

## ECONOMETRIC ANALYSIS OF DIFFERENTIAL TRADE PREFERENCES IN THE ECONOMIC SOCIETY OF WEST AFRICAN COUNTRIES

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**Abstract:** *This study is an econometric exploration of the impact of differential trade preferences on the Economic Society of West African Countries with focus on the Cotonou Agreement period of 2001 to 2013. The aim was to empirically evaluate using panel least squares regression method the degree to which the preferential trade agreement between EU and ECOWAS has affected intra-ECOWAS integration. Given a significant interactive effect, we accept the supposition that EU exceptional trade agreements with ECOWAS countries have not significantly enhanced intra-ECOWAS trade. Accordingly, the study found that the adverse effect of ECOWAS openness to the EU on ECOWAS intra-trade is instituted on intermittent differentials of favored treatments to different ECOWAS member countries. There is need for the consistency of the special treatment of ECOWAS by the EU.*

**Keywords:** *Trade, Preferences, Economic Society, African Countries.*

**JEL Classification:** *C58, F13, F17.*

### 1. Introduction

The trade link between the European community and West African countries has taken different dimensions and characteristics in issues of country groups/communities and product coverage as well as rule of origin. Before the formation of Economic Community of West Africa States in 1975, two major forms of preferential trade agreements with the European Community involved West African countries. These agreements were the two Yaounde Conventions of 1963 to 1975, which involved only French West African countries among other non-West African former French colonies.

The preferential trade agreement between the sub-region of ECOWAS and that of the EU is the Cotonou Agreement. Between 2008 and 2013, Cote d'Ivoire and Ghana operated under the EPA interim agreements, while Nigeria operated under the Generalized Special Preferential (GSP) initiative. The foundation of ECOWAS since 1975 has increased intra-trade as one of its main objectives. The explanation is that scale economics that can result from improved intra-trade can enhance the international competitiveness of export products of the sub-region. This condition is exceedingly applicable for ECOWAS whose individual countries constitute small markets on their own. The countries also rely on a few primary products for exports which expose them to fluctuations in the international commodity prices with resultant development problems such as unemployment and social unrest or conflicts.

Efforts to stimulate intra-trade among ECOWAS member countries seem not to have yielded good results. Many reasons beyond the trade theory underpinning have been given. These have formed sources of research studies. The major factor that has been hypothesized to be linked with low intra-trade in ECOWAS is the EU trade link with ECOWAS. Trade link in terms of openness to the EU has been considered to be associated with the special trade contract between the two associations. This factor has gained miniature or no empirical verification. This study is meant to attend to this gap.

The relevant research question is *has the preferential trade regime between the ECOWAS nations and the EU enhanced intra-WAEMU trade?* Also have the EU preferential trade agreements with ECOWAS countries been pro intra-WAMZ trade? The study hypothesized that EU preferential trade agreements with ECOWAS countries have

not significantly enhanced intra-ECOWAS trade. The study so seeks to assess the degree to which the preferential trade agreement between EU and ECOWAS has affected intra-ECOWAS integration. Following this introduction is the empirical literature review, thereafter; we have the theoretical framework and model specification which is followed by estimation results and conclusion.

## 2. Succinct Review of Previous Studies

The provision of preferential trading arrangement offered to developing countries is of late a common issue in emerging countries. Besides the EU that has championed the course, US, Canada, Japan and China, have offered improved access to their markets for African goods. A good example of this is the African Growth and Opportunity Act (AGOA) offered by US to African countries, since 2000. EU exceptional trade programmes have taken different forms.

To Gamberoni (2007), the traditional GSP is least favorable and the ACP agreements most favorable to the developing countries. According to Balogun (2010), there are three types of cumulation: The first is bilateral cumulation. This is mainly applicable to a Free Trade Area. As the name goes, this is connected with two countries. Under this arrangement, country (I) can use inputs from country (II), if they form a Free Trade Area without affecting the originating status.

Next, is the diagonal cumulation which is connected with the EU as it allows countries covered by the same agreements, the use of intermediate materials that originate in any one of them. This assumes that materials originate in the country where the final processing is done. Last of all, we have Full cumulation. This differs from diagonal cumulation by being more relaxed. The value-added in countries of final processing may be very minute, but yet it is still considered to have the originating status to the final good.

## 3. Theory, Framework & Model

The theoretical framework of the study derives from the pareto-optimum theorem due to Lipsey and Lancaster (1956) that intra-industry trade is a materialization of product differentiation, and that product differentiation highlights the position of economies of scale in trade. In view of the Pareto-optimum of Lipsey and Lancaster (1956), we specify the model as follows:

$$G(Z_1, Z_2, \dots, Z_n) \quad (3.1)$$

Where G is a utility function and Zi is the quantity of commodity i which is consumed. The maximization of F is confined to:

$$t\ddot{o}(Z_1, Z_2, \dots, Z_n) = 0 \quad (3.2)$$

( $\ddot{o}$  being a production possibilities constraint. Invoking the presumptuous that the solution can be found at the interior position, then it will be illustrated by the conditions that maximize the Lagrangian function:

$$L = Z(Z_1, Z_2, \dots, Z_n) - \ddot{o}\ddot{o}(Z_1, Z_2, \dots, Z_n) \quad (3.3)$$

where  $\ddot{o}$  is a Lagrangian multiplier. The paretian optimal conditions are given by the n first order conditions

$$F_i - \ddot{o}\ddot{o}_i = 0 \quad (3.3), \quad i = 1, 2, \dots, n \quad (3.4)$$

where the subscript i denotes the partial derivatives with respect to the i<sup>th</sup> variable. Further expression of these conditions is as follows:

$$Z_1/\ddot{o}_1 = Z_2/\ddot{o}_2 = \dots = \frac{F_n}{\ddot{o}_n} \quad (3.5)$$

This is obtained from

$$Z_i - \ddot{o}\ddot{o}_i = 0, \quad Z_1 = \ddot{o}\ddot{o}_1 \quad (3.6)$$

and from

$$Z_2 - \frac{\partial \partial_2}{\partial_2} = 0, Z_2 = \frac{\partial \partial_2}{\partial_2}. \quad (3.7)$$

The solution for  $\lambda$  in  $\lambda = Z_1/\varphi_1$  and  $\lambda = \frac{Z_2}{\varphi_2}$  implies that:

$$Z_1/\varphi_1 = \frac{Z_2}{\varphi_2} = \dots = \frac{Z_n}{\varphi_n}. \quad (3.8)$$

If a condition is not meant, assuming

$$Z_1/\varphi_1 \text{ so that } \frac{Z_1}{\varphi_1} = K \frac{Z_2}{\varphi_2}; K \neq 1 \text{ such that}$$

$$\frac{Z_1}{\varphi_1} - K \frac{Z_2}{\varphi_2} = 0 \quad (3.9)$$

is an additional constraint. This requires the reformulation of the optimum problem in the form:

$$\begin{aligned} & \text{Max } G(Z_1, Z_2, \dots, Z_n) \\ & \text{Subject to } \varphi(X_1, X_2, \dots, X_n) = 0, \\ & \text{and } Z_1/Z_2 - K \frac{\varphi_1}{\varphi_2} = 0 \end{aligned} \quad (3.10)$$

Maximize the langrangian function:

$$L = G(Z_1, Z_2, \dots, Z_n) - \lambda^1 \varphi(Z_1, Z_2, \dots, Z_n) - \eta (Z_1/Z_2 - K \frac{\varphi_1}{\varphi_2}) \quad (3.11)$$

Employing the partial derivatives and noting that  $du_1$  and  $du_2$  require the application of quotient rule, we obtain the new optimum conditions as follows:

$$Z_i - \lambda^1 \varphi_1 - \mu \left[ \frac{Z_2}{Z_2^2} Z_i - \frac{Z_1 Z_2 i}{\varphi_2^2} - K \frac{\varphi_2 \varphi_1 i - \varphi_1 \varphi_2 i}{\varphi_2^2} \right] = 0, i = 1, 2, \dots, n \quad (3.12)$$

The question now is whether the conditions for the second best optimum, is the same, as the first best Pareto optimum in equation (3.11). The two equations are comparable if and only if, the following two conditions hold such that (i)  $\mu = 0$  (ii)  $\mu \neq 0$ , but the expression in (the parentheses) in equation (3.12) is zero for all  $i$ .

That the condition for the second best optimum, given any additional constraint will be different from the corresponding conditions for the pareto optimum. The empirical model in log form is:

$$\begin{aligned} \text{Ln}T_{(ij)t} = & f_0 + f_1 \text{Ln}Y_{it} + f_2 \text{Ln}Y_{jt} + f_3 \text{Ln}N_{it} + \\ & f_4 \text{Ln}N_{jt} + f_5 \text{Ln}M_{it} + f_6 \text{Ln}M_{jt} + f_7 \text{Ln}T_{(ij)t-1} + e_{ijt} \end{aligned} \quad (3.13)$$

Variables: Different studies have adopted different specifications of variables capturing trade creation and trade diversion in a gravity model. The measurement of trade has taken basically three forms. It has been (i) average trade, (ii) exports and (iii) imports “mirroring” exports. Considering the size of informal trade within the ECOWAS region, where official data underestimates the true magnitude of both inter-country and intra-regional trade, the need to use imports becomes necessary. The equations estimated in this research work include interaction variables such as the exporter and importer countries openness to the EU.

The issue of openness to EU as a measure of the effect of the preferential trade agreements on ECOWAS intra-trade helps to avoid different measures and appropriateness of preference values. These measures include the preference margin (a difference between the MFN tariff and the preference tariff rate), the coverage rate of the preferential treatment (dutiable imports for preferential treatment), utility rate (dutiable imports entered with preferences and lastly the utilization rate (the measure of the degree to which

preference-eligible dutiable imports enter under preferential-rather than the MFN-tariffs (Plummer, Cheong and Hamanaka, 2010).

Although this advantage claimed has the serious assumption that all trade are carried out under preference legibility. The study utilized the fixed effects estimator. The fixed effects estimator was adopted in this study in light of the Hausman test. In the fixed effects framework, the intercept varies across the time period T and/or the N cross-sectional units.

**Table no. 1: Definition of Variables and Data Sources**

<i>Variables</i>	<i>Units</i>	<i>Explanation</i>	<i>Sources of Data</i>
<i>T</i>	<i>US\$</i>	<i>Import of country from country</i>	<i>UN comtrade</i>
<i>LnY<sub>i</sub></i>	<i>US\$</i>	<i>Importer country real GDP</i>	<i>World Development Indicators of the World Bank</i>
<i>LnY<sub>j</sub></i>	<i>US\$</i>	<i>Log of exporter Country real GDP</i>	<i>World Development Indicators of the World Bank</i>
<i>LnM<sub>i</sub></i>	<i>%</i>	<i>ECOWAS' individual country's export to and imports from EU as a % of the respective country's GDP (importer countries)</i>	<i>UN comtrade and author's computation</i>
<i>LnM<sub>j</sub></i>	<i>%</i>	<i>ECOWAS's individual country's exports to and imports from EU as a % of the respective country's GDP (exporter countries)</i>	<i>UN comtrade data and author's computation</i>
<i>LnN</i>	<i>Million</i>	<i>Importer Country's population</i>	<i>World Development Indicators</i>
<i>LnN</i>	<i>Million</i>	<i>Exporter country's population</i>	<i>World Development Indicators</i>
<i>LnT( )<sub>t-1</sub></i>		<i>One period lag of T</i>	<i>Author's computation</i>

#### 4. Econometrics Results

From Table no. 2, the constant term, though significant at 5%, does not make much economic sense with the negative sign. In line with the apriori, expectation the coefficient of the importer and exporter GDPs are correctly signed. They are both significant at 10% level of significance. The importer country GDP (GDP<sub>i</sub>) indicated that a 1% increase in GDP was associated with 38.6% increase in demand for imports.

Furthermore, a 1% increase in openness of the exporter country resulted in about 0.24% increase in intra-trade at 5% level. The interaction effect linking the importer and exporter openness to EU has a negative sign and significant at 10%, all things been equal. The F-statistic is highly significant even at 1% level of confidence. This shows the R<sup>2</sup> 0.

The GDP of the importer country (GDP<sub>i</sub>) indicated that a 1% increase in GDP stimulated about 38.6% increase in demand for imports. Similarly, a 1% rise in the GDP stimulates about 38.7% increase in export supply within the ECOWAS nations.

The coefficients of population are significantly different from zero at 10% level of significance and as such enhance intra-ECOWAS trade. Distinctively, the coefficient of N<sub>i</sub> shows that a 1% increase in population would induce about 0.43% increase in imports.

A 1% increase in population of the exporter country, about 0.40% increase in supply of exports is generated. The coefficients of the variables of openness of ECOWAS

to the EU,  $M_i$  and  $M_j$  are both significant and directly related to intra-ECOWAS trade. A 1% increase in the import generates 0.57% increase in the intra-trade.

**Table no. 2: Panel Least Squares**  
 Dependent Variable  $T_{ij}$

<i>Regressors</i>	<i>Fixed Effect</i>
<i>Constant</i>	-8.243**
	(-2.288)
	{0.522}
<i>LnY<sub>i</sub></i>	38.637***
	(1.725)
	{0.084}
<i>LnY<sub>j</sub></i>	38.732***
	(1.7345)
	{0.836}
<i>LnN<sub>i</sub></i>	0.4274**
	(2.328)
	{0.0207}
<i>LnN<sub>j</sub></i>	0.480**
	(2.3689)
	{0.014}
<i>LnM<sub>i</sub></i>	0.5670*
	(4.5791)
	{0.000}
<i>LnM<sub>j</sub></i>	0.23572***
	(1.966)
	{0.052}
<i>LnT( )<sub>t-1</sub></i>	1.4562***
	(18.376)
	{0.000}
<i>R<sup>2</sup></i>	0.8573
<i>S.E of Reg.</i>	1.3264
<i>F-ratio</i>	66.935
<i>Durbin Watson</i>	1.366772

*P-value in bracket,*  
*t-stat in parenthesis, significant at 1%,*  
*\*\*significant at 5% and*  
*\*\*\*significant at 10%.*

**Source:** Author's Results

**Results of the Test of Hypothesis**

Testing the stated hypothesis based on estimated results, we found an overwhelming negative and significant interactive effect. We so accept the hypothesis that EU preferential trade agreements with ECOWAS countries have not significantly enhanced intra-ECOWAS trade.

**5. Concluding Remarks**

The study evaluated the consequences of the differential trade preferences on ECOWAS member countries. The unfavorable effect of ECOWAS openness to the EU on

ECOWAS intra-trade is instituted on intermittent differentials of favored treatments to different ECOWAS member countries. Consistency of the preferential treatment of ECOWAS by the EU is needed. Also, there is a necessity to have full cumulation. This will enable products with imported intermediates from outside qualifying for the preferential treatment.

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