spirits was concluded in the 1990s that they would face preference erosion as their production costs increased with inflation and their products exceeded the price point and were graduated out of the protected rum categories. However, with the new bilateral trade agreements being pursued by the EU, Caribbean producers are now faced with additional preference erosion which will affect individual CARIFORUM countries.

EU trade policy scenarios and Caribbean rum exports

In a recent Commonwealth Secretariat-supported study, the impact of FTAs and quota on CARIFORUM countries has been analysed under different liberalisation scenarios. These scenarios reflect the

current EU agreements in place with Central America, Peru and Colombia. The EU granted a quota of up to 700,000 litres for Central America, up to 150,000 litres for Colombia, up to 100,000 litres for Peru and up to 100,000 litres for Panama in the bulk rum sectors defined by CN22084051 and CN22084099. It is important to note that these quotas are much greater than the current market shares of Central American countries, Peru and Colombia in CN22084099 category (currently about 65,000 litres of pure alcohol representing 1.7% of the EU imports in that category).

The European law does not specify whether the quota will be filled by Central American, Peruvian and Colombian producers with exports in the category CN22084099 and CN22084051. For this reason, we consider two scenarios (Scenario I and Scenario II) which assume that exports will be filled respectively by rum exporters in the category CN22084099 and CN22084051.

There are no quotas for the bottled rum categories categorised as CN22084011 and CN22084039; instead, the EU established a gradual abolition of import tariffs in three years for Central America and four years for Peru and Colombia. No detailed discussions on bottled rum will be considered here, as it is estimated that in the transition period the annual variations of losses for Caribbean producers are not substantial. The full liberalisation of these tariffs, however, could coincide with producers in Central America, Peru and Colombia substantially increasing the volumes of rum which they export under these categories in the future. This cannot be predicted on the basis of past export flows, the analysis of which underpins this study.

As a benchmark, the results derived from the two scenarios reflecting the current EU policies are compared with alternative scenarios to understand how the future evolution of agreements with other

countries beyond Central America, Peru and Colombia could trigger adverse consequences for the Caribbean. These alternatives are defined as:

- 1) EU import tariffs are eliminated only for Central America, Peru and Colombia but quotas do not exist;
- 2) EU import tariffs are eliminated for Central America, Peru and Colombia as well as Mercosur countries (Argentina, Brazil, Venezuela, Paraguay and Uruguay) but quotas do not exist; and
- 3) full liberalisation of the EU rum market is undertaken with complete abolition of import tariffs and quotas (in line with a likely outcome of the Doha Round of multilateral trade talks).

The results

Broadly speaking, there are four factors that determine the extent to which individual Caribbean countries are vulnerable to preference erosion: (i) the extent of the trade shock; (ii) the behavioural

response in terms of trade patterns; (iii) the exposure of individual countries to the changes in trade patterns; and (iv) the resilience of individual countries to respond to the changes in trade patterns. This is summarised in Table 2.

The analysis presented in the Commonwealth Secretariat-supported study is based on the findings of a new econometric estimation of the price elasticity of EU rum imports market, distinguished by import sources. These estimates are important to our discussion. As the EU import tariffs are eliminated for some non-CARIFORUM countries, the prices of rum from non-Caribbean countries reduce. If non-Caribbean prices fall, the relative prices of Caribbean rum increase. If the relative prices increase, the relative exports from the Caribbean decrease, as the Caribbean becomes less competitive. As Caribbean rum becomes more expensive, European consumers turn to purchase from non-Caribbean sources.

Table 2: What factors increase the vulnerability of Caribbean countries to preference erosion in the market for rum following EU FTAs with third countries?

Broad areas of vulnerability	Specific issues affecting the outcomes	Countries affected
The extent of the trade shock	The more ‘third’ countries are included in FTAs with the EU	All Caribbean countries (but some compete more with third countries than others)
	The greater the quota awarded to the third countries and the greater their tariff decrease. Quota set by the EU may be more important than FTAs in determining the extent of the trade shock	All Caribbean countries (but some compete more with some third countries than others)
The magnitude of the behavioural response	The higher the price sensitivity of rum imports by source and between rum and other categories. The estimate suggests that a 10 per cent increase in Caribbean prices leads to a 3.6 per cent reduction in Caribbean export quantities	All Caribbean countries
The exposure to the change in terms of trade	(1) The greater the country rum exports in total Caribbean exports; (2) The greater the loss in that rum category in the Caribbean country’s export structure (3) With full quota utilisation, exposure to the categories of CN22084051 and CN22084099 in particular is important	Highly vulnerable: Barbados and Guyana Intermediate vulnerability: Jamaica, Trinidad and Tobago, and Dominican Republic (details can be found in the original study)
The resilience to respond to the shock	The lower the GDP per capita The weaker the institutional capacity to respond The fewer finances (including Aid for Trade) to respond	Among the most vulnerable countries, Guyana is the least resilient mainly because of the lower level of GDP per capita Depends on which countries receive aid for trade resources and their effective utilisation

The new econometric evidence provided under the aforementioned study suggests that imports of the four categories covering 100 per cent of protected rum imports into the EU are sensitive to price changes across sources of supply. The estimated price elasticity of -0.36 is statistically significant, indicating that a 10 per cent increase in the relative price of Caribbean rum would lead to a 3.6 per cent decrease in the relative volume from the Caribbean. In other words, if the preferences faced by third countries change, Caribbean exporters will be affected.

The relative Caribbean price change and corresponding expected relative quantity change due to FTAs has also been estimated (see Table 3 for a summary). The greater the number of countries receiving zero tariffs in the EU, the greater the effects on the Caribbean. Caribbean suppliers export around €25 million to the EU in four rum categories (CN codes: 22084011, 22084039, 22084051 and 22084099). Using detailed trade data, it is estimated that a full liberalisation scenario, where the EU grants duty-free access for rum imports from all countries in the world, would decrease Caribbean exports by up to 5.5 per cent, equalling €1.3 million per year. If the EU agrees an FTA with a limited number of countries such as Central America, Peru, Colombia and Mercosur countries, exports would decrease by up to 3 per cent.

If FTAs were restricted to Central America, Peru and Colombia only, rum exports could decrease by up to 0.15 per cent, that is, €38,000 per year. This is based on the currently low share of these countries in the EU market; however, the share is increasing fast with large potential. Moreover, the quotas granted to Central America, Peru and Colombia in the bulk rum

categories CN22084051 and CN22084099 are large. For example, when assumed that these quotas are fully utilised, these countries would expand their market share from currently almost non-existent to up to 47 per cent in the category CN22084051, and from 1.7 per cent to up to 7 per cent in the category CN22084099. The scenario where Central America, Peru and Colombia are increasingly able to fill their quotas is quite plausible, given the recent substantial increase of Central American rum exports from €5 million to €25 million over the period 2006–2011 in the CN rum category 220840.

If Central America, Peru and Colombia fill the quotas granted by the EU at the expense of Caribbean suppliers, the result would be a reduction of up to 14 per cent in exports of the latter, amounting to about €3.4 million per year. If quotas were granted to Central American countries, Peru and Colombia and duty-free access was extended to Mercosur, the loss for Caribbean countries would be up to 16.5 per cent of exports (i.e., about €4 million).

As suggested in the framework in Table 2, different Caribbean countries face different vulnerabilities. Guyana and Barbados are most vulnerable because they have a high share of Caribbean exports to the EU and because they have a less diversified manufacturing economy compared to other countries in the region. Guyana is less resilient than Barbados because of a lower level of GDP per capita, which describes in broad terms the capability of countries to respond to a shock. Other Caribbean countries such as Dominican Republic, Jamaica, and Trinidad and Tobago also have a high share of rum in manufacturing exports, but to a lesser extent than Barbados and Guyana.

Table 3: Estimated costs of liberalisation for Caribbean rum exporters, by type of liberalisation

EU FTA / liberalisation scenarios	Annual estimated losses for the Caribbean	Estimated declines in Caribbean rum exports
Complete trade liberalisation	€1.3 million	5.5%
FTA with Central America, Peru, Colombia and Mercosur	€715,000	3.3%
FTA with Central America, Peru and Colombia	€38,000	0.15%
FTA with Central America, Peru and Colombia and full utilisation of quotas (i.e. increased market access in the rum category 22084051)	€3.4 million	14%
FTA with Central America, Peru, Colombia and Mercosur and full utilisation of quotas (i.e. increased market access in the rum category 22084051)	€4 million	16.5%

Dominican Republic, Trinidad and Tobago and (to a lesser extent) Jamaica have a more diversified manufacturing economy. Losses in the rum market have a lower effect as measured as the percentage of total exports in these countries.

Moreover, in the scenario assuming FTAs with Peru, Colombia and Central America and quotas, the market share for bulk rum in Trinidad and Tobago and the Dominican Republic is lower than that of Guyana and Barbados. Trinidad and Tobago, Dominican Republic and Jamaica have lower market shares than Guyana and Barbados in the heavy bulk rum category. Other Caribbean countries such as St Vincent and the Grenadines, Grenada, The Bahamas, St Lucia, St Kitts and Nevis, Haiti, Suriname, and Antigua and Barbuda are not vulnerable to specific policy changes as their EU import market share in the rum categories subject to the EU trade policy reform (CN 22084011, 22084039, 22084051 and 22084099) is low (below 5% of total EU imports of that rum category).

Conclusions

The current and potential trading arrangements of the EU with third countries affect Caribbean rum exports. It is estimated that the current EU trade policy arrangements including duty free quota for Central America, Peru and Colombia and a 1,050,000 litres of pure alcohol quota could reduce Caribbean countries' rum export earnings by up to €3.4 million per year, which corresponds to about 14 per cent of current Caribbean rum exports to the EU.

Barbados and Guyana are particularly exposed to the EU trade policy shock, due to their high market share especially in the bulk rum categories that are subject to quota. The scenarios assuming that quotas are filled suggest big losses for the Caribbean. Exporters that are traditional recipients of preferences such as Guyana and Barbados have a relatively low level of manufacturing exports beyond rum. Guyana further seems weak in terms of

resilience because of its low level of GDP per capita. Jamaica, Trinidad and Tobago, and Dominican Republic are also vulnerable to a lesser extent. The Dominican Republic has a stronger resilience and better market position especially in those rum categories that are not subject to quota, and also has a more diversified economy. Jamaica and Trinidad and Tobago are less vulnerable, as Jamaica has limited exposure to the bulk rum categories while rum exports are a much smaller share of total merchandise exports in Trinidad and Tobago compared to Barbados and Guyana.

Our results show that Caribbean exporters are likely to be affected by the new bilateral trade agreements being pursued by the EU. Caribbean producers are now faced with additional preference erosion which they had not expected some time ago. This will affect individual countries such as Guyana, Dominican Republic, Barbados and Jamaica.

Preference erosion has become a major concern for Caribbean rum exporters and the findings in this study underline that. Aid for Trade has been designed especially to meet such challenges. It can help the Caribbean adjust, by making Caribbean producers more productive (through targeted assistance for rum producers or general support that benefits all exporters) or by encouraging diversification away from affected industries. It is noticeable that while volumes of aid for trade have increased in recent years, AfT for trade adjustment has been scarce and its enhancement can greatly support countries that have been traditionally dependent on trade preferences.

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Cantore, N, J Kennan and D W te Velde (2012), 'The impact of EU bilateral trade agreements with third countries on the Caribbean rum sector', report for the Commonwealth Secretariat.

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This Trade Hot Topic is brought out by the International Trade and Regional Co-operation (ITRC) Section of the Economic Affairs Division (EAD) of the Commonwealth Secretariat, which is the main intergovernmental agency of the Commonwealth — an association of 54 independent states, comprising large and small, developed and developing, landlocked and island economies — facilitating consultation and co-operation among member governments and countries in the common interest of their peoples and in the promotion of international consensus-building.

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11-13 September 2012: South Asia Economic Summit (SAES V) held in Islamabad, Pakistan

7-8 September 2012: Istanbul Programme of Action for LDCs (2011-2020): LDC IV Monitor Expert Group Meeting held in Dhaka, Bangladesh

3-4 September 2012: Strengthening Competitiveness of South Asia through Regional Supply Chains — consultation workshop on leather and Leather products, held in Chennai, India

29-August 2012: A Commonwealth Roundtable with Prof. Joseph Stiglitz on 'Aid for Trade: Perspectives on Progress and Emerging Issues' held in Marlborough House, London

9-13 July 2012: A Briefing Session on Commonwealth Secretariat's Work Programme on International Trade, 24th WTO Geneva Week, held in Geneva, Switzerland

9-10 July 2012: Workshop on Trade Policy for Commonwealth Parliamentarians (African Region) held in Mahe, Seychelles

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