



# POLICY BRIEF

## No. 107

JANUARY 2023

### KEY POINTS

- Trade prospects of the least developed countries are increasingly conditioned by the use of trade policy as an instrument of climate policies of trade partners.
- Uncoordinated carbon policies are likely to impose disproportionate trade costs on least developed country exports.
- Systemically important traders should take into account least developed country structural features when enacting trade policies aimed at environmental or climate objectives.
- The least developed countries should explore regional markets through cooperation on trade-enhancing infrastructure, value chains for strategic products, and business linkages, raising their productive capacities to boost production and improving the quality of traded goods.

## Trade policies for the low-carbon transition need to take into account least developed country structural features\*

Increasing the share of manufactured goods in total exports would be beneficial to least developed countries (LDCs), but achieving industrial growth remains elusive. This goal can be jeopardized by the increasing use of trade policy measures to achieve climate or environmental goals. While these goals are legitimate, uncoordinated measures by systemically important traders can have adverse consequences for LDCs. To attenuate them, these traders should adopt special measures to help LDCs adapt to the evolving international regulatory scene. LDCs should invest more on upgrading their productive capacities and intensify trade with regional markets.

\* This policy brief is based on the contents of UNCTAD (2022), *The Least Developed Countries Report: The Low-Carbon Transition and Its Daunting Implications for Structural Transformation*, available at <https://unctad.org/webflyer/least-developed-countries-report-2022>.



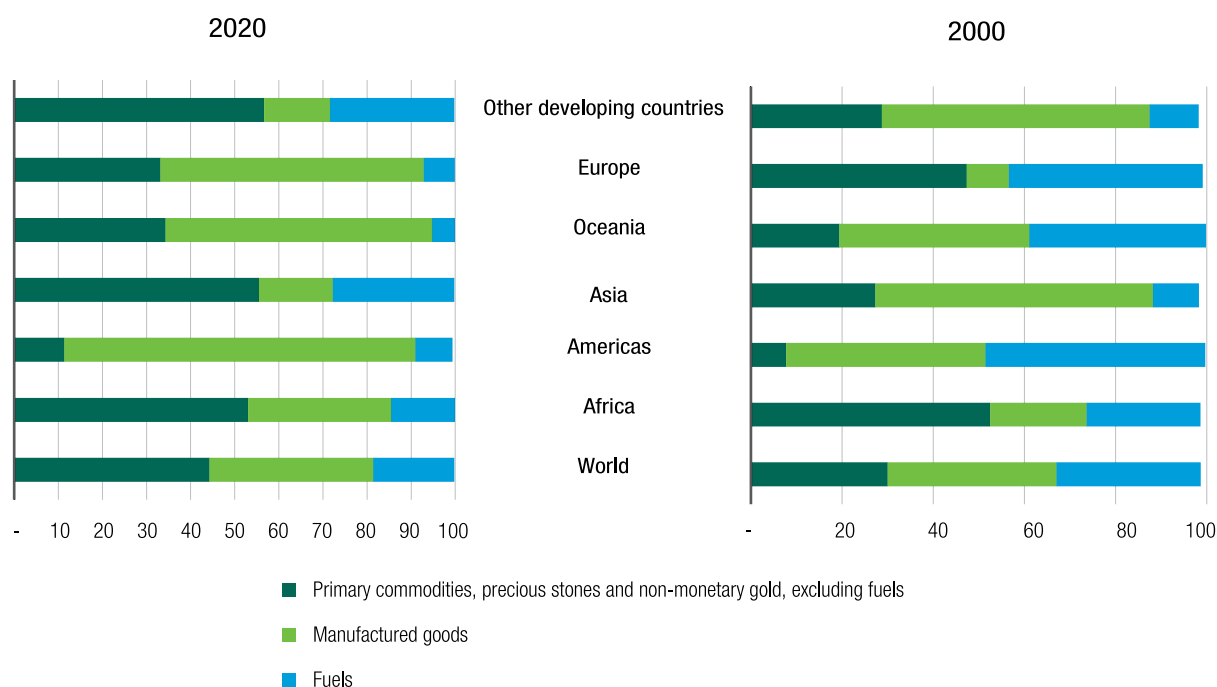
### The evolving patterns of LDC trade

LDCs trail other countries in all forms of product transformation, value addition and product diversification. As a result, the patterns of trade between LDCs and their trade partners confirms diverting trends that point to further marginalization of LDCs.

Global merchandise trade more than quadrupled from \$5.1 trillion in 1995 to \$22.1 trillion in 2021. At the same time, LDC exports rose from \$23.8 billion in 1995 to \$234 billion in 2021; however, this expansion was barely enough to make their share of global exports reach 1 per cent of the world total.

Out of total world trade, manufactures accounted for 68 per cent in 2021, but the share of LDCs therein was even lower than in total trade: just 0.36 per cent. Increasing the share of manufactured goods in total exports would benefit LDCs, but achieving industrial growth remains elusive. This is reflected in the declining share of manufactures in their exports to some key markets. The share of manufactured goods in their exports to Asia and other (i.e. non-LDC) developing countries (ODCs) declined from 61 per cent and 59 per cent, respectively, in 2000 to just 17 per cent and 15 per cent in 2020. In contrast, the share of commodities in total exports to ODCs had more than doubled from 40 per cent in 2000 to 85 per cent in 2020, while in the case of Asia, the corresponding share doubled from 27 per cent to 55 per cent (figure 1). This reveals stark challenges in penetrating high-value chains in major markets. A falling share of manufactured exports compared to primary commodities is a worrying trend that reflects the geographic spread of modular production units in global value chains that are increasingly marginalizing small-scale producers in LDCs.

**Figure 1 Shift in the composition of least developed country exports by destination, 2020 and 2000 (per cent)**



Source: UNCTAD secretariat calculations based on data from the UNCTADStat database [accessed May 2022].

LDC trade patterns highlight their dependence on primary commodities and the extent to which their exports are affected by trade costs, marginal participation in high-value chains, and trade integration failures. Trade costs captured by bilateral distances between LDCs and their trade partners impose high costs on LDC exports. UNCTAD estimates that a 1 per cent increase in bilateral distance between LDCs and their trade partners reduces exports by 2 to 3.4 per cent.

### The weakness of multilateral consensus on climate mitigation programmes opens the way for uncoordinated policies

The global interdependence of production and trade has intensified with the deepening of global value chains. At the same time, international trade patterns are increasingly influenced by using trade policy measures as instruments of the transition towards a low-carbon economy.



To mitigate climate change and accelerate the transition towards a low-carbon economy, countries need to raise the price of carbon in their economy. However, so far the international community has not been able to reach a consensus on what the international price of carbon should be, or on how it should be determined. This has led to several uncoordinated national or regional policies on carbon pricing being adopted, aimed at creating a carbon market and achieving higher carbon prices. However, these initiatives are not necessarily coherent or consistent among themselves. The consequence is the prevalence of a multiplicity of prices in different carbon markets around the world. This raises the possibility that domestic efforts to raise the carbon price are bypassed by imports of carbon-intensive goods.

To counter this possibility, national – and in some cases, regional – policymakers have increasingly resorted to trade policy measures. Their aims are: (i) preventing the effects of their policy measures to be negated by imports of carbon-intensive goods which do not incorporate the same carbon price as the domestic ones; and (ii) encouraging trade partners to adopt climate policies and patterns that are similar to – or at least coherent with – their own.

Environmental regulations affecting trade have increased since 2009, a trend that has been especially prevalent in developed countries. The number of such measures has risen 15-fold (from 215 to 3,365) between 2009 and 2020. The largest number of such measures has affected the sectors of agriculture, manufacturing and energy.

Recently, initiatives using trade policy instruments to reach climate policy goals have strengthened with the announcement of carbon border adjustment measures by systematically important traders. The European Union has announced the adoption of the Carbon Border Adjustment Mechanism (CBAM), and a similar proposal was under analysis in the United States Senate, in late 2022.

The adoption of unilateral initiatives can have a positive environmental impact by providing an incentive for the adoption of stricter environmental standards that help the global drive to mitigate climate change. However, at the same time, it is likely to have adverse consequences on countries that are not systemically important in international trade, but have the least institutional and economic capacity to comply with evolving climate regulation and trade policy changes of export markets.

## Consequences for LDCs

Although LDCs contribute just 1 per cent to world trade, their trade exposure is high as total-trade-to-GDP ratios averaged close to 70 per cent in 2020. At the same time, historically, LDCs account for a minor share of greenhouse gas (GHG) emissions. Cumulatively, between 1750 and 2019, the GHG emissions of LDCs were just 3 per cent of the world's total. At present, they contribute only 4 per cent of the global total GHG emissions.

Climate policies (including CBAM-type) would further marginalize LDCs by compounding the impacts of trade costs, policy frictions, and other remoteness measures that significantly dampen exports, particularly for LDCs that are structurally weak and have high export concentrations.

LDCs mainly supply intermediate inputs to producers of other goods and services in an intricate web of value chains in which their exports are absorbed, and this exposes LDCs to trade policies that target specific commodities and their derivatives. UNCTAD estimates that embodied emissions in LDC exports may increase by 1.6 per cent from a 1 per cent increase in international demand for intermediate goods originating from LDCs. Therefore, any policy that targets embodied emissions in exports is likely to have daunting consequences for the LDCs because of the interlinked nature of production and the systematic vulnerabilities of LDC exports in various regional markets.

Compliance with ever stricter environmental and climate-related regulations adopted by systemically important traders has very high costs for developing and least developed country trade partners. UNCTAD simulations suggest that a 1 per cent reduction in European Union demand in the sectors deemed carbon-intensive by CBAM leads to a slight decline in output (GDP) in 21 of 38 LDCs included in the simulation, including Chad, Guinea, Lao People's Democratic Republic, Mali and Senegal.

Moreover, LDCs face the risk of carbon leakage, by which producers of carbon-intensive goods relocated their production from countries with stricter environmental regulation to countries with less demanding environmental regulation, as is the case of LDCs. These countries' carbon emission footprints may increase for specific products or supply chains targeted by the new policies, as product complementarities mean that suppliers in developed countries could replace domestic production with imports. Technology and cost differences between LDCs and their developed trading partners are typically the main factors, which may also trigger a shift in carbon-intensive production to LDCs if their carbon-intensive exports are treated differently or exempted. While this may contribute to strengthening their industry, it may also jeopardize their path towards a low-carbon economy.

LDCs would have to contend with trade-related spillover risks to other sectors not initially targeted by climate policies that could adversely affect structural transformation. The iron and steel sectors are critical for the diversification of exports and industrialization, but a large proportion of metal exports are ores. In addition to coke, petroleum and non-metallic mineral products, the iron and steel sector has been attracting greenfield investments. Carbon border adjustment mechanisms may also distort trade because of the unilateral nature of the policies and the cost advantages the policies award to producers that fall outside their reach. LDCs are crucial suppliers of raw materials to sectors targeted by such policies and are likely to face higher trade costs which could harm their exports.

## Policy recommendations

Policymakers of systemically important trading countries should consider the likely adverse effects of their initiatives on LDCs and adopt complementary measures and mechanisms to mitigate these negative consequences. The possibility of exempting LDCs from the main measure of the European Union CBAM has been discussed. However, UNCTAD research indicates that LDCs would likely face negative consequences, even in the case of exemption, given the globally interconnected nature of international trade, global value chains and trade policy. Therefore, some more positive measures should be considered, such as those aimed at strengthening the institutional and productive capacities of LDCs to face higher environmental standards.

This can comprise the implementation of technical assistance programmes aimed at improving the capacity of LDC policymakers to follow changes in the environmental / climate regulation of trade partners and understand their implications for domestic exporters. This will also assist them in playing a more active role in international negotiations of multilateral, regional and bilateral rules and regulations on the trade-climate change nexus.

Beyond the public sector, development partners can enact programmes and measures to strengthen the capacity of the entrepreneurial sector of LDCs to adapt their products to the changing requirements of import markets. This can be achieved by strengthening the human, institutional and financial resources of domestic industrial extension services, and technical and standards agencies.

Unlike other product groups, carbon-intensive exports from LDCs are also very sensitive to trade costs imposed by remoteness to markets and, therefore, are less likely to prosper in far-removed markets. To mitigate the impact of trade costs, LDCs should explore regional markets and intensify trade with neighbouring countries through cooperation on trade-enhancing infrastructure, value chains for strategic products, and business linkages.

Enhancing trade competitiveness remains the priority for LDCs as they navigate the evolving trade patterns and market dynamics. LDCs could improve the competitiveness of exports by diversifying their economies, increasing domestic productive capacities, and expanding the technological embodiment and sophistication of products. Boosting their presence in the more sophisticated semi-finished and finished goods value chains, as well as improving technology content in the predominantly labour- and material-intensive manufactures would benefit countries that have anchored their development plans on trade and industrial strategies. The focus should be on improving the quality and diversity of products, the state of physical and social infrastructure that supports trade, and other productive capacities that can significantly improve the competitiveness of exports.

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