



CENTRE FOR
INTERNATIONAL
ECONOMICS

Bananas:

***straightening out
bent ideas on trade as aid***

Prepared for the:

Conference on agriculture and new trade agenda from a

development perspective: 1-2 October 1999, Geneva

Brent Borrell

***Centre for International Economics
Canberra & Sydney***

September 1999

The Centre for International Economics is a private economic research agency that provides professional, independent and timely analysis of international and domestic events and policies.

The CIE's professional staff arrange, undertake and publish commissioned economic research and analysis for industry, corporations, governments, international agencies and individuals. Its focus is on international events and policies that affect us all.

The CIE is fully self-supporting and is funded by its commissioned studies, economic consultations provided and sales of publications.

The CIE is based in Canberra and has an office in Sydney.

© Centre for International Economics 1999

This work is copyright. Persons wishing to reproduce this material should contact the Centre for International Economics at one of the following addresses.

CANBERRA

Centre for International Economics
Ian Potter House, Cnr Marcus Clarke Street & Edinburgh Avenue
Canberra ACT

GPO Box 2203
Canberra ACT Australia 2601

Telephone +61 2 6248 6699 Facsimile +61 2 6247 7484

Email cie@intecon.com.au

Website www.intecon.com.au

SYDNEY

Centre for International Economics
Level 8, 50 Margaret Street
Sydney NSW

GPO Box 397
Sydney NSW Australia 1043

Telephone +61 2 9262 6655 Facsimile +61 2 9262 6651

Email ciesyd@intecon.com.au

Website www.intecon.com.au

Abstract

The world banana market is dominated by one large and obvious trade distortion: EU import restrictions. Ostensibly the EU banana policy operates to deliver aid to several developing nations by raising the prices these countries receive for their products in the EU market. In reality, it costs EU consumers a fortune (\$2 billion a year), with only a small proportion (\$150 million a year) reaching its target. Most of the rest is extracted by banana importers and wholesalers with import quotas. With alternative mechanisms the aid objective could be achieved at a fraction of its current cost to consumers. Moreover, the trade restrictions impose costs on other developing countries wishing to efficiently export bananas to the European Union. Despite substantial criticism and repeated WTO rulings against it, the policy remains. Currently the European Union is considering how to respond to the WTO's last dispute settlement ruling against the policy. Whatever the outcome, the inefficiency of the policy, the greater efficiency of alternatives and the difficult process to reform it raise many issues for the next WTO round. These are addressed in this paper.

Criticism of EU banana policy is intense but the policy remains

Over a dozen analytical studies have been conducted highlighting the high costs of the EU policy and several of these have been widely publicised and discussed. The German Government and others have taken cases against the policy to the European Court of Justice, which seriously criticised the policy. The Hamburg Financial Court attempted to override the policy. There has been a wave of press articles and editorials lambasting the policy. The governments of Germany, Italy, Sweden, Belgium, Austria, Finland and Luxembourg have publicly opposed the policy. The United States with Guatemala, Honduras, Mexico and Ecuador are the latest countries to have filed complaints against the policy through the WTO. And seven times now the GATT or WTO have ruled that EU banana policies are illegal. Further, since the last ruling the United States has imposed retaliatory measures against the European Union. Yet, at the time of writing, still the European Union persists with its distortionary policy. The European Union will report to the EU countries in September how it proposes to respond to the WTO's latest ruling on the illegalities of the policy.

Whether or not the European Union decides to fundamentally reform its banana policy on 23 September, the EU banana policy story is worth retelling. It shows:

- the inefficiency and insecurity of aid being delivered through trade preferences;
- the benefits of tariffs set at reasonable levels compared with quotas;
- the benefits of direct compensatory aid;
- the prohibitive nature of over-quota tariffs;
- the ploys countries are prepared to pursue to avoid making even obvious reforms;
- the role of the policy transparency process and publicity;
- the fundamental importance of changing the political will and political balance in the country imposing trade barriers;
- the preparedness of a major WTO player to flout international trade rules in favour of domestic political considerations;
- the entrenched political powers of those protected by quotas;
- the place of the disputes settlement procedures and other WTO disciplines;
- the emerging role of GATS and competition policy;
- the importance of involving the private sector in trade negotiations.

The story told here draws together work from Borrell and Yang 1990 and 1992; Borrell 1993, 1994 and 1996; and Borrell and Cuthbertson 1991.

EU policies have a big effect on the world banana market

As a big rich trading bloc, with little banana production of its own, the European Union is an important player on the world market, importing around 40 per cent of all internationally traded bananas. The high trade barriers it imposes against banana imports are therefore highly disruptive to trade. The United States, with around a third of all imports, is the other big importer of bananas but it imposes no barriers.

Until 1993, EU countries had a range of separate national policies

For many years some EU countries restricted banana imports, while others imposed no barriers. But with single market unification in 1992-1993, all EU countries were forced to impose common barriers.

France, the United Kingdom, Spain, Italy, Portugal and Greece used quota-based import restrictions to provide preferential access and aid to high cost growers (preferred suppliers) in four territories and seven small African, Caribbean and Pacific countries. Only Germany had a completely free market in bananas, although trade interference in the Netherlands, Belgium, Luxembourg, Denmark and Ireland was relatively mild tariff intervention. These countries, with little or no intervention in the market, typically imported their bananas from efficient growers in Latin America (non-preferred suppliers) —table 1.

1. Preferred and non-preferred suppliers of EU banana imports

<i>Preferred suppliers</i>	<i>Country giving special preference</i>	<i>Non-preferred suppliers</i>
African, Caribbean and Pacific (ACP) countries ^a		Latin America or so-called 'dollar' area countries of Central and South America
Belize	United Kingdom	Colombia
Jamaica	United Kingdom	Costa Rica
Surinam	United Kingdom	Guatemala
Windward Islands	United Kingdom	Honduras
Somalia	Italy	Panama
Cameroon	France	Ecuador
Ivory Coast	France	Brazil
<i>EU overseas territories</i>		
Guadeloupe	France	
Martinique	France	
Madeira	Portugal	
Canary Islands	Spain	

^a Under the Lomé Convention all ACP countries have duty free access to protected EU markets. Germany is virtually a free market, so gives no preference to ACP suppliers.

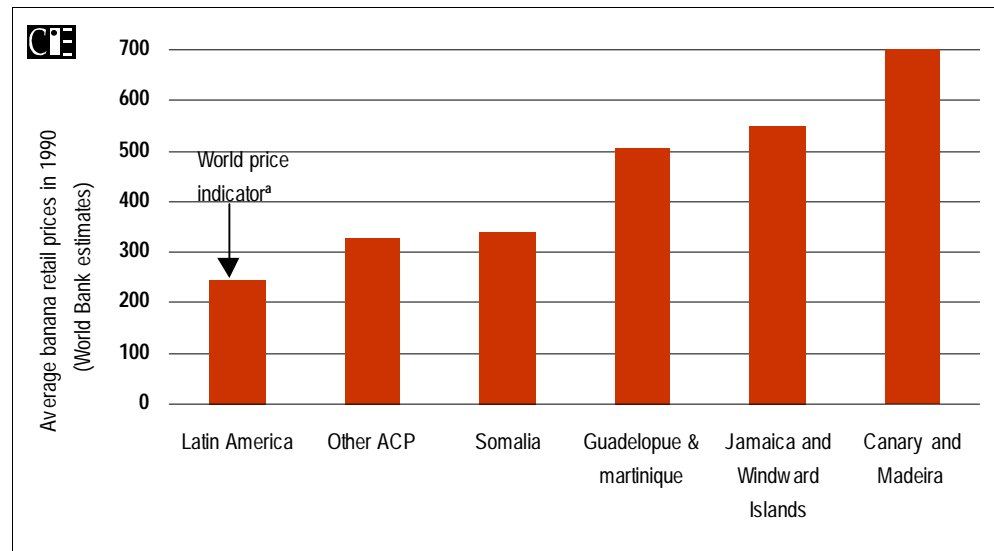
Consumers in EU import-restricted markets paid much more for bananas, ate fewer of them — 8 kilos UK versus 14 kilos per person per year in Germany — and ate lower quality bananas. Quota restrictions created high prices and the scope for *rent seeking*. The quotas were intended to raise the price received by preferred suppliers, but they also enabled others in the

marketing chain to seek benefits, because of the way import quotas were allocated.

Restricted access for non-preferred suppliers doubled prices in some EU countries

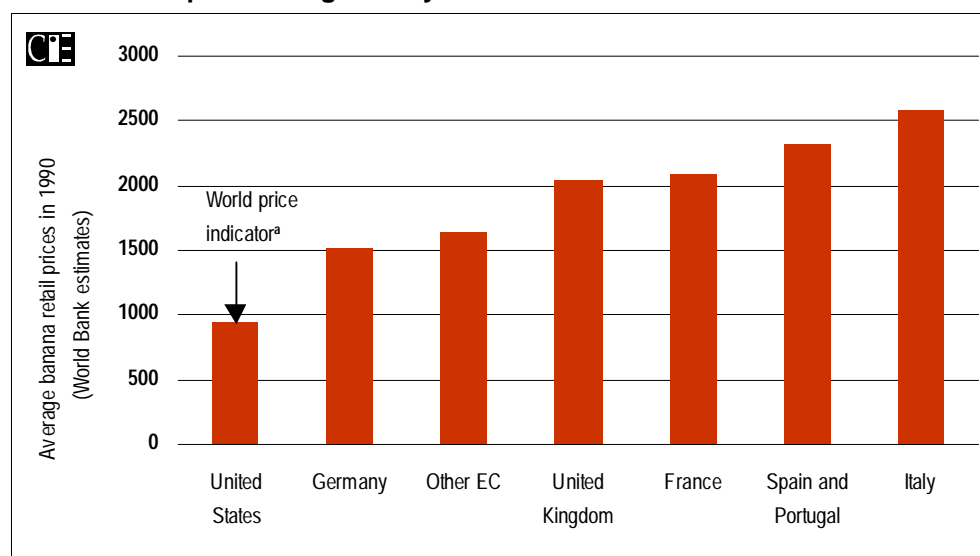
Preferential access resulted in preferred suppliers receiving *fob* prices about double the prices received by non-preferred suppliers (chart 2). But, perhaps more importantly, restricted import rights from quotas resulted in marketing margins in import-restricted markets being double those in the United States and up to 50 per cent higher than in the European Union's only free market, Germany (chart 3). For further details of the national policies see Borrell and Yang 1990 and Borrell and Cuthbertson 1991.

2 Most producer prices of preferred suppliers to EU markets are over double the world price indicator



^a Latin American countries receive prices determined by the forces of supply and demand in the world banana market.
Data source: Borrell and Yang (1992).

3 EU retail prices are generally well above those of the United States



^a The United States has no barriers to the entry of bananas and so the forces of supply and demand in the world market determine US retail prices.

Data source: Borrell and Yang (1992).

Model estimates revealed the costs of old quota-based policies were excessive

To estimate the economic costs of the EU banana policies, an economic model of the EU and world banana market was constructed (see Borrell and Yang 1990, Borrell and Yang 1992). The results are summarised in chart 4 and show that:

- the cost to consumers of paying preferred suppliers double the world price for bananas was estimated to be \$576 million a year;
- the cost to consumers of paying excessive marketing margins in import restricted markets (instead of paying the marketing margins faced by German consumers) was estimated at \$917 million a year;
- tariff revenue collected on imports cost consumers an extra \$112 million a year;
- the value of the \$576 million being paid by consumers to preferred suppliers was only worth an estimated \$302 million a year in extra income to them because resources had to be used up and paid for to grow bananas to qualify for the aid;
- high EU consumer prices lowered EU consumption causing lower world price and lower exports for efficient Latin American exporters, which cost these exporters \$98 million a year.

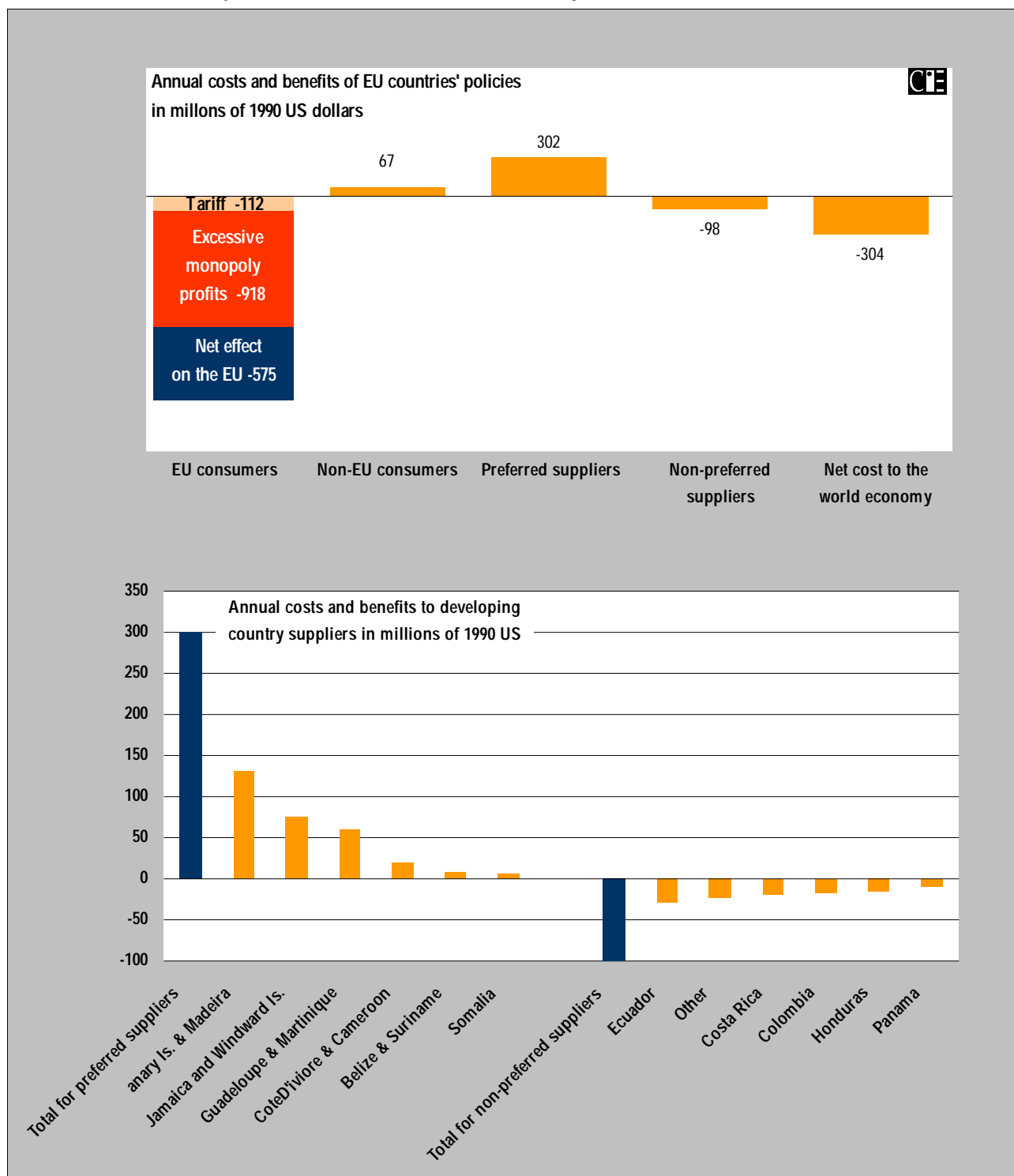
So, before the introduction of the current policies, consumers in import-restricted EU markets incurred excess costs of \$1.6 billion a year to deliver

\$300 million a year to the 11 developing economies of the preferred suppliers. Meanwhile it caused collateral damage of \$98 million a year to exporters in other developing countries, so the net benefit to developing countries was only \$202 million a year.

It cost consumers \$5.30 to transfer a dollar of aid to preferred suppliers

Put another way, it cost EU consumers an estimated \$5.30 to deliver \$1.00 of net banana aid to 11 developing country economies and caused \$0.32 in damage to other exporters. Of the \$5.30, over \$3.00 was estimated to be siphoned off in excessive marketing margins to EU marketers. About \$0.30 was collected as tariff revenue. After allowing for the excessive margins and tariffs which are just internal EU transfers, the net cost to the European Union was estimated at about \$2.00 (\$1.90). About \$1.00 of this was estimated as outright waste to the world economy, while the other \$1.00 was the one reaching its target as aid.

4 National banana policies of EU countries were costly



Data source: Model results.

Suppliers were forced to grow bananas at high cost to qualify for aid

The outright waste of \$1.00 per \$5.30 cost to consumers occurred because more resources than necessary were used to produce bananas. At least some of the bananas produced at high cost by preferred suppliers could have been produced with fewer and cheaper resources in the more efficient suppliers of Latin America. Moreover, to qualify for aid, preferred suppliers had to grow bananas using up precious land, labour and capital that could have been used in other more productive pursuits, such as is occurring in the export processing zones in the Dominican Republic and Jamaica — see World Bank 1993.

The old quota-based policies operating in the European Union were grossly inefficient as an aid mechanism.

More efficient policies could provide aid at a fraction the cost

The 1992-93 initiative to unify EU markets provided an opportunity to reform the disparate policies of member states. The stated objective of the unified policy is to provide support (aid) to EU territorial producers and those banana exporters of the Lomé ACP countries, while ensuring consumers are adequately supplied with good quality bananas.

A 17 per cent tariff-only policy could fund aid at virtually no cost or distortion

Borrell and Yang (1990 and 1992), Borrell and Cuthbertson (1991) identified alternative policy options that would meet the EU objectives at a fraction of the cost of the old disparate policies. With a tariff of only 17 per cent as the only restriction to imports, sufficient funds could have been raised to support well-targeted direct financial aid or deficiency price payments to preferred producers. Either of these options would have virtually eliminated the costs to EU consumers of the old policies, while the aid benefits could have been retained or improved. Further, the collateral damage to Latin American exporters could have been virtually eliminated. The cost to EU consumers of transferring one dollar of aid could have been reduced from \$5.30 to just over a dollar.

A tariff-only option would offer other advantages.

- It would be simple to administer compared with quota-based schemes.
- Transfers of direct aid or deficiency payments would be systematic, with control to ensure they reached their targets, compared with rents

from quotas and licences which tend to be uncertain and hit-or-miss in nature.

- The setting of the tariff could be done in an objective way and would therefore be less vulnerable to political interference compared with quotas.
- The effect of the tariff would be simple to monitor relative to the effects of quotas and licences.
- The marketing of bananas in the EU would be subject to the full forces of competition. This would encourage open, expansionary practices, efficiency, innovation, quality and consumer-oriented marketing efforts. It would eliminate protection for inefficient marketers.

The EU chose policies more costly than those it replaced

On 1 July 1993 the European Union replaced the disparate import policies of its member states with a unified policy. However, instead of adopting efficient policies, the European Union chose to extend across the entire European Union the most protectionist and costly of the former national policies.

The new policy used import quota restrictions over tariffs

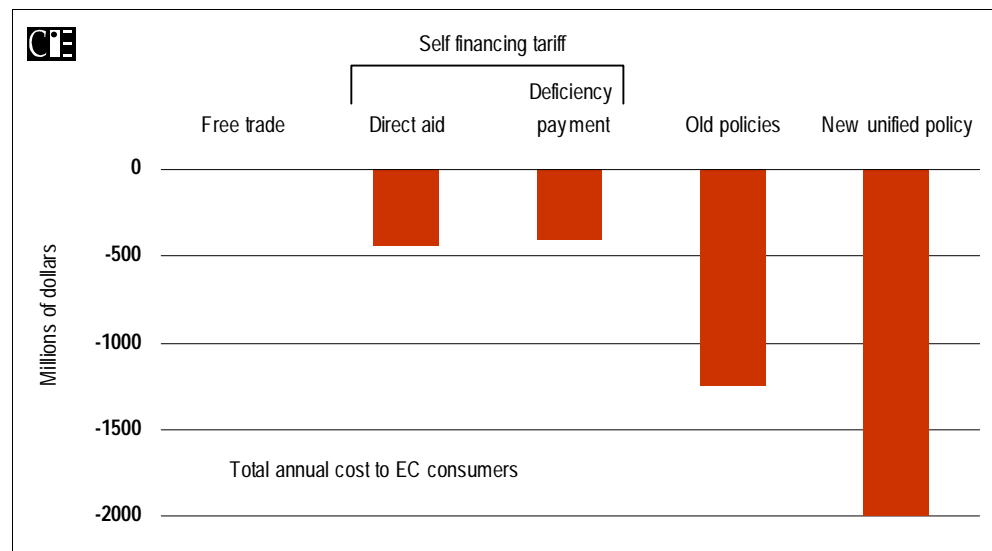
The new policy:

- relied on a prohibitive tariff-quota on Latin American imports, to restrict supply and raise internal EU prices;
- applied a tariff to quota imports from Latin America to raise revenue;
- greatly limited competition in the marketing of bananas through a system of import licences which divides up market shares and quota rents;
- restricted trade and supply for Latin American bananas to below the aggregate level previously allowed under national policies;
- allowed EU territorial bananas free and open access and a deficiency payment; and
- allowed duty-free, but quota-restricted, country specific access for ACP bananas, based on a best-ever reference amount.

Costs increased and aid benefits fell

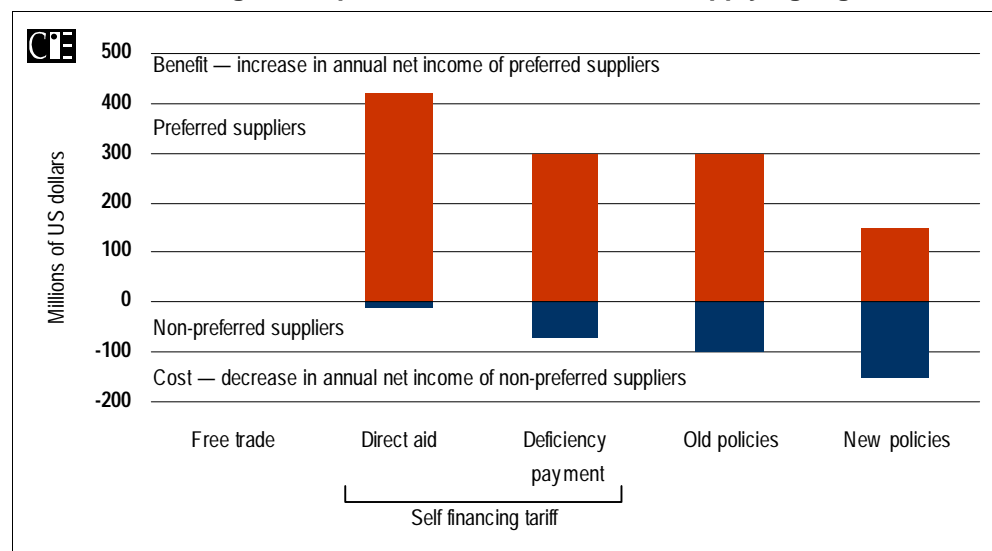
The costs and benefits of the self-financing tariff policies, the old disparate policies and the new unified policy are set out in charts 5 and 6. Because the new policy restricted aggregate imports by more than the total of the separate national policies it replaced, EU consumer price rose and the world price fell, increasing the costs of the policy to consumers and non-preferred suppliers. Costs to consumers rose from around \$1.6 billion a year under the old national policies to around \$2.0 billion a year under the new unified policy (Borrell 1996). Aid benefits to preferred suppliers declined. The delivery of aid required uncertain incentives and cumbersome instruments to encourage importers to share some of their quota rents with suppliers.

5 Self financing tariff options would be much less costly than quotas



Data source: Model results.

6 Self financing tariff options are best for banana supplying regions too



Data source: Model results.

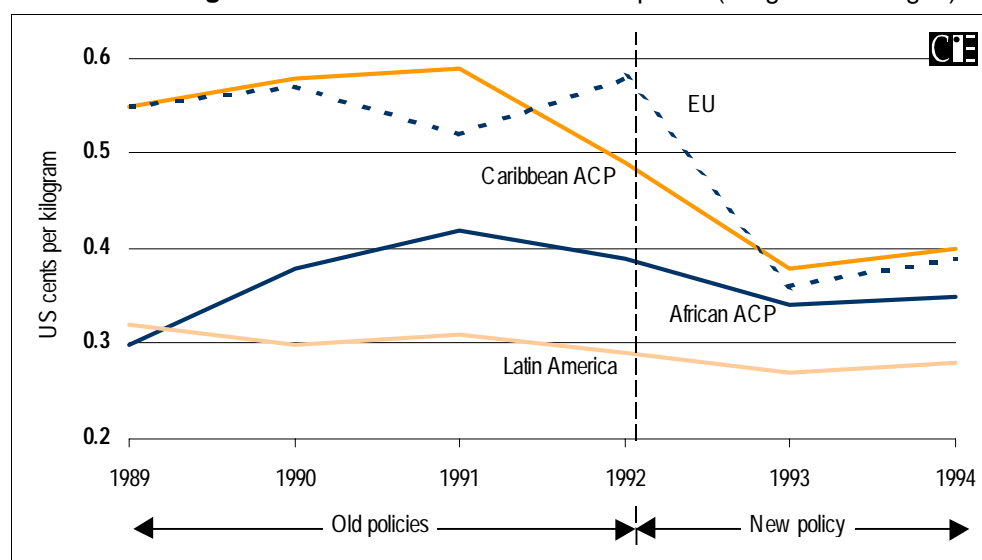
Aid was given through an unpredictable cross-subsidy from consumers

The mechanism for providing support was complicated and indirect. It involved using quotas on imports to raise consumer prices for bananas above what they would have been in a free and open market. The rights to market bananas in the European Union at these higher prices, and earn windfall gains, were selectively allocated. A system of licences was used to achieve this. Those companies marketing bananas from the countries to which the European Union wished to provide aid were allocated extra licences. This was intended to increase the demand for bananas from EU territories and ACP countries. Increased demand was intended to raise the prices for fruit from these sources, bidding it up above the world price. In this way it was intended to provide support or aid through a cross-subsidy to these exporters. Instead it mainly afforded the quota holders windfall gains.

But the cross-subsidy did not appear to get through

Chart 7 shows that support prices to Caribbean ACP producers and Caribbean EU territorial growers dropped by over 30 per cent in the first 18 months of operation of the new policy. Maybe as much as 8 per cent was due to the decline of the ECU against the dollar over this period. The support component of the price, the margin by which support prices are above the world price, dropped by over 60 per cent. Values of exports dropped accordingly, except for African ACP banana exporters — chart 8. The total value of banana exports from ACP and Caribbean EU territorial

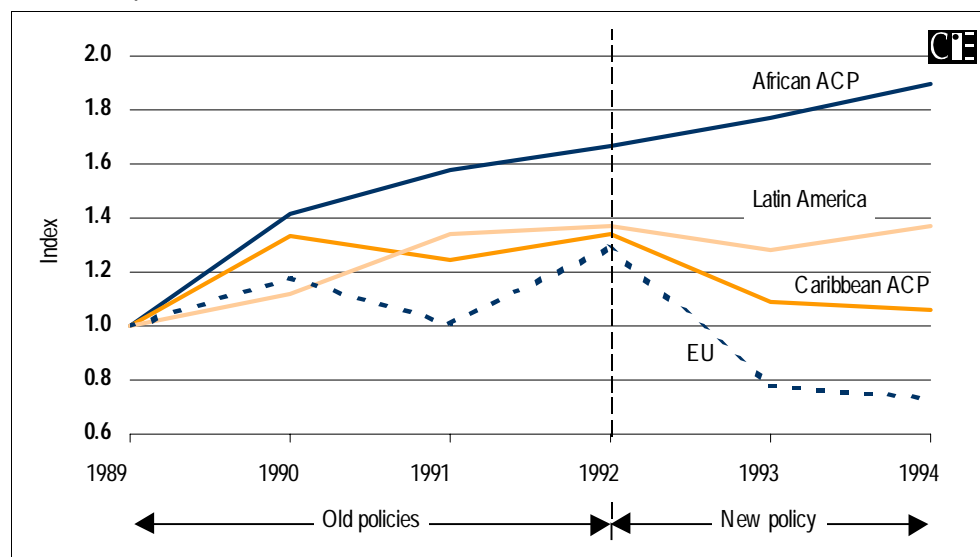
7 The new EU policy caused EU and Caribbean ACP fob prices to fall/converge toward African ACP Real 1994 prices (weighted averages)



Data source: FAO (1995).

8 Value of exports fell to most beneficiaries of the EU new banana policy

Real prices



Data source: FAO (1995).

suppliers dropped by 21 per cent from \$473 million in 1992 to \$373 million in 1994. African ACP exporters experienced a 14 per cent increase in export value. This occurred as a combination of a 22 per cent increase in quantity exported and a 7 per cent price decline. Meanwhile, Caribbean ACP and EU territorial exporters experienced a 30 per cent drop in export value. Mostly this was due to the decline in price, but volume also declined by 13 per cent. By 1997, Windward Island exports to the European Union had halved.

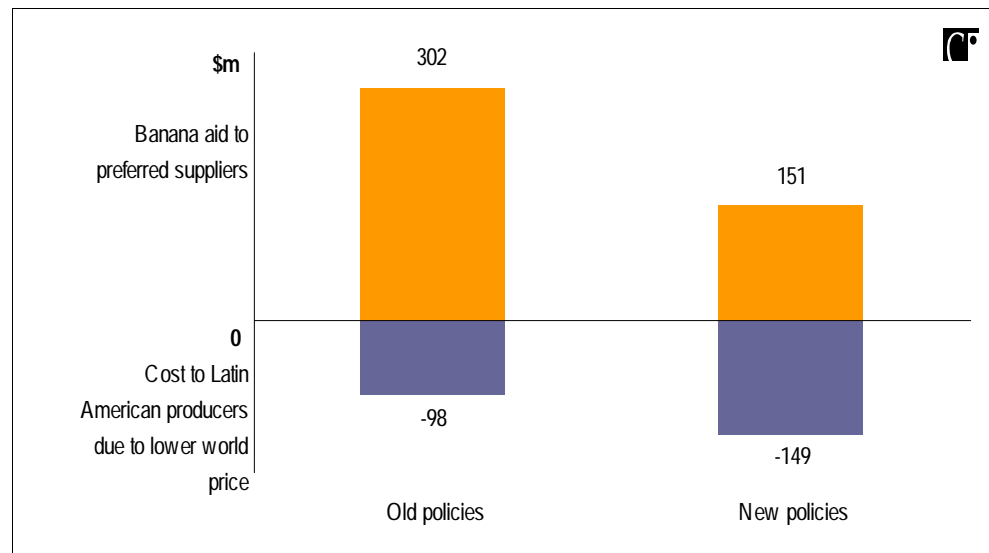
Data on the Canary Islands, the other main preferred supplier, are not so easily interpreted. However *cif* import value data of the Commission for the European Communities (1995), suggest they also faced big declines in export values. Import prices for Canary Island fruit dropped 35 per cent and volume dropped 13 per cent. Their *FOB* export values could conceivably have dropped by over 40 per cent.

From the data above the new policy appears to have failed to achieve its main objective. In its first two years of operation, export values appeared to drop by 30 per cent or more for about 80 per cent of intended beneficiaries. For the other 20 per cent, the African suppliers, export values increased due to increased volume, not price. The increase in African supplies may be due to their greater comparative advantage. Their industry structures are much more like those of the efficient Latin American producers than like those of the Caribbean producers.

Aid has halved and costs to non-preferred suppliers have risen

It appears that on average for all preferred suppliers, the aid component of their price (the cross-subsidy) fell by 50 per cent after the introduction of the new policy. If so, the \$302 million received under the old policies was slashed to around \$150 million a year. Worse still, the net cost of further reductions in imports to Latin American suppliers increased from \$98 million to \$147 million a year (Borrell 1996). If so, aid to one set of developing countries is being exactly offset by the costs it is imposing on another set of developing countries — chart 9.

9 The net aid effect for developing countries may be zero



Data source: Borrell (1996).

Aid was thrown into further confusion in January 1999

On 1 January 1999, the European Union reallocated import licences on the basis of licences held during 1994-96 and abolished country-specific quotas for each ACP country, while maintaining the total size of the ACP quota. This is likely to lower ACP prices further because:

- with extra licences no longer being allocated to those marketing ACP fruit, competition and demand for ACP bananas will decline; and
- with country-specific quotas not needing to be filled, the supply of ACP fruit may expand relative to demand, especially if competitive African ACP suppliers can profitably increase output and undercut Caribbean ACP producers.

The Framework Agreement did not compensate

After 1994 the Framework Agreement was implemented. This was designed to extend support prices of a sort to some Latin American producers. Given the performance of the indirect cross-subsidy to preferred suppliers as a vehicle for delivering banana aid, the likelihood of a similar mechanism compensating Latin American producers for the costs the policy imposes on them seems remote.

Normal commercial conditions do not apply, and much commercial uncertainty is created

The policy interferes with the normal commercial workings of the market. Many resource allocation decisions in production and marketing are made centrally and bureaucratically rather than commercially. As a result political and bureaucratic objectives can be expected to get in the way of commercial ones. Costly red tape and politically induced uncertainty is introduced to the marketing of Latin American bananas in the European Union.

The new policy favours those EU marketing companies (mostly EU owned) that benefited previously under the various national policies. Previously it did this through allocating these companies special licences (category B – see below). This handed them a third of the Latin American trade. Previously these companies were not competitive enough to command this trade. Only through the special privilege conferred on them by their special licences are they able to participate.

The companies that traditionally marketed Latin American bananas (mostly US owned) suffer from this restriction. They previously marketed bananas in the relatively open and contestable EU markets such as Germany, the Netherlands, Belgium, Luxembourg, Denmark and Ireland and in the three recent entrants to the European Union — Austria, Sweden and Finland. They had the overall size of their markets reduced directly in two ways: through quotas that restrict growth and through an allocation of licences (category A) that restricts their share of this market to around two-thirds of the total. The two-thirds was further restricted by the 57, 28, 15 percentage allocation between importers, customs clearers and ripeners. The other third was distributed between favoured EU marketing companies (as B licences) and as a small amount (C licences) to non-traditional marketers. Since 1 January 1999, the reallocation of quotas based on 1994-96 allocations has cemented in the allocations created by the new policy.

Higher prices are no compensation

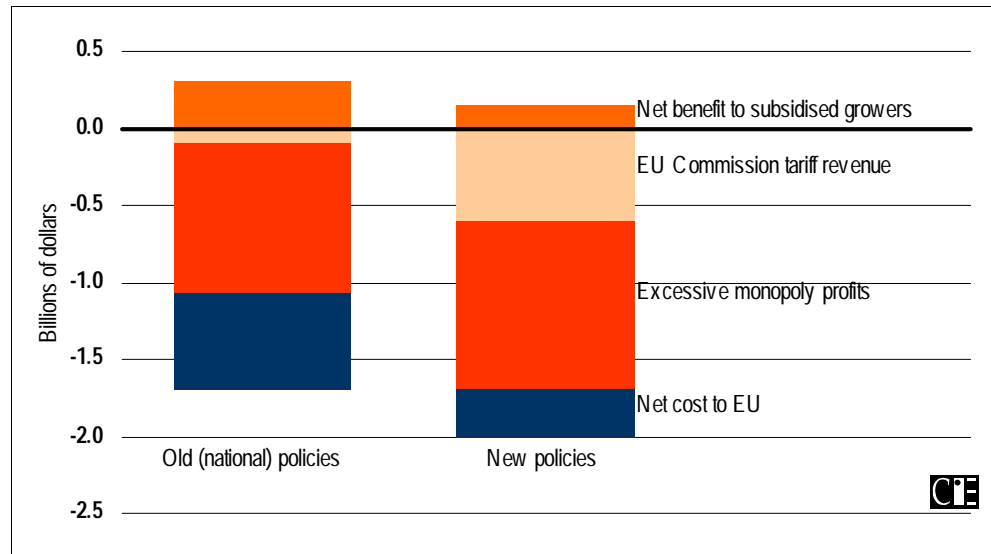
It may be argued that the higher prices received due to the quota system is some compensation to the marketers of Latin American fruit. But reduced volume reduces economies of scale and scope and so raises their costs. Compliance to the red tape of complex quota and licensing arrangements raises costs. The arbitrary nature of the policy - how it is administered, how licences are allocated and how it could change due to political and bureaucratic interference - introduce investment risks that add greatly to costs. The arbitrary nature by which market shares are allocated denies competitive companies their main security and comparative advantage — that is, their right to compete. It imposes an opportunity cost on them because it denies them the right to compete for future profit streams through good current commercial performance, and delivering what the consumer wants. Thus, whatever the benefits of higher prices, they are offset by higher costs and reduced commercial opportunities.

Under quotas and licences, winning market share requires extensive and expensive lobbying. But even then this guarantees no favour. This is one reason why competitive growth-oriented companies continue to resist quotas.

It now appears to cost consumers over \$13 to transfer \$1 in banana aid

If it costs EU consumers \$2.0 billion to transfer only \$151 million a year to preferred suppliers in the form of banana aid, this implies the new policy is more than twice as inefficient as the old policy in achieving its objective. It costs consumers \$13.25 to transfer \$1.00 of benefit to preferred banana suppliers. Under the old policies it was estimated to cost consumers \$5.30 to transfer each \$1.00 of banana aid. The increase in cost is due to the fact that windfall gains on the sale of bananas have been deliberately raised by the policy and even less of these windfall gains are being passed back to preferred suppliers in the form of higher prices than occurred previously — chart 10.

10 Total annual benefit to subsidised growers and cost to EU consumers

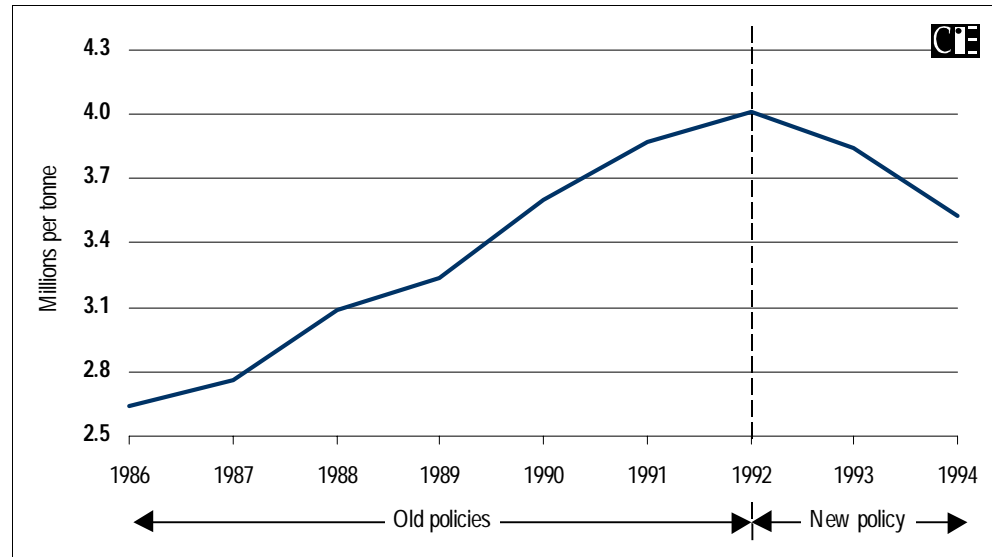


Data source: Borrell (1996).

The true objectives appear to have little to do with aid

In moving to adopt a new unified policy, the European Union missed an opportunity to rationalise its distortionary national banana policies. Of the options open to it, the European Union chose one of the most discriminatory and distortionary. Clearly the policy has failed in terms of its objective to provide support to preferred producers. It has also failed in terms of its objective to provide adequate supplies to consumers. Availability to consumers declined 11.5 per cent between 1992 and 1994 (chart 11) and retail prices rose by at least 42 per cent in Germany, the biggest EU market, with 30 per cent of trade. Quality may also have dropped (Borrell 1996).

11 EU banana consumption has dropped 11.5 per cent since the new EU policy



Data source: of European Communities (1995).

It is hard to escape the conclusion that the European Union is pursuing another objective. The most obvious is that it wishes to protect and expand the vested interests of EU based marketing companies. This group is the clear beneficiary of the policy. EU consumers, other marketers and Latin American producers are clearly the big losers, although ironically preferred suppliers also appear to be losing out. Clearly, the main objective is not to provide aid to ACP and EU territorial producers. To have disrupted the market so much, and to have imposed such high costs on consumers to deliver so little, makes a mockery of the aid objective. It also raises many issues about the effectiveness of existing and future international trade rules and procedures.

Several lessons emerge from the banana story

The banana is only one commodity and relative to many other commodities its trade is not large. However, it is important to many developing country exporters, and it is the most traded fruit. Growth in trade of fruit and vegetables is more rapid than that of agriculture, and this trend is expected to continue (Borrell 1998). But, perhaps more importantly, the fact that EU trade policy can grow so much more disruptive at a time when many had hoped strengthened trade disciplines would restrain protection, means the banana trade debate and dispute set several precedents. These precedents make the banana story an important one and drive home several lessons worth considering in the lead-up to the millennium round.

Persistence of the policy is a reminder that countries ultimately act unilaterally

The new EU policy is a reminder that countries even as important as the European Union are prepared to flout international trade rules in favour of domestic political considerations. The policy's evolution shows a pattern of purposeful EU indifference to the principles of international trade rules. In 1992 when GATT explicitly condemned the European Union's old restrictive national policies, the European Union blocked GATT approval of that ruling and ignored its content in structuring the new policy. In 1994 when GATT, for a second time, ruled against the EU banana policies and called for a restructuring of their new policy, the European Union again blocked the ruling. Even supported by strengthened dispute settlement procedures and new disciplines governing services, licensing and investments, the WTO rulings against the policy under GATT and GATS in 1997 have not yet succeeded in bringing sensible reform.

The policy also seems to flout the European Union's own internal competition policy rules — table 12. On an economic interpretation of this law, the banana policy would appear to fall down on every category.

To change the policy the political balance inside the EU must swing

The EU policy is so blatantly inefficient and so much effort has been expended for so long to change it that it seems inevitable that it will eventually be changed. On the other hand, its persistence in the face of such pressures also shows how difficult it is to change policies where quota rents create powerful vested interests.

Publicity and policy transparency remain important to gain support

That so much effort and money has been expended over nearly a decade to change EU banana policy is one indication that many believe the political balance can be swung in favour of reform. That so much effort has been undertaken to mount GATT and WTO cases without success or change is also an indication that trade rules and dispute settlement procedures are seen to have value in the policy reform process. At the very least they bring considerable publicity to the issue. And if the banana story leaves one lasting message, it is that policy transparency and publicity at least sustain an issue and drive a wide-ranging debate.

Until 1990 there had been very little analysis of the costs of EU banana trade restrictions. One exception was the work of Noichi (1985). While this paper provided a sound theoretical structure to analyse the policy, it did

12 How EU banana policy contravenes EU competition policy

<i>Key features of EU competition law</i>	<i>An economic interpretation of this law as it applies to EU banana policy</i>
Article 3(g) of the Treaty of Rome provides that the activities of the European Union shall include a system ensuring that competition in the internal market is not distorted.	Quotas and licensing guarantee that competition in internal markets is distorted.
Articles 85 and 86 of the Treaty of Rome further lay out the basis of European Union competition policy. The following shall be prohibited as incompatible with the common market: all agreements between undertakings; decisions by associations of undertakings and concerted practices which may affect trade between member states and which have as their object or effect the prevention, restriction or distortion of competition within the common market; and, in particular, those which:	The stated object is to deliberately prevent, restrict and distort competition to orchestrate an indirect monetary transfer to a small group of banana producers.
1. directly or indirectly fix purchase or selling prices or any other trading conditions;	Quotas and licences directly fix trading conditions and indirectly fix the selling price.
2. limit or control production, markets, technical development, or investment;	Quotas and licences limit production, investment and technical development and blatantly control markets.
3. share markets or sources of supply;	Licences mean there is blatant market sharing.
4. apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage; and	Conditions applying to licences mean there is blatant discrimination against one type of marketing company over another.
5. make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts (Martin 1994).	Category A, B and C licences have supplementary obligations attached to them.
Exemptions may apply if the action promotes technical or economic progress and consumers share in the benefits	The policy would appear to cause the exact opposite and so there are no grounds for exemptions.

not quantify the costs and benefits, nor gain much publicity. Not until Borrell and Yang (1990) built a quantitative model to measure the costs and benefits did the issue gain currency and publicity. Since then there have been probably a dozen studies fuelling the debate and keeping it alive (see for example Fitzpatrick and Associates 1990; McNerney and Peston 1992; Mathews 1992, Read 1994; Kersten 1995, Messerlin 1998). The GATT and WTO challenges have also fuelled the debate and given the studies relevance and more publicity. The combined effect of consistent studies and regular challenges has at least created a political balance, so far, that has kept the proponents of reform active.

Involving official institutions and large companies is important

Quantifying costs and benefits and clearly explaining the hidden effects of policy through press releases were important in stimulating the debate and gaining publicity. Having the imprimatur of an official institution, such as the World Bank in the case of Borrell and Yang, was also important to gain credibility for the numbers and the arguments. Another interesting ingredient in the banana debate has been the important role of the private sector in seeking reform. The US importers and marketers constrained by

the policy had a big incentive to push for reform. The energy, vitality and resources of companies can help provide a focus and sense of importance to the debate that governments cannot easily achieve. Historically, trade debates have been the domain of governments. Harnessing the energy and resources of food processing and marketing companies may be important in helping to drive trade reform in agriculture. Identifying their interests may be an important part in future trade transparency studies.

GATS may be a vehicle for gaining more publicity for agriculture

On 9 September 1997, the WTO banana panel found that ‘the EU policy creates less favourable conditions of competition for like services and like service suppliers of the Complainants’ origin and is therefore inconsistent with the requirement of Article XVII of GATS’. To make its policy conform to GATS obligations, the European Union will have to dismantle the licence allocation mechanism of its quota system to eliminate licensing discrimination in favour of EU interests. This will render the quotas impotent in terms of achieving either the stated or intended objectives of the policy. In short, the European Union will have to design a new policy that does not discriminate against successful foreign marketing services.

Historically, the WTO banana case marks the first time that the WTO disputes settlement panel has ruled on GATS. The panel’s ruling holds far-reaching implications. It suggests that any trade impediment that restricts the ability of a foreign company to market its services by discriminating against it in favour of local or other foreign service providers, could be challenged as a violation of GATS, provided the country imposing the restriction has listed the sector under GATS. Perhaps in Japan, the McDonald’s hamburger company could argue that restrictions on beef and sugar imports constrain its ability to market its food services in competition with providers of like services such as fast food sushi and sashimi.

Trade as aid is a lose-lose situation

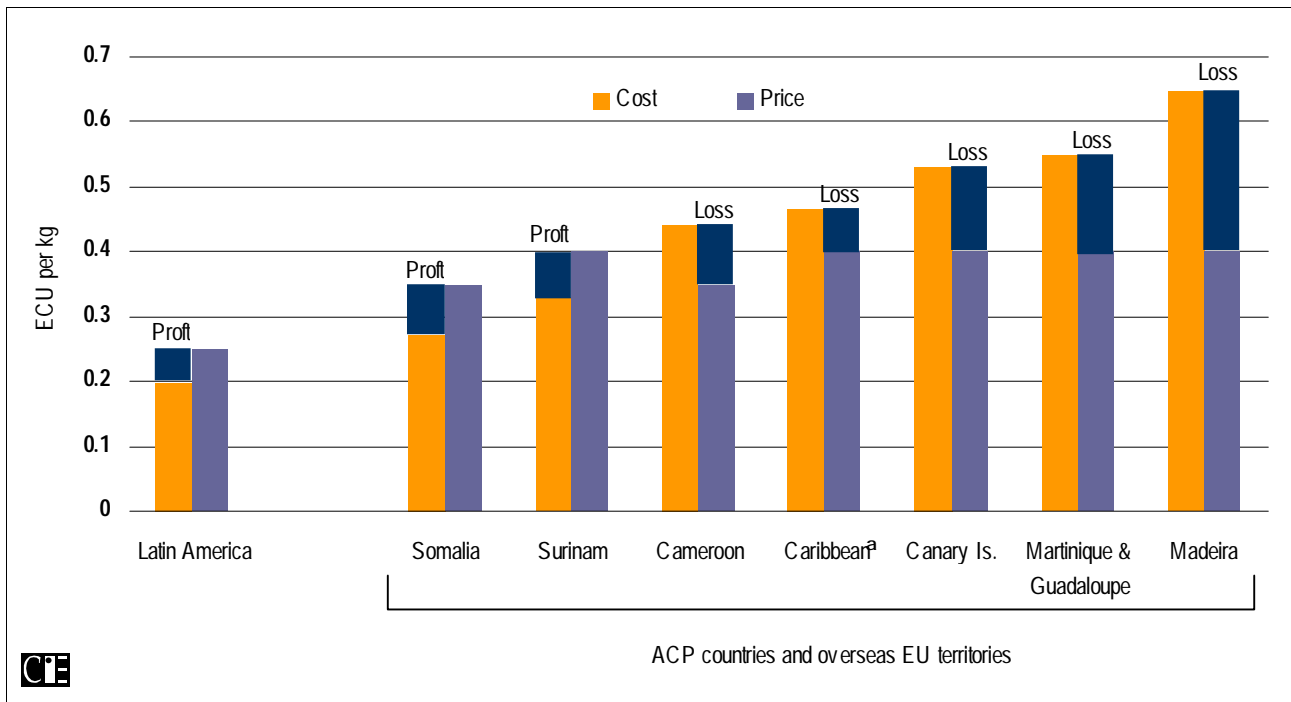
The message to emerge for preferred suppliers is that in its current form banana aid has become more uncertain and is of questionable value. It builds up economic dependence on an industry and preferential market which has a highly doubtful future and offers little prospect for helping the economies develop. The challenge for such countries is to make the transition to more open and competitive markets and to find practical and sustainable alternative policies and industries that encourage development and growth.

Aid dependency for an industry can be its kiss of death

Bananas make up around 60 per cent of export earnings of the Windward Island and 30 per cent of their GDP. In Martinique and Guadeloupe they make up around 50 per cent of export earnings. Given that the national policies of EU countries approximately doubled *FOB* banana prices for these economies, they have become highly reliant on that aid. Moreover, from a comparison of costs of production and world prices of bananas it is easy to see that these countries would have great difficulty in producing bananas were the aid removed and if productivity gains were not made to reduce their costs.

Charts 13 and 14 show estimates of costs of production by various producing countries. World prices at *FOB* level are about \$250 a tonne, almost a third of Martinique’s costs of production.

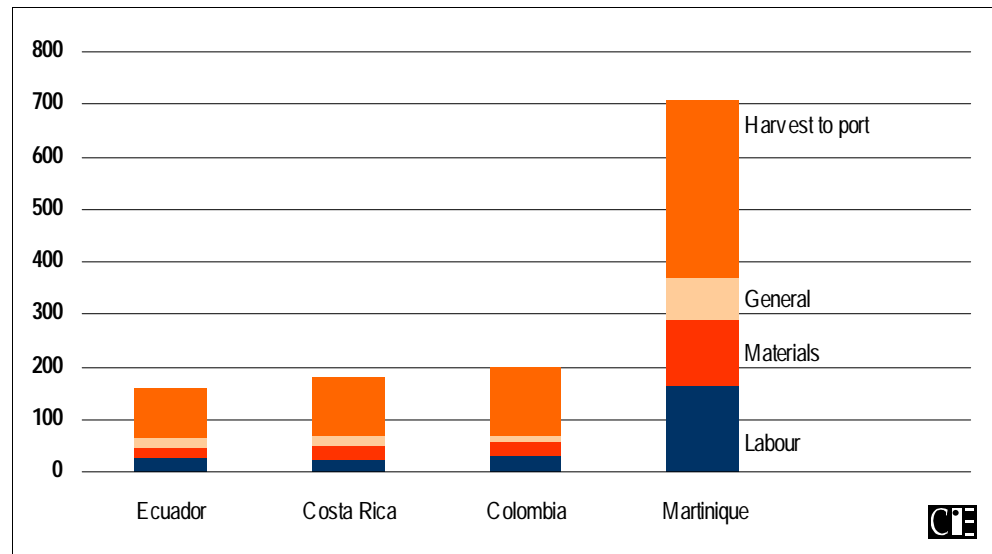
13 Most ACP and EU territories appear to be suffering big losses



^aDominica, Grenada, St Lucia, St Vincent and Jamaica.

Data source: World Bank (1995).

14 Martinique costs are more than three times higher than those in Latin America



Data source: FAO (1994).

Welch (1994) in an article titled *Albatross or life raft?* highlights the precarious situation the new EU banana policy creates for the Windward Islands economies due to their high dependency on banana aid. She raises serious doubts about the economic and environmental sustainability of the industries in these countries.

Her analysis points out the importance of constructively seeking out realistic alternatives that avoid degradation of the environment by excessive concentration on a single crop. One interpretation of her analysis is that there is an urgent need for better mechanisms to guarantee and deliver aid in ways that ease economic dependency on banana aid.

Commenting on economic development in the Caribbean, the World Bank (1993) notes that changes in aid flows for small Caribbean economies can create major macroeconomic imbalances. This can be a particular problem with discretionary non-project aid or subsidies (such as the cross-subsidy through banana aid). The World Bank points out that the UK's banana quotas have in some cases been inconsistent with the development purpose. The paper goes on to state that 'If it is decided to subsidise an economy with foreign aid, it may be more efficient to do it directly, basing the subsidy on an agreed development program.' (p. 93).

The paper also highlights the fact that one of the major constraints to export performance of the economies of the Caribbean is the myriad of distortions caused by government interventions in trade, production, and labour market. It cites the telling evidence of the strong success of export processing zones in the Dominican Republic and Jamaica, where such

interventions are nonexistent. This suggests there are realistic alternatives to development.

Grossman (1994) argues that technical and financial assistance has failed to adequately increase efficiency in the Windward Islands. This perhaps reinforces the point made in the World Bank article, that export performance is held back by distortions caused by government interventions. Cargill Technical Services (1995) in a detailed study of the Windward Islands' industries comes to the same conclusion.

Banana aid creates complacency and reduced competitiveness

The Cargill Technical Services Ltd (1995) study on the Windward Islands points out that:

- poor management at all levels is a bigger problem for the industry than inherent climatic, topographical or structural weaknesses;
- the industry has the capacity to function competitively in a free market if the necessary organisational and technical changes are made;
- Windward Island bananas are perceived to be low yielding, high cost and of inconsistent quality relative to Latin American fruit;
- costs of production are twice those of Latin American producers;
- guaranteed access to the UK market up to 1993 was a disincentive to solving fundamental quality and cost inefficiencies (a common occurrence);
- despite good support prices and conditions between 1989 and 1992, the industry's marketing bodies were accumulating debt;
- when prices fell in 1993, debt of marketing bodies blew out to ECU 113 million, putting the industry in an unsustainable financial/debt position; and
- the industry is financially unsustainable without massive increases in productivity and competitiveness, substantial debt write-offs and infusions of equity.

The findings for the Windward Islands probably hold a great deal of relevance for other preferred suppliers too. Most countries are in financially unsustainable positions unless they solve underlying problems of competitiveness. Direct aid aimed at technical assistance and structural adjustment can be used to address these problems. Indirect banana aid (the cross-subsidy) only provides incentive to put off making the difficult structural adjustments that must be made.

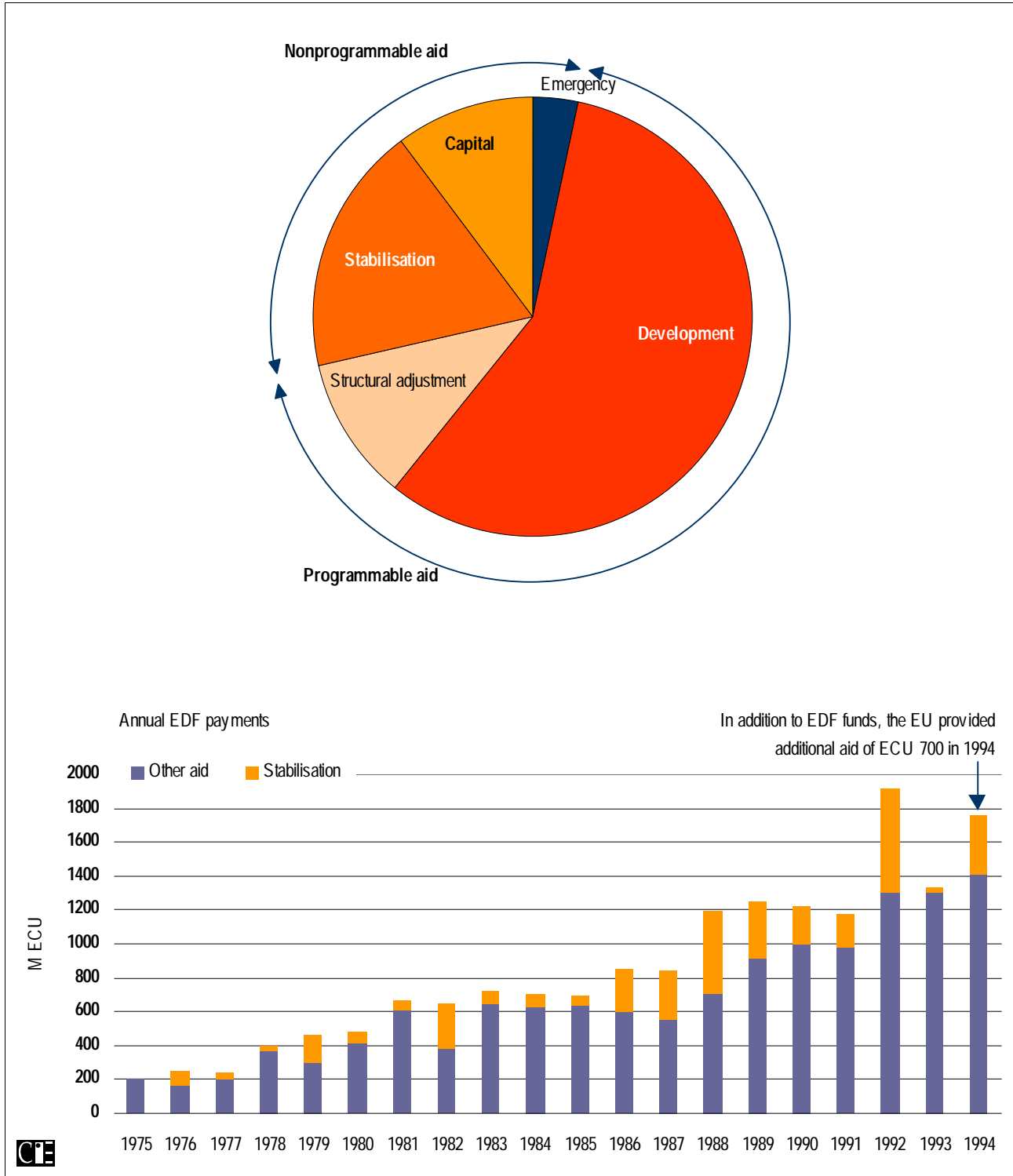
Direct aid is more likely to be a win-win situation

Indirect banana aid is inconsistent with the EU commitment to direct aid. The European Commission (1995) appears to recognise that ‘... many ACP states have really not benefited from their preferential access...’, that ‘... the Uruguay Round...’ will mean ‘... access to the European market will mainly be determined by the differences in competitiveness between competitors...’, that ‘... the new Lomé IV Convention should be enriched with a series of new arrangements aimed at improving the competitiveness of ACP states...’ and, that ‘... new elements should not only focus on reforming the trade policies of ACP countries, but also on other economic policies within carefully conceived structural adjustment programs.’ (p. 55 and 57). And indeed, the European Union has a special adjustment assistance program (a form of direct aid) for banana growers which was introduced as part of the new EU banana policy.

EU direct aid mechanisms exist already

Further, the European Union already has a comprehensive direct aid program with several well-established mechanisms for delivering aid to ACP countries including ACP banana producers. In 1994, the European Union provided nearly ECU 2.5 billion in direct aid to ACP countries — chart 15. This does not include direct aid to the preferred suppliers, Canary Islands and Madeira, which account for a quarter of preferred suppliers’ bananas. Nearly ECU 1.8 billion of EU direct aid came from its European Development Fund. ACP banana producers receive around 11 per cent of these funds. Up to the end of 1994 they had received ECU 948 million under Lomé IV, most of which was allocated in the three years up to that time. Therefore, direct aid of about ECU 300 million a year is already being delivered to these countries.

15 The EU makes a large direct aid commitment to ACP countries from its European Development Fund (EDF) already



Data source: European Commission (1995).

Direct aid offers many advantages

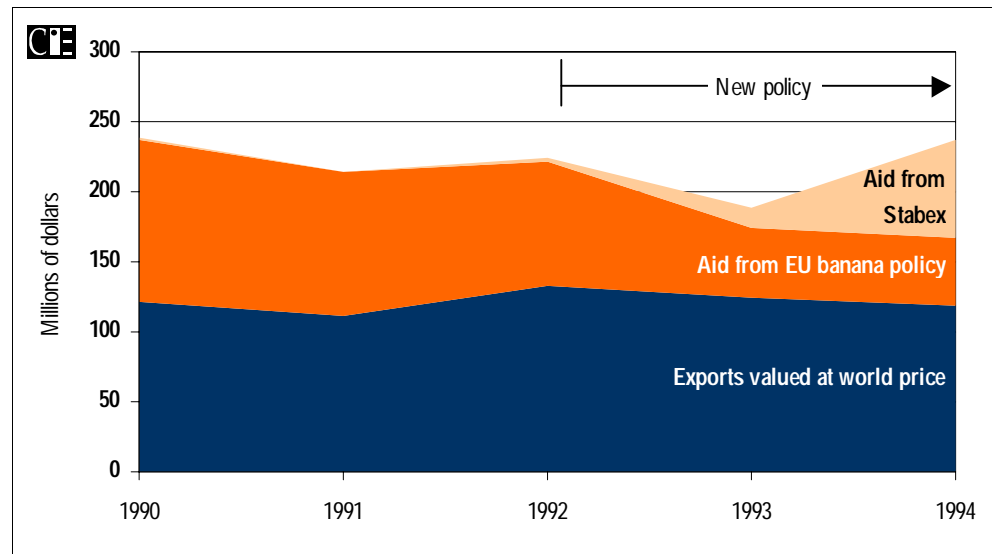
Direct aid given by the European Union is either programmable aid for development programs and projects, or nonprogrammable aid that is given based on particular circumstances of economic difficulty. Through its direct aid program, the European Union places a great deal of emphasis on planning, selecting, implementing, coordinating, avoiding inconsistencies with other activities, evaluating and monitoring aid transfers and the effectiveness of their use. Many factors are considered in assessing the worthiness of aid. All this is in recognition of the difficult task involved in making aid effective. Providing quality aid is a major objective of the European Union's direct aid program (European Commission 1995). By comparison, the aid it provides as banana aid (the cross-subsidy) is entirely haphazard. In this regard it appears to be inconsistent with the European Union's aid strategy.

Direct aid is occurring by default anyway

The decline of banana aid that has occurred since the new policy came into effect has invoked new forms of aid for ACP countries from the European Union. In particular, an aid mechanism known as Stabex has been invoked. Stabex is a mechanism that automatically kicks in aid to compensate ACP countries with direct financial aid if they experience losses of export earnings from agricultural or fishery products. The switch from banana aid to direct Stabex aid for Caribbean ACP countries and Caribbean EU territories is shown in chart 16. In 1994, more aid was scheduled to come from Stabex than came from cross-subsidy. In addition, special adjustment assistance for banana growers was provided. For all ACP countries around ECU 14 million of special adjustment assistance was committed in 1993 and ECU 30 million in 1994.

The European Management Committee approved a massive ECU 272 per tonne deficiency payment for banana producers in the Canary Islands, Martinique, Guadeloupe and Madeira to compensate them for the drop in price in 1995 (Eurofruit Magazine 1996). This represents a deficiency payment per tonne that is greater than the *lob* world price of bananas. In total it represents a direct payout of ECU 179 million (\$240 million) a year. This alone (without considering Stabex payments and special adjustment assistance to other beneficiaries) is larger than the aid estimated as being delivered by the indirect banana aid through the cross-subsidy in chart 16.

16 In 1994, Stabex aid was more important than banana aid through the cross-subsidy Caribbean ACP



Data source: FAO (1995).

The shift to direct aid is good but it is also a damning piece of evidence

The necessity for direct aid payments demonstrates the complete inadequacy of the indirect banana aid through the cross-subsidy mechanism. But more important, this one piece of evidence reveals that the policy has failed almost entirely and does not in any way serve its stated purpose. But it does nonetheless impose huge costs on consumers and the EU economy.

Discretionary quotas and licences are bad instruments

The cost of the new policy is as high as it is because its main instrument (discretionary quotas–licences) is one of the most market distorting instruments that it is possible to have. Such intervention chokes commercial and competitive behaviour by discouraging open expansion and sound consumer-oriented marketing. It stifles innovation, quality and market dynamism. No market can be expected to function efficiently under such circumstances. To continue with such mechanisms even if the policy were achieving its objective would be highly inefficient because the same objective could be achieved using alternative mechanisms which do not involve disrupting the market. The alternative mechanisms simply involve using direct aid in place of indirect banana price aid and many options exist. The cost of direct aid could even be raised through a tariff (around 20 per cent ad valorem) on all banana imports.

Quota-based policies are difficult to remove even when past their use-by date

The ultimate irony in the banana story is that the stated aim of the EU banana policy can be shown to be irrelevant and redundant, but the market is being left the legacy of one of the most intrusive pieces of intervention that exist. Quota rents that establish privilege in a market place, once captured by powerful political lobbies, are hard to shift. Further, quota rents once established can get captured by groups they were not intended to benefit. This is one of the reasons tariff-based barriers are preferred to quota-based barriers.

The outcome on bananas is important to the millennium round

What the European Union announces in coming weeks will in part set the tone for the millennium round. There are five possible outcomes.

- The status quo.
- A reallocation of licences and quotas.
- A tariff-only regime with an unacceptably high tariff — above about Euro 100 a tonne.
- A tariff-only regime with an acceptable tariff — below about Euro 100 a tonne.
- Free trade with direct aid.

A status quo outcome may dampen enthusiasm for another round

A status quo outcome, or change without genuine reform, could lead to the escalation of an already well-publicised trade dispute between two of the WTO's main players, the European Union and the United States. US retaliatory measures are likely to continue. This may test the resolve of both countries to become wholeheartedly involved in a millennium round. At the very least they will be reluctant to treat agricultural issues seriously, and the leadership they may have been able to offer will be diminished. Such an outcome is also likely to dampen the enthusiasm of other countries to treat the round seriously or to abide by international trade laws. Commitments to trade liberalisation by the European Union, indications of a genuine willingness to reform and indications of a willingness to comply with dispute rulings will become important.

Some people may argue that the disputes over hormones in beef and genetically modified foods are equally important and maybe they are. However, here at least there is some room left for debate about scientific

issues and institutional mechanisms to deal with consumer concerns. In another way, the tensions over hormones and genetically modified foods increase the importance to get an acceptable result on bananas.

Specifically for bananas, should the status quo outcome occur, it will reinforce the need to focus on measures aimed at changing the political will and balance in the countries imposing barriers. This will place added emphasis on policy transparency. Certainly, in the case of bananas, ways will need to be found to keep the debate alive and to find increased support for change inside the European Union. A big issue for preferred suppliers will be how to avoid further loss of their aid. Working with the European Union to convert it to direct development aid may be important.

Reallocating licences may placate the Americans temporarily, but ...

A fairer allocation of import licences and quotas reflecting pre-1993 market shares, may placate the United States temporarily, but it would defeat the stated objective of the policy and not lower the costs of the policy to consumers. It would still not allow open competition and would continue to discriminate against efficient marketers wishing to expand the market. This outcome would still send a clear message that trade liberalisation, even for something as obvious as bananas, is something the European Union is prepared to sidestep. A question it would raise is: if the European Union is prepared to sidestep a straightforward issue such as bananas, what is the probability it will seek genuine reform in other more difficult areas?

Should this outcome occur, it would require an alternative direct aid mechanism to assist ACP countries to adjust to the new environment. Focus in a new round would need to be on shifting toward tariffs and tariff reductions to encourage expanded EU consumption and lower prices.

A high tariff-only outcome would be a disappointment

A high tariff outcome would continue to constrain EU consumption and is unlikely to placate the United States. Tariffs ranging from Euro 175 to 300 per tonne have been mentioned. Should they be imposed the dispute may continue and remain in the way of strong US and EU commitments to the millennium round. It is not likely to cause the US retaliatory measures to be lifted. However, should this outcome occur, attention would shift to lowering the tariff and this would become an important priority in the next round.

A low tariff or free trade would engender confidence in the next round

Either of these outcomes would raise confidence in policy transparency processes and multilateral trade liberalisation procedures. They would demonstrate that the debate and dispute of the last decade have had a huge payoff for the effort involved. They would help raise expectations of what could be accomplished on agriculture in the millennium round. However, they would not allow past costs to be recouped, which highlight another problem; the need to find ways to speed up trade reform. A major emphasis of the millennium round may be to find approaches and mechanisms to achieve speedier outcomes.

References

- Borrell, B. and Cuthbertson, S. 1991 *EC Banana Policy 1992: Picking the Best Option*, Centre for International Economics, Canberra.
- Borrell, B. and Yang, M. 1990, *EC Bananarama 1992*, WPS 523, International Economics Department, World Bank, Washington, D.C.
- Borrell, B. and Yang, M. 1992, *EC Bananarama 1992, The Sequel, The EC Commission Proposal*, WPS 958, International Economics Department, World Bank, Washington, D.C.
- Borrell, B. 1993, *Way out of reach: EC over-quota banana tariff: a prohibitive tariff on dollar fruit*, Centre for International Economics, August, Canberra.
- Borrell, B. 1994, *EU Bananarama III*, Policy Research Working Paper, 1386, World Bank, Washington, DC.
- Borrell, B. 1996, *Beyond EU Bananarama 1993: the story gets worse*, Centre for International Economics, Canberra.
- Borrell, B. 1998, *Emerging issues*
- Cargill Technical Services 1995, *Proposals for Restructuring the Windward Islands Banana Industry, Draft Final*, United Kingdom.
- Commission of European Communities 1995, *Report on the Operation of the Banana Regime*, Brussels.
- Commission of European Communities 1995, *EU-ACP Cooperation in 1994*, Belgium.
- Commission of European Communities 1995, *Financial Cooperation Under the Lomé Conventions: Review of Aid at the End of 1994*, Geneva.
- FAO (Food and Agriculture Organization) 1994, *Review of Costs of Production Trade and Distribution of Bananas for Selected Countries*, Committee on Commodity Problems, Intergovernmental Group on Bananas, Fourteenth Session, Rome.
- FAO (Food and Agriculture Organization) 1995, *Banana Information Note*, Intergovernmental Group on Bananas, Rome.
- General Agreement on Tariffs and Trade 1993, EEC — *Member States' Import Regimes for Bananas: Report of the Panel*, Geneva.
- General Agreement on Tariffs and Trade 1994, EEC — *Import Regime for Bananas: Report of the Panel*, Geneva.
- Jim Fitzpatrick and Associates Economic Consultants 1992, *Trade Policy and the EC Banana Market: An Economic Analysis*, United Kingdom.

- Kersten, L. 1995, *Impacts of the EU banana market regulation on international competition, trade and welfare*, European Review of Agricultural Economics 22 pp. 321–325, Berlin.
- Mathews, A. (1992), *The European Community's Banana Policy after 1992*. Discussion paper N. 13. Institut für Agrarpolitik und Marktforschung, University of Giessen.
- McInerney, J. and Lord Peston (eds.) 1992, *Fair Trade in Bananas, Report No. 239*, University of Exeter, United Kingdom.
- Read, R. 1994, *The EC internal banana market: The issues and the dilemma*, The World Economy, vol. 17, no. 2, pp. 219–35.
- World Bank, 1993, *The Caribbean: Export Preferences and Performance*, In Stanley Lalta and Marie Freckleton (eds., *Caribbean Economic Development: The First Generation*, ch. 6, pp. 78–104, Ian Randle Washington, D.C.